U.S. Regulation of the International Securities and Derivatives Markets, § 14.01, INTRODUCTION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.01 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

Securities brokers and dealers (commonly collectively referred to as "broker-dealers") that are required by the Exchange Act to register with the SEC are subject to a comprehensive U.S. federal regulatory scheme that includes stringent financial, recordkeeping, customer protection and other substantive requirements. SEC-registered broker-dealers are also required to become members in one or more securities industry self-regulatory organizations ("SROs") and to comply with the SROs' additional detailed rules. [1]

The regulatory reach of both the SEC and the SROs extends in many respects to all activities of an SEC-registered broker-dealer, not only to its U.S. personnel and activities or to its securities activities. Consequently, the first line of consideration for non-U.S. financial institutions contemplating U.S. activities is whether SEC registration as a broker-dealer is required. If the proposed U.S. activities would require registration, an international financial organization should generally seek to arrange its U.S. securities activities so that they may be conducted in a separate SEC-registered broker-dealer without subjecting the organization's non-U.S. activities or nonsecurities activities to SEC registration and regulation.

Entities that effect transactions in futures contracts or swaps also may be subject to regulation under the Commodity Exchange Act ("CEA") as futures commission merchants ("FCMs"). [2] Entities that deal in security-based swaps may also be subject to regulation by the SEC as security-based swap dealers ("SBSDs") and entities that deal in other types of swaps may be subject to regulation by the U.S. Commodity Futures Trading Commission ("CFTC").

Footnotes

1 In addition, broker-dealers may be subject to registration and regulation in the states where they have offices or customers. Under the National Securities Markets Improvement Act of 1996 (hereinafter the "NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996), however, a state may not generally impose regulatory requirements (other than the requirement to register with and pay filing fees to the state securities administrator) that differ from or add to those established by the SEC. *See* § 14.12.

2 Entities that effect transactions in security futures products are subject to registration both as broker-dealers under the Exchange Act and FCMs (or introducing brokers) under the CEA, although intermediaries registered as an FCM (or an introducing broker) under the CEA or as a broker-dealer under the Exchange Act, but not both, may avail themselves of a notice registration procedure to register in the other capacity for the limited purpose of trading security futures products. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 4. Security futures products generally are defined as futures contracts on individual nonexempt securities or narrow-based groups or indices of nonexempt securities. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[5][c].

U.S. Regulation of the International Securities and Derivatives Markets, § 14.02, SEC JURISDICTION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.02 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

p. 14-6

Section 15(a)(1) of the Exchange Act makes it "unlawful for any broker or dealer … to make use of the mails or any means or instrumentality of interstate commerce [3] to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security … unless such broker or dealer is registered … [with the SEC]." [4] The literal meaning of this language is to require SEC registration by any non-U.S. broker-dealer that telephones or sends documents into the United States (commonly referred to as using "jurisdictional means") to contact U.S. investors. The SEC endorses this interpretation, stating that a "broker-dealer operating outside the physical boundaries of the United States, but using the U.S. mails, wires, or telephone lines to trade securities with U.S. persons located in this country, would not be… transact[ing] a business in securities without the jurisdiction of the United States." [5] Indeed, the SEC has stated that § 15 of the Exchange Act could require registration by a non-U.S. broker-dealer whose only U.S. contacts are the execution of unsolicited orders from U.S. customers. [6]

The SEC has also claimed authority to require registration in several circumstances that go beyond the literal language of § 15, stating that it could require the registration of any non-U.S. broker-dealer that (i) effected a transaction, even from outside the United States, in a security registered in the United States or listed on a U.S. exchange [7] or (ii) specifically targeted

p. 14-6

p. 14-7

identifiable groups of foreign-based U.S. citizens (*e.g.*, military and embassy personnel). [8]

As discussed below, the SEC has not required broker-dealer registration in all circumstances where its view of the scope of its jurisdiction would permit.

Footnotes

3 Interstate commerce includes any "trade, commerce, transportation, or communication… between any foreign country and any State … [and] any [use of a] facility of a national securities exchange or of a telephone." § 3(a)(17) of the Exchange Act.

4 *See also* §§ 15B(a) and 15C(a) of the Exchange Act (requiring registration of certain dealers in municipal securities and certain brokers and dealers in government securities).

5 SEC Release No. 34-27017 (July 11, 1989) (hereinafter the "Rule 15a-6 Adopting Release"), 54 Fed. Reg. 30,013, 30,016 n.41 (July 18, 1989).

6 *See* Rule 15a-6 Adopting Release at 54 Fed. Reg. 30013, 30017 (July 18, 1989) ("the requirements of section 15(a) do not distinguish between solicited and unsolicited transactions").

7 To illustrate the extent of the SEC's asserted authority to require broker-dealer registration under § 15, the Rule 15a-6 Adopting Release cites, among other cases, *Schoenbaum v. Firstbrook*, 405 F.2d 200, 208 (2d Cir.), *rev'd in part on other grounds*, 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied sub nom. Manley v. Schoenbaum*, 395 U.S. 906 (1969). Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,016 n.41 (July 18, 1989). That case held that U.S. courts have jurisdiction under the Exchange Act over an antifraud claim relating to a foreign security registered with the SEC and traded on a U.S. exchange. There is some

indication that U.S. courts are more likely to extend U.S. jurisdiction to non-U.S. activities in the context of asserted fraud or manipulation than in matters involving registration or filings. In 2010, in *Morrison v. National Australian Bank Ltd.*, 561 U.S. 247 (2010), the Supreme Court limited the extraterritorial reach of the antifraud provisions of the Exchange Act by providing that § 10(b) of the Exchange Act applied only to securities transactions in the United States or securities listed on U.S. exchanges. A month later, the Dodd-Frank Act restored SEC and Department of Justice (the "DOJ") extraterritorial power (*see* §§ 929P(b) and 929Y of the Dodd-Frank Act), but the *Morrison* transactional test still applies for private rights of action. In 2012, the SEC released a study "on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act," which did not take a position on whether Congress should override the *Morrison* transactional test for private rights of action. *See* SEC, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 AS REQUIRED BY SECTION 929Y OF THE [DODD-FRANK ACT] (Apr. 11, 2012). While the SEC's view is that anyone who facilitates any stock transaction through conduct in the United States must register with the SEC under § 15(a), one federal district court has applied *Morrison* to interpret the Exchange Act more narrowly to exclude certain entities that operate in the United States but where the ultimate and intended purchase and sale is foreign and does not occur on a national securities exchange. *See SEC v. Benger*, 934 F. Supp. 2d 1008, 1013 (C.D. Ill. 2013) ("[A] broker's failure to register under Section 15(a) of the [Exchange] Act is not actionable in those cases where the ultimate and intended purchase and sale was foreign and thus, itself, outside the scope of the Act."). For additional discussion on *Morrison*, *see* § 11.10[3].

8 *See SEC v. Siamerican Securities, Ltd.*, SEC Litigation Release No. 6937 (June 17, 1975) (charging a broker-dealer that solicited securities transactions from U.S. servicemen stationed abroad for execution primarily in U.S. markets with failure to register); *see also* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,017 (July 18, 1989).

U.S. Regulation of the International Securities and Derivatives Markets, § 14.03, SEC REGISTRATION AS A BROKER-DEALER

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Notwithstanding the broad jurisdictional reach of § 15 of the Exchange Act, there are circumstances in which non-U.S. (and U.S.) financial institutions engaged in securities activities using jurisdictional means are not subject to SEC registration. [9] Broadly speaking, a conclusion that SEC registration is not required can follow from any one of three determinations: the financial institution is not a "broker" or "dealer"; the financial institution, although a "broker" or "dealer," engages only in activities that do not require registration under § 15; or the financial institution is not based in the United States and engages only in those U.S. activities that the SEC permits (often subject to various conditions) to foreign broker-dealers. [10]

[1] Definition of Broker and Dealer

The registration requirement under § 15 of the Exchange Act is applicable only to "brokers" and "dealers" in "securities."

[a] Broker

p. 14-8

Prior to the enactment of the Gramm-Leach-Bliley Act (the "GLB Act") in 1999, the term "broker" was defined in § 3(a)(4) of the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others, but … not … a bank." [11] The GLB Act modified the Exchange Act definition of "broker" by replacing the blanket bank exclusion with a number of specified exceptions. [12] In September 2007, the SEC and the Board of Governors of the Federal Reserve System (the "Board") jointly adopted Regulation R implementing the broker exceptions and setting forth related exemptions and definitional clarifications. [13]

To be "engaged in the business" of effecting securities transactions for others generally requires a regularity of securities activity, but not that such activity be an entity's principal business or source of income. An entity may be a "broker" even though its securities transactions are a small part of its business activities or its income. [14]

In the SEC's view, the term "broker" includes two types of entities that might not ordinarily be considered to be engaged in the business of effecting securities transactions for others. First, an entity or individual that engages in activities related to corporate mergers and acquisitions may be deemed a "broker." [15] Entities that do nothing more than bring merger-and acquisition-minded companies or investors and companies together (*i.e.*, "finders"), who do not participate in negotiations or in the distribution of securities and who are paid on an hourly or flat fee basis generally are not deemed to be brokers. [16] On the other

p. 14-8

p. 14-9

hand, entities that negotiate merger or acquisition transactions involving securities (*e.g.*, all of the stock of a target company), as opposed to assets, engage in other activities to consummate the transactions, advise whether to enter into transactions and receive fees that are contingent upon the completion, or proportional to the size, of the transactions are more likely to be considered brokers. [17]

In 2014, the SEC issued no-action relief to "M&A Brokers" in connection with the transfer of ownership of a privately-held company without registering as a broker or dealer. [18] For purposes of the relief, an M&A Broker was defined as "a person engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company." [19] To avail itself of the relief, the M&A Broker cannot bind any party to the relevant transaction, cannot provide financing (directly or indirectly through an affiliate) for the transaction, cannot handle or control

p. 14-9

p. 14-10

funds or securities in connection with the transaction for the account of others, cannot assist in the formation of the group of buyers and must abide by certain other restrictions contained in the letter. [20]

Second, the term "broker" may include employees of an issuer who participate in the sale of the issuer's securities. Generally, however, an issuer's employees would not be considered brokers where they are not employed solely or primarily to market securities, their compensation is not tied to the sale of securities and certain other requirements are satisfied. [21]

The SEC has had the opportunity to consider broker-dealer registration issues in connection with the provision of access to financial services on the Internet. For instance, the SEC has granted no-action relief allowing an online service provider, such as America Online or CompuServe, to provide subscribers access to the services of a broker-dealer without the online service itself having to register as a broker-dealer. [22] The SEC has also permitted an online research center to provide subscribers with direct communication links to registered broker-dealers as well as access to financial and business information such as market quotations, economic indicators, annual and quarterly reports for listed companies, new offering filings and press releases without the research center itself having to register as a broker-dealer. [23] The SEC has also granted no-action relief to a company that provides a computerized platform linking registered broker-dealers to one another, permitting broker-dealers to send electronic messages that communicate buy and sell orders to other broker-dealers participating on the platform with whom a sending broker has a pre-existing brokerage relationship. [24] In all three instances, the relief granted is subject to several assumptions and conditions, one of the more prominent being that the compensation to the service provider from the broker-dealer will be a flat fee on a per order or per usage basis and will not vary with the number or value of the shares in any order placed through the service or depend on whether such an order results in an executed trade.

In 2000, however, the SEC refused to grant a no-action request submitted by MuniAuction Inc., a web-based municipal bond auction site, in which

p. 14-10

p. 14-11

MuniAuction stated that it did not "(1) actively solicit investors, (2) advise investors as to the merit of an investment, (3) act with ‘certain regularity of participation in securities transactions' [or] (4) receive commissions or transaction-based compensation." [25] In its response letter to MuniAuction (the "MuniAuction Letter"), the SEC staff described the key elements it uses to determine "broker" status. First, the SEC noted that "[a] person effects transactions in securities if he or she participates in such transactions ‘at key points in the chain of distribution.'" Such participation includes, among other activities:

- assisting an issuer to structure prospective securities transactions;
- helping an issuer to identify potential purchasers of securities;
- soliciting securities transactions; and
- participating in the order-taking or order-routing process. [26]

The MuniAuction Letter stated that "[f]actors indicating that a person is ‘engaged in the business' include, among others: receiving transaction-related compensation; holding one's self out as a broker, as executing trades, or as assisting others in settling securities transactions; and participating in the securities business with some degree of regularity. In addition to indicating that a person is ‘effecting transactions,' soliciting securities transactions is also evidence of being 'engaged in the business.'" [27]

Noting, among other factors, that "MuniAuction brings buyers and sellers of securities together for a fee … solicits issuers and other securities holders to use its auction services to sell securities through its site … [and] participates in the order-taking process through purchasers' submission of their bids on issuers' and other holders' securities through its website," the staff stated its belief that MuniAuction was acting (and should register) as a "broker" within the meaning

p. 14-11

p. 14-12

of § 3(a)(4) of the Exchange Act and further cautioned that, given its activities, MuniAuction may also be required to register as an exchange or satisfy the exemption from exchange registration provided for so-called "alternative trading systems" by Regulation ATS. [28]

In November 2015, the SEC adopted Regulation Crowdfunding, a set of new rules permitting the limited offering and sale of securities through Internet crowdfunding without the registration of such securities. [29] Regulation Crowdfunding is intended to provide a balance between protecting investors and enabling small businesses to raise capital through small investments from ordinary investors without overburdening them with regulation. The new rules, which took effect in May 2016, require that crowdfunding transactions be conducted exclusively through an intermediary that is registered as a broker or a "funding portal," a new form of SEC registrant subject to strict limitations on its activities. [30] A maximum of $1 million can be raised by an issuer through crowdfunding in a twelve-month period, and only certain categories of issuers are eligible to take advantage of Regulation Crowdfunding. [31] In addition, the securities purchased by investors in a crowdfunded offering are subject to restrictions on resale and generally cannot be transferred for at least a year. [32] The rules require that all filings use a new Form C, which generally demands less extensive disclosure than that required in registered offerings.

For the new funding portals, Regulation Crowdfunding finalized a new form for funding portal registration ("Form Funding Portal"), which requires similar, but less extensive and costly, information as that required by Form BD. [33] For funding portals that register with the SEC, the rules provide a non-exclusive, conditional safe-harbor from the broker-dealer registration requirements of the Exchange Act. [34] In addition to SEC registration, funding portals are required to become members of FINRA. [35] The activities in which a funding portal may engage are far more limited than those of a registered broker-dealer and include: (1) limited offerings on the funding portal platform; (2) highlighting and displaying offerings on the platform; (3) providing communication channels for potential investors and issuers; (4) providing search functions on the platform; (5) advising issuers on the structure or content of offerings; (6) compensating

p. 14-12

p. 14-13

others for referring persons to the funding portal and for other services; and (7) advertising the funding portal's existence. [36] Funding portals are prohibited from most other broker-dealer activities, including offering investment advice or soliciting purchases and sales.

Because of the low offering limit and still substantial disclosure requirements, it is unlikely that, outside of small Internet startups, most issuers will take advantage of Regulation Crowdfunding.

[b] Dealer

Prior to the enactment of the GLB Act, the term "dealer" was defined in § 3(a)(5) of the Exchange Act as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise," but not a bank, or any person insofar as he "buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business." [37] The GLB Act modified the Exchange Act definition of "dealer" by replacing the blanket bank exclusion with a number of specified exceptions. [38] Banks have been required to comply with the revised definition of "dealer" and related rules adopted by the SEC since September 30, 2003. [39]

Title VII of the Dodd-Frank Act further modified the Exchange Act definition of "dealer" by specifically excluding persons engaged in the business of buying and selling security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants. [40]

To be a "dealer," one must be "engaged in the business" of buying and selling securities for one's own account. However, the term does not include a person whose buying and selling are "not … part of a regular business." [41]

"Dealer" status is generally a more complicated matter than "broker" status. There are numerous entities and individuals (*e.g.*, insurance companies, hedge funds and other private investment partnerships and individual investors) that engage as principals in securities transactions to an extent that might, for other purposes, be regarded as "engaged in business" or in a "regular business." Moreover, interposition of a "broker" in a principal's trading activities does not exclude the principal from "dealer" status, since the term "dealer" includes principals who trade "through a broker or otherwise." The SEC has, however,

p. 14-13

---

p. 14-14

interpreted the definition of "dealer" to exclude "investors," including those whose activity is large and frequent enough to make them "active traders." [42] On the other hand, the SEC has indicated that a low volume of securities activity by itself does not establish that an entity is not a dealer. [43]

It is often the case that no single factor will determine whether an entity is an "investor" or "trader" as opposed to a "dealer." A conclusion must be reached that takes into account each of the entity's securities-related activities. In the SEC's view, the following activities would ordinarily be engaged in by a dealer, but not by an investor or trader:

- issuing or originating securities; [44]
- participating in a selling group or underwriting securities; [45]
- purchasing or selling securities as principal from or to customers rather than from or to only brokers or dealers; [46]
- carrying a dealer inventory; [47]
- quoting a market in securities or publishing any quotations on or through any quotation system used by dealers, brokers or institutional investors or otherwise quoting prices other than on a limited basis through a retail screen broker; [48]
- holding oneself out as a dealer or market-maker or as otherwise willing to buy or sell particular securities on a continuous basis; [49]

p. 14-14

---

p. 14-15

- rendering incidental investment advice; [50]
- handling other people's money or securities or executing securities transactions on other people's behalf; [51]
- extending or arranging for the extension of credit to others in connection with securities; [52]
- conducting processing or clearing activities; [53]
- obtaining a regular clientele; [54] and
- engaging in trading transactions for the benefit of others, rather than consistently with one's own judgment, investment and liquidity objectives. [55]

[c] Banks

Unlike a broker or dealer, which may be a person of any nationality, the term "bank" as defined in the Exchange Act is limited to U.S. federal and state organized and regulated banks and savings associations with deposits insured by the Federal Deposit Insurance Corporation ("FDIC"). [56] A foreign bank is thus

p. 14-15

p. 14-16

not a "bank" for purposes of the Exchange Act, although a U.S. branch of a foreign bank is generally considered to be a "bank" for purposes of the Exchange Act. [57] A bank holding company or nonbank subsidiary or affiliate of a bank is likewise not a "bank" for Exchange Act purposes.

As discussed above, prior to the enactment of the GLB Act, U.S. banks enjoyed a blanket exclusion from the Exchange Act definitions of both "broker" and "dealer." [58] However, the GLB Act eliminated these blanket exclusions and replaced them with more limited exceptions, effectively requiring banks to "push out" into registered broker-dealers activities that do not come within the exceptions. [59]

Under the GLB Act amendments to the definition of "broker," a bank is not considered to be a broker merely because it engages in the following activities:

- so-called "networking" or "kiosking" arrangements with third-party brokers or dealers (subject to restrictions on advertising and restrictions on incentive compensation);
- trust and fiduciary activities (subject to restrictions on advertising and restrictions on incentive compensation);
- transactions in commercial paper, bankers' acceptances, commercial bills, exempt U.S. or Canadian federal, state, provincial or municipal government or agency securities ("specified exempt securities") or "Brady bonds";
- transactions for employee benefit, dividend reinvestment and shareholder plans (subject to certain conditions);
- sweep account transactions into money market mutual funds registered with the SEC;
- transactions for the account of an affiliate (other than a U.S. broker-dealer or merchant banking affiliate);
- private placements (subject to certain limits); however, the private placement exception is not available if, at any time after November 11, 2000, the bank is affiliated with a broker-dealer that has been registered for more than one year in accordance with the Exchange Act and engages in dealing, market-making or underwriting activities (other than with respect to specified exempt securities);

p. 14-16

p. 14-17

- safekeeping and custody services (subject to certain conditions);
- transactions in "identified banking products"; [60]
- transactions in municipal securities; or
- transactions pursuant to a *de minimis* exception (up to 500 transactions per year, [61] which may not be effected by staff shared with a broker-dealer affiliate). [62]

The Financial Services Regulatory Relief Act of 2006 (the "FSRRA") [63] required the SEC and the Board to issue joint rules implementing the broker push-out exceptions. In 2007, the SEC and the Board jointly adopted new Regulation R, which implements four of the exceptions from the definition of "broker" available to banks: "networking" arrangements, trust and fiduciary activities, sweep accounts, and safekeeping and custody activities. [64] In addition, Regulation R also provides several conditional exemptions for activities in which a bank may engage without being deemed a "broker" under the Exchange Act, including exemptions permitting banks to engage in:

- certain transactions effected in securities issued pursuant to Regulation S ;
- certain securities lending transactions;

- certain transactions in mutual funds and variable insurance contracts; and
- certain transactions in a company's securities for its employee benefit plans. [65]

p. 14-17

p. 14-18

Regulation R also provides banks with a limited "good faith" exemption from contract rescission liability under § 29(b) of the Exchange Act for violation of the broker-dealer registration requirements. [66]

Under the GLB Act amendments to the definition of "dealer," a bank is not considered to be a dealer merely because it:

- buys or sells commercial paper, bankers' acceptances, commercial bills, specified exempt securities or "Brady bonds";
- buys or sells securities for investment, trust or fiduciary purposes;
- engages in the issuance or sale of asset-backed securities, if the underlying assets are predominantly originated [67] by the bank, an affiliate that is not a broker-dealer or (if the asset-backed securities are mortgage or consumer-related) a syndicate of banks [68] of which it is a member; or

p. 14-18

p. 14-19

- buys or sells "identified banking products." [69]

In addition to clarifying these statutory exceptions, the SEC adopted, in the Dealer Release, an exemption from the definition of "dealer" for banks engaging in certain securities lending transactions in which the bank is acting as a conduit lender or agent and is conducting such transactions with or on behalf of (i) a qualified investor (as defined in § 3(a)(54) of the Exchange Act), or (ii) any employee benefit plan that owns and invests on a discretionary basis not less than $25,000,000 in investments. [70] The SEC has also adopted an exemption permitting banks to engage in certain riskless principal transactions in Regulation S securities with non-U.S. persons. [71]

[d] U.S. Branches and Agencies of Foreign Banks

The Exchange Act definition of "bank" includes "any other banking institution … doing business under the laws of any state or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising a fiduciary power." [72] It has long been understood that U.S. branches of foreign banks were entitled to the benefits of the Exchange Act "bank" exclusion from broker-dealer registration. [73] However, with the elimination of the bank exclusion by the GLB Act, those U.S. branches of foreign banks that continue to qualify as "banks" for purposes of the Exchange Act are, like U.S. domestic banks, subject to potential registration and regulation as "brokers" or "dealers."

Whether a U.S. agency of a foreign bank can qualify as a "bank" for purposes of the Exchange Act depends on the particular agency's activities, which may in turn depend on the particular regulatory scheme to which it is subject. Historically, a key distinction between foreign banks' U.S. branches and their

p. 14-19

p. 14-20

agencies was that branches could take deposits while agencies could not. [74] Currently, however, agencies in a number of states can take deposits from nonresidents. For example, New York agencies can issue deposit-type obligations to institutions in denominations of $100,000 or more; [75] New York law also permits agencies (like branches) to exercise fiduciary powers with special authorization from the New York Superintendent of Financial Services. [76] Federal agencies, on the other hand, cannot accept deposits or exercise fiduciary powers. [77]

[e] Business in Securities

A broker or dealer is only required to register with the SEC if it conducts a business in "securities." The term "security" is defined in § 3(a)(10) of the Exchange Act (and discussed in Chapter 12). [78] An entity engaged in activities involving exclusively nonsecurities is therefore not required to register as a broker or a dealer. [79] However, both the securities and nonsecurities activities of an entity that is required to register are subject to regulation. As a result, most financial institutions that provide financial services with respect to both securities and nonsecurities conduct their securities activities in a registered broker-dealer and have established one or more separate affiliates to carry out wholly nonsecurities activities in areas such as real estate, currencies, lending and certain derivative instruments. [80]

[2] Exclusions

p. 14-20
p. 14-21

There are a number of additional explicit exclusions from the registration requirement under § 15 of the Exchange Act. [81]

[a] Business Exclusively Intrastate

Section 15 of the Exchange Act does not require registration of a broker or dealer "whose business is exclusively intrastate." As any communication from outside the United States into a state is "interstate" rather than "intrastate," a foreign broker-dealer using jurisdictional means cannot make use of this exclusion. [82] Even for U.S.-based broker-dealers, the scope of the intrastate exemption is so limited that it is of little utility. [83]

[b] Business Exclusively in Certain Instruments

A broker or dealer whose business is exclusively in "commercial paper," bankers' acceptances, commercial bills or "exempted securities" [84] is also not required by § 15(a) of the Exchange Act to register with the SEC.

[i] *Commercial Paper*

The term "commercial paper" is not defined in the Exchange Act. By current practice, however, it is understood that this term is coextensive with the exemption from registration provided under the Securities Act for notes used to

p. 14-21
p. 14-22

finance current transactions and having a maturity of less than nine months. [85] The general Securities Act requirements for establishing that a note is of the type commonly referred to as "commercial paper" are that it: (i) is of prime quality and negotiable, (ii) is of a type not ordinarily purchased by the general public, (iii) has a maturity of less than nine months, and (iv) is issued solely to derive proceeds that fund "current transactions." [86]

[ii] *U.S. Government Securities*

U.S. government securities are "exempted securities" for purposes of § 15(a) of the Exchange Act; accordingly, broker-dealers conducting a securities business exclusively in U.S. government securities need not register under that section. [87] However, § 15C of the Exchange Act requires all U.S. government securities broker-dealers (i) that are not banks or similar financial institutions to register with the SEC or (ii) that are banks or similar financial institutions to give notice of their government securities activities to the "appropriate regulatory agency," [88] generally the agency responsible for regulation of their banking activities.

[3] Exemptions Available to Foreign Broker-Dealers

p. 14-22
p. 14-23

[a] Background; Rule 15a-6

In 1989, the SEC adopted a general exemptive rule—Rule 15a-6 under the Exchange Act [89]—which specified a variety of circumstances in which foreign broker-dealers may have contact with U.S. investors and use U.S. jurisdictional means without registering as a broker or dealer with the SEC. [90]

Certain of the registration exemptions provided by Rule 15a-6 are available to all foreign broker-dealers ("general exemptions"). The remaining Rule 15a-6 exemptions from registration are available only to those foreign broker-dealers that comply with certain additional conditions specified in the rule ("conditional exemptions"). A precondition to both types of exemptions is that, except as specifically permitted by the rule (or subsequent liberalizing interpretations

p. 14-23

p. 14-24

discussed below), the foreign broker-dealer has no physical presence conducting securities activities in the United States. [91]

[b] General Exemptions

The general exemptions provided in Rule 15a-6 under the Exchange Act fall into three categories. All foreign broker-dealers may: (i) effect "unsolicited" securities transactions with U.S. persons, (ii) solicit and effect securities transactions for specified categories of counterparties, and (iii) provide research to "major U.S. institutional investors." The Rule 15a-6 Adopting Release also recognizes additional mechanisms by which all foreign broker-dealers may distribute research reports generally in the United States, provide quotations to U.S. investors and execute trades through linkages with U.S. securities exchanges.

[i] *Unsolicited Transactions*

Rule 15a-6 provides that all foreign broker-dealers may effect "unsolicited" transactions with U.S. persons. [92] Rule 15a-6 itself does not define "solicitation," and the Rule 15a-6 Adopting Release states that the SEC will determine the term's meaning on a case-by-case basis, taking into account SEC precedents.

The Rule 15a-6 proposing release defines "solicitation" generally as "including any affirmative effort by a broker or dealer intended to induce transactional business for the broker-dealer or its affiliates….[It] includes efforts to induce a single transaction or to develop an ongoing securities business relationship." [93] "Solicitation" has also been interpreted as including the following activities:

- telephone calls from a broker-dealer to a customer encouraging the use of the broker-dealer to effect transactions;
- transmission of a market-maker's bid/ask quotations into the United States;
- any attempt by a broker-dealer to make its business known in the United States, whether through an individual introductory meeting with a potential customer or through advertisement of its services on a television or radio

  p. 14-24

  p. 14-25

  broadcast into the United States or in a publication of "general circulation" [94] in the United States;
- the conduct by a foreign broker-dealer of investment seminars for U.S. investors, even though the seminar is hosted by a registered broker-dealer and the subject of the seminar is not specific securities but a general explanation of regulation in an overseas securities market in which the foreign broker-dealer is active; [95]
- the making of any recommendation of a security in an instance in which the recommendation is likely to lead to a transaction with the recommending broker-dealer;

- the provision by a broker-dealer of research to investors, even to investors who have actively sought out and requested the research; [96] and
- a series of frequent transactions or a significant number of transactions between a foreign broker-dealer and a U.S. investor. [97]

The distribution of research to U.S. investors is such a strong indicator of solicitation that, in the SEC's view, a foreign broker-dealer should establish "adequate procedures to avoid transmission of research reports into U.S. markets," except as permitted by Rule 15a-6, in order to avoid the conclusion that the broker-dealer is using the research to induce U.S. customer transactions. [98]

p. 14-25

p. 14-26

In sum, the SEC views "solicitation" as including any action by a broker-dealer intended to induce transactions, to develop customer goodwill or to make itself known. A good illustration of the breadth of the concept in the SEC's view is its statement that a foreign broker-dealer could be deemed to have solicited a U.S. investor who on his own initiative opened an account with the foreign broker-dealer and became a "regular customer." [99]

In 2013, the staff of the SEC's Division of Trading and Markets clarified that a foreign broker-dealer that administers or seeks to administer an employee stock option plan or other employee benefit plan established and administered in accordance with foreign law for a foreign issuer that is organized outside the United States and whose principal office and place of business are located outside the United States would not, solely because of that activity, be considered to have solicited the U.S. employees or U.S. subsidiary, provided that the foreign broker-dealer deals exclusively with management and employee benefit representatives from the foreign issuer (located outside the United States) in administering the plan and limits its activities with respect to U.S. persons to certain activities. [100] Permitted activities include facilitating the transfer of the foreign issuer's securities to a U.S. person employed for the foreign issuer or its U.S. subsidiary; sending required plan documents, account statements, confirmations, privacy notices, prospectuses, proxy statements or other legally required documents to the employee; and selling, transferring or otherwise disposing of the foreign issuer's securities, so long as the activities relate solely to foreign securities acquired by U.S. persons pursuant to the applicable employee benefit plan. [101]

[ii] *Activities with Selected Counterparties*

Rule 15a-6 specifies categories of counterparties who all unregistered foreign broker-dealers may solicit and with whom they may engage in transactions. These counterparties are: SEC-registered broker-dealers, banks acting in a broker or dealer capacity, certain supranational organizations, certain foreign persons temporarily visiting the United States and U.S. persons resident outside the United States.

[A] Registered Broker-Dealers and Banks Acting Under a Broker or Dealer Exception

p. 14-26

p. 14-27

All foreign broker-dealers may solicit and engage in transactions with "a registered broker-dealer, whether … acting as principal for its own account or as agent for others, or a bank acting pursuant to certain exceptions from the Exchange Act definition of 'broker' or 'dealer.'" [102] This exemption, which predates the adoption of Rule 15a-6, [103] recognizes that, if investors are to be able to buy securities traded in markets outside their home countries, broker-dealers must be able to do business with each other across national borders. [104] It also recognizes that U.S. banks (including U.S. branches and agencies of foreign banks) engage in broker and, to a more limited extent, dealer activity, though these activities have been curtailed by the full implementation of the push-out provisions of the GLB Act. [105] Although Rule 15a-6 is not explicit on this point, it seems clear that the exempted transactions in which registered broker-dealers or U.S. banks purchase securities as principal include purchases for investment purposes as well as those for dealing inventory.

Certain members of the SEC staff have expressed the view, on an informal basis, that the exemption for transactions between foreign broker-dealers and U.S. broker-dealers pursuant to Rule 15a-6(a)(4)(i) in which the U.S. broker-dealer acts as agent for a U.S. customer may not be available for certain over-the-counter ("OTC") derivative transactions involving the purchase and sale of a security where there is contractual privity between the foreign broker-dealer and the U.S. customer and the obligations of the counterparties are ongoing. However, there has been no published authority explicitly addressing this informal staff position and this interpretation does not appear to be consistent with either

p. 14-27

p. 14-28

the structure of Rule 15a-6 or the policy considerations articulated by the SEC in connection with the rule's adoption. [106]

[B] Supranational Organizations

Rule 15a-6 contains a list of supranational organizations that foreign broker-dealers may solicit and with which they may engage in transactions in the United States. [107] The listed supranational organizations are the African Development Bank, the Asian Development Bank, the Inter-American Development Bank, the International Bank for Reconstruction and Development (commonly referred to as the "World Bank"), the International Monetary Fund, the United Nations, and their respective agencies, affiliates and pension funds.

[C] Foreign Persons Temporarily in the United States

Any foreign broker-dealer may solicit and effect transactions for a foreign person temporarily present in the United States with whom the foreign broker-dealer had a "*bona fide*, pre-existing relationship before the foreign person entered the United States." [108] For this purpose, a non-U.S. citizen can be treated

p. 14-28

p. 14-29

as "temporarily present" in the United States so long as such person has not become a lawful permanent resident of the United States (*i.e.*, a "Green Card holder"). [109]

This exemption evidences the SEC's greater willingness than in the past to avoid application of U.S. regulatory schemes to situations involving only foreign investors, [110] as well as a willingness to apply pragmatically the SEC's traditional territorial approach to securities law jurisdiction. [111]

U.S. advisers acting for non-U.S. persons are specifically treated as non-U.S. persons for purposes of Regulation S under the Securities Act. [112] However, Rule 15a-6 under the Exchange Act does not contain a similar provision. Accordingly, technical compliance with Rule 15a-6 requires that an SEC-registered broker-dealer be interposed in transactions with U.S.-based advisers for non-U.S. persons, which can result in greater restrictions on such U.S.-based advisers and place them at a competitive disadvantage *vis-á-vis* their non-U.S.-based counterparts. In an effort to alleviate these competitive disadvantages, the SEC issued in 1996 a no-action letter that grants relief from broker-dealer registration requirements to certain foreign broker-dealers affiliated with U.S.-registered

p. 14-29

p. 14-30

broker-dealers that directly contact and effect transactions with certain U.S.-resident professional fiduciaries that act for "offshore clients" in connection with transactions in "foreign securities." [113]

[D] U.S. Persons Abroad

Foreign broker-dealers may solicit (i) an agency or branch of a U.S.-organized entity permanently located outside the United States and (ii) a U.S. citizen resident outside the United States, provided in each case that the resulting securities transactions "occur outside the United States." [114] However, in the case of U.S. citizens resident abroad, foreign broker-dealers may not direct their selling efforts to "identifiable groups" of U.S. citizens, [115] *e.g.*, military and embassy personnel. [116] This treatment of U.S. persons abroad under Rule 15a-6 is

p. 14-30

p. 14-31

generally consistent with their treatment for purposes of Regulation S under the Securities Act. [117]

[iii] *Provision of Research Reports*

[A] To Major U.S. Institutional Investors

Rule 15a-6(a)(2) provides that all foreign broker-dealers may provide research reports, without involvement by a U.S. broker-dealer in the review, approval or distribution of the reports, to "major U.S. institutional investors" and effect any resulting transactions. [118] Major U.S. institutional investors are certain "U.S. institutional investors" that have, or have under management, total assets exceeding $100 million. [119] Under the definitions set forth in Rule 15a-6, however, a corporation or partnership generally will not qualify as a "major U.S. institutional investor," even if it owns or manages $100 million in assets and is, for example, a "qualified institutional buyer" within the meaning of Rule 144A under the Securities Act. [120] This limitation, which significantly reduced the utility of, and reliance on, the rule, has been largely eliminated by SEC no-action

p. 14-31

p. 14-32

relief granted in 1997 to the effect that qualifying foreign broker-dealers may provide research reports to, and under the conditional exemption discussed below, may enter into transactions with, institutional entities (including corporations and partnerships) that own or control (or, in the case of registered or unregistered investment advisers, have under management) in excess of $100 million in aggregate financial assets ("$100 Million Entities"). [121] The SEC staff's expanded view of the term "major U.S. institutional investor" applies to all provisions of Rule 15a-6 in which that term is used. [122]

This exemption is subject to the following conditions:

- the research reports do not recommend the use of the foreign broker-dealer to effect trades in any security;
- the foreign broker-dealer does not initiate contact to follow up on the research reports and does not otherwise attempt to induce securities transactions by those investors;
- the foreign broker-dealer does not provide research pursuant to any express or implied understanding that those U.S. investors will direct commission income to the foreign broker-dealer (*i.e.*, there may not be any "soft dollar" arrangements between the U.S. investors and the foreign broker dealer); [123] and
- if the foreign broker-dealer enters into a so-called "chaperoning" arrangement with an SEC-registered broker-dealer (as described in § 14.03[3][c][ii] below), any trades with the recipient of the research in securities that were discussed in the research reports must be effected "through" such registered broker-dealer. [124]

[B] To Other Investors

p. 14-32

p. 14-33

The Rule 15a-6 Adopting Release specifies conditions under which all foreign broker-dealers may distribute research to any U.S. investor. These conditions are that: (i) a registered broker-dealer "accepts responsibility" for the research and the research report states this prominently, [125] (ii) the research report prominently indicates that any U.S. persons wishing to effect transactions in the securities discussed in the research do so through the registered broker-dealer, and (iii) all resulting transactions are in fact effected by the registered broker-dealer. [126] One consequence of these conditions has been to make this exemption of practical utility primarily to those foreign broker-dealers that have an affiliated registered broker-dealer. [127]

[iv] *Participation in Third-Party Quotation Systems*

A non-U.S. broker-dealer's provision of bid/ask quotations into the United States is a form of "solicitation" that, in the view of the SEC, generally requires the broker-dealer's registration. However, the provision of quotations to registered broker-dealers and to banks excepted or exempt from the Exchange Act definitions of "broker" or "dealer" is an exempted activity under Rule 15a-6. [128]

Prior to 1997, the SEC position, as stated in the Rule 15a-6 Adopting Release, was that the SEC also would grant interpretive relief from broker-dealer registration to permit the use of certain "third-party" quotation systems (that is, systems not controlled by an individual broker-dealer). Specifically, relief would be granted for distribution of quotations on "systems operated by foreign marketplaces or by private vendors, that distributed these quotations primarily in foreign countries … [and only to those] third-party systems that did not allow securities transactions to be executed [directly online]." [129] However, the Rule 15a-6 Adopting Release indicated that the SEC would not approve a "direct dissemination" quotation system (that is, a system controlled by an individual foreign broker-dealer) [130] and that the SEC would have "reservations" concerning any "specialized" quotation system, such as a system that disseminated quotes only for large block trades. [131]

Under the 1997 Cleary Letter, the SEC reconsidered its prior position on electronic quotation systems in light of increasing globalization and technological changes in the securities markets. First, the SEC eliminated the qualification for relief that quotations are distributed "primarily in foreign countries." Furthermore, providing U.S. investors with access to proprietary and third-party screen-based quotation systems that supply quotations, prices and other trade-reporting information input directly by foreign broker-dealers will not constitute an impermissible "contact" with a foreign broker-dealer, so long as any transactions between the U.S. investor and the foreign broker-dealer are effected in accordance with the requirements (including, to the extent required, the intermediation requirements) of Rule 15a-6. The SEC has indicated that it would also be willing to provide individual firms with additional guidance regarding the execution of such intermediated transactions through an automated trading system operated by the registered U.S. broker-dealer intermediary. [132]

[v] *Trades Through Stock-Exchange Linkages*

p. 14-34

p. 14-35

The SEC has stated that it "generally views agreements between U.S. and foreign securities exchanges [permitting the transfer of orders between the exchanges] as positive developments." [133] The SEC has approved three linkages between Canadian and U.S. exchanges: the Montreal Stock Exchange with the Boston Stock Exchange, [134] and the Toronto Stock Exchange with each of the AMEX [135] and the Chicago Stock Exchange (formerly, the Midwest Stock Exchange). [136] In all three cases, the linkage was limited to dual-listed stocks. In addition, in 2000, the NYSE announced its intention to establish a 24-hour "Global Equity Market," linking the NYSE to nine other foreign exchanges, [137] but none of the linkages between the NYSE and the foreign exchanges is currently in operation. [138]

[vi] *Participation in Exempt Exchanges*

In 1999, the SEC granted exemptive relief to Tradepoint Financial Networks plc ("Tradepoint") permitting it to operate the Tradepoint Stock Exchange (a screen-based electronic market regulated as a recognized investment exchange

p. 14-35

p. 14-36

in the United Kingdom) in the United States without registering as a national securities exchange. [139] Under the terms of the exemptive relief and later no-action relief, certain U.S. institutions and brokers are permitted to become members of Tradepoint and to trade on Tradepoint certain stocks eligible to be traded on the London

Stock Exchange directly from terminals located in the United States (subject to certain limitations on the trading of "restricted securities" under the Securities Act). [140] There are currently no other non-U.S. securities exchanges permitted to place electronic trading terminals in the United States.

[c] Conditional Exemptions

Rule 15a-6(a)(3) under the Exchange Act permits unregistered foreign broker-dealers, acting from outside the United States (except to the limited extent that the rule permits U.S. visits), to solicit and take orders for securities transactions from "U.S. institutional investors" and "major U.S. institutional investors," [141]

provided that certain conditions are met. [142] These conditions are briefly summarized as follows:

- the foreign broker-dealer must enter into an arrangement (a "Rule 15a-6 arrangement") with an SEC-registered broker-dealer, pursuant to which the SEC-registered broker-dealer must agree to effect all securities transactions resulting from contacts undertaken in reliance on the conditional exemptions and take on certain other responsibilities with respect to securities-related contacts and transactions between the foreign broker-dealer and U.S. investors (such SEC-registered broker-dealer is hereinafter referred to as a "chaperoning broker-dealer"); and
- the foreign broker-dealer and those of its personnel involved in transactions pursuant to the exemptions must consent to the service of process in the United States and comply with certain additional conditions specified in the rule (a foreign broker-dealer that has entered into such an arrangement and has complied with such additional conditions is hereinafter referred to as a "qualifying foreign broker-dealer").

[i] *Qualifying Foreign Broker-Dealer*

A foreign broker-dealer seeking to rely on the conditional exemptions set forth in Rule 15a-6(a)(3) must enter into a Rule 15a-6 arrangement with a chaperoning broker-dealer. [143] The chaperoning broker-dealer may, but need not, be an affiliate of the qualifying foreign broker-dealer, and may (so long as it is properly registered with the SEC) be located in a jurisdiction (including the foreign broker-dealer's home country) outside the United States. [144] A qualifying foreign broker-dealer may enter into Rule 15a-6 arrangements with any number of chaperoning broker-dealers. [145]

As part of the Rule 15a-6 arrangement, a qualifying foreign broker-dealer must consent to service of process for any civil action brought by, or proceeding before, the SEC or an SRO, and this consent must be maintained by the chaperoning broker-dealer as part of its books and records. Once this consent has been executed and submitted to the chaperoning broker-dealer, there appears to be no limit as to the purposes for which process may be served. In other words, the SEC apparently takes the view that its jurisdiction under the rule over a qualifying foreign broker-dealer is as extensive as if the foreign broker-dealer were registered with the SEC, and thus it is not restricted to taking action concerning only those transactions which the qualifying foreign broker-dealer effects under Rule 15a-6, through the chaperoning broker-dealer or even with U.S. persons. [146]

In addition to consenting to service of process, a qualifying foreign broker-dealer also must provide the SEC "with any information or documents within [its]… possession, custody, or control … any testimony of foreign associated persons, and any assistance in taking the evidence of other persons, wherever located, that the [SEC] requests and that relates to transactions [effected pursuant to the conditional exemptions]." [147]

[A] Associated Persons of Qualifying Foreign Broker-Dealers

Each employee or other "associated person" of a qualifying foreign broker-dealer who proposes to solicit or otherwise engage in contacts with U.S. investors pursuant to the conditional exemptions must consent to service of process in the same manner as the qualifying foreign broker-dealer and provide certain employment and other background information to the chaperoning broker-dealer so that the chaperoning broker-dealer can determine whether to approve the associated person's participation in the Rule 15a-6 arrangement (each such approved associated person is hereinafter referred to as a "qualifying foreign associated person"). [148]

[B] Oral Communications from Outside the United States

p. 14-38

p. 14-39

Qualifying foreign associated persons may engage in oral communications (*e.g.*, by telephone), from outside the United States, with U.S. institutional investors, major U.S. institutional investors and, pursuant to the 1997 Cleary Letter, $100 Million Entities, provided that, in the case of oral communications with U.S. institutional investors that are not major U.S. institutional investors or $100 Million Entities, either (i) a duly licensed employee of the chaperoning broker-dealer participates in such communication, or (ii) in accordance with the 1997 Cleary Letter, such communication takes place outside NYSE trading hours and no orders to effect transactions other than those involving foreign securities (as defined in the 1996 Cleary Letter) are accepted. [149]

[C] Visits to the United States

Under Rule 15a-6, qualifying foreign associated persons may visit U.S. institutional investors and major U.S. institutional investors in the United States provided that a duly licensed employee of the chaperoning broker-dealer chaperones these visits. [150] The chaperone must be familiar with any research reports discussed during these visits, must conduct a prior review of any written materials that are to be distributed and of any summaries or outlines of the qualifying foreign associated person's oral presentation and must know whether the qualifying foreign associated person's statements are consistent with the qualifying foreign broker-dealer's current recommendations. The Rule 15a-6 Adopting Release states that the responsibility imposed on the chaperoning broker-dealer and its employees for these visits is the same as if the chaperoning broker-dealer were acting directly on its own behalf. [151] In addition, pursuant to the 1997 Cleary Letter, a qualifying foreign associated person may also have in-person, unchaperoned contacts during visits to the United States with major U.S. institutional investors and $100 Million Entities so long as the number of days on which such contacts occur does not exceed 30 per year and the qualifying foreign associated

p. 14-39

p. 14-40

person does not accept orders to effect any securities transactions (whether involving U.S. or foreign securities) while in the United States. [152]

[D] Manner of Effecting Transactions

All transactions entered into pursuant to the Rule 15a-6 arrangement must be "effected" by the chaperoning broker-dealer. [153] This condition will be deemed fulfilled if the chaperoning broker-dealer performs each of the following activities: [154]

- effecting the transactions (other than negotiating their terms);
- issuing all required confirmations and statements to U.S. investors; [155]
- as between the qualifying foreign broker-dealer and the chaperoning broker-dealer, extending or arranging for the extension of any credit to U.S. investors in connection with the transactions; [156]
- maintaining Exchange Act-required books and records relating to the transactions; [157]

p. 14-40

p. 14-41

- complying with the SEC's net capital and customer protection rules; [158] and

- receiving, delivering and safeguarding funds and securities in connection with the transactions.

The requirement that the chaperoning broker-dealer actually "effect" the transactions entered into between the qualifying foreign broker-dealer and U.S. counterparties would still be met even if the chaperoning broker-dealer were to delegate to the qualifying foreign broker-dealer the task of physically executing foreign securities trades in foreign markets or on foreign exchanges. [159] Further, the qualifying foreign broker-dealer may be appointed to process all records related to the transaction, as long as the records comply with applicable requirements under U.S. law and the chaperoning broker-dealer retains responsibility for, and maintains the originals or copies of, the records. [160]

[ii] *Chaperoning Broker-Dealer*

In addition to being responsible for the mechanics of effecting securities transactions between qualifying foreign broker-dealers and U.S. institutional investors, major U.S. institutional investors and $100 Million Entities, a chaperoning broker-dealer should treat the investor as its customer for purposes of

p. 14-41

---

p. 14-42

applicable sales practice and other requirements. [161] The Rule 15a-6 Proposing Release would have required the chaperoning broker-dealer to be responsible for taking steps to assure itself that there was a reasonable basis for all recommendations made by a qualifying foreign broker-dealer. [162] While the Rule 15a-6 Adopting Release did not adopt such a requirement, it does state that the chaperoning broker-dealer has "a responsibility to review … [Rule 15a-6] trades for indications of possible violations of the federal securities laws … [and] an obligation, as it has for all customer accounts, to review any Rule 15a-6 account for indications of potential problems." [163] For example, it can be expected that the SEC would take the position that such reviews require monitoring likely instances of insider trading or fraud by the qualifying foreign broker-dealer where the chaperoning broker-dealer arguably should know of such activities. [164] These reviews should include periodic examination of the accounts, any transactions, related correspondence and lending activity.

[d] Government Securities Activities

After the SEC's adoption of Rule 15a-6 under the Exchange Act, the U.S. Treasury department adopted an exemptive rule under § 15C of the Exchange Act covering government securities activities that essentially parallels Rule 15a-6. [165] Moreover, the Treasury staff has indicated that the relief provided in the 1997 Cleary Letter applies equally to those entities subject to § 15C. [166] Treasury's exemptive rule (as modified by the 1997 Cleary Letter), like Rule 15a-6, permits execution of unsolicited transactions, transactions with the selected counterparties described in Rule 15a-6 and the 1997 Cleary Letter, the distribution of research reports to major U.S. institutional investors and $100 Million Entities and the limited solicitation of major U.S. institutional investors, U.S.

p. 14-42

---

p. 14-43

institutional investors and $100 Million Entities by qualifying foreign broker-dealers. [167]

[e] Violations of U.S. Law

The Rule 15a-6 Adopting Release provides that the SEC would not view isolated violations of § 15 of the Exchange Act by virtue of a foreign broker-dealer's failing to comply with the exemptions provided by Rule 15a-6 under the Exchange Act as preventing the foreign broker-dealer's reliance on the rule with respect to its other activities. However, if a foreign broker-dealer "repeatedly engaged in nonexempt … activities intermittently with exempt … activities," the SEC could conclude that all the foreign broker-dealer's U.S. activities had been conducted in violation of the § 15 registration requirement. [168]

A foreign broker-dealer's violation of the Exchange Act registration requirement would be deemed to have concluded when it had "completely ceased to conduct U.S. securities activities … not exempt under the Rule" or registered with the SEC. [169] The foreign broker-dealer would, however, remain liable for the violations it had committed, and in particular, could be liable to private investors with whom the foreign broker-dealer had wrongfully effected transactions. [170] In addition, even foreign broker-dealers that conduct their U.S. activities in compliance with Rule 15a-6 remain subject to the various antifraud provisions of the U.S. securities laws. [171]

[f] The Recognition Concept Release

At the time it adopted Rule 15a-6 under the Exchange Act, the SEC also issued a concept release on Recognition of Foreign Broker-Dealer Regulation, which proposed and requested comment regarding the concept of a conditional exemption from registration for certain limited categories of foreign broker-dealers located in foreign countries (i) with regulatory schemes "comparable" to

that provided by the Exchange Act and (ii) whose local securities authority and the SEC have in place a Memorandum of Understanding or treaty providing for "the fullest mutual assistance possible." [172] Although reaction to the proposal was generally negative at the time and it was not pursued, [173] there was a resurgence of interest in 2007 to 2008 in the implementation of a "mutual recognition" approach. This interest has been reflected in numerous articles and speeches by senior SEC staff, commissioners and others and, in June 2007, the SEC sponsored a Roundtable on Selective Mutual Recognition. [174] In August 2008, the SEC announced its entry into a mutual recognition arrangement that provides a framework for the SEC, the Australian government, and the Australian Securities and Investment Commission to consider regulatory exemptions that would permit U.S. and eligible Australian stock exchanges and broker-dealers to operate in both jurisdictions, without the need for these entities (in certain aspects) to be separately regulated in both countries. [175] In addition, in 2008 the SEC staff began working with the Committee of European Securities Regulators and, separately, with four Canadian securities regulators, to define the process to be followed in discussing mutual recognition arrangements. [176] No further progress has been made on these mutual recognition arrangements since that time; however,

it is possible that the acceptance by other U.S. and non-U.S. regulators of equivalent or comparable foreign regulation would lead the SEC to once again consider accepting equivalent foreign broker-dealer regulation. [177]

[g] Increasing Reliance on Rule 15a-6

There is no publicly available information on the number of foreign broker-dealers that are relying on the conditional exemption provided by Rule 15a-6(a)(3) under the Exchange Act; however, by most accounts the number continues to increase. In the period immediately following the adoption of Rule 15a-6, the benefits of complying with the conditional exemption were viewed as quite limited because, for example, the conditional exemption could not (until the issuance of the 1997 Cleary Letter) be used by foreign broker-dealers to contact U.S. operating companies, no matter how large, even those that satisfied the definition of "qualified institutional buyer" for purposes of Rule 144A under the Securities Act. In addition, the broad consent to SEC jurisdiction required from foreign broker-dealers also appears to have discouraged foreign broker-dealers from relying on the conditional exemption. [178] Accordingly, foreign broker-dealers that had a registered U.S. affiliate generally elected to rely upon that affiliate to contact U.S. investors, including through so-called "dual employees" stationed outside the United States, [179] rather than comply with the terms of the conditional exemption.

Over time, however, a number of countervailing considerations seem to have encouraged more foreign broker-dealers to rely on Rule 15a-6(a)(3). First, as the SEC has increased its own ability to obtain information about foreign

broker-dealers from foreign securities regulatory authorities, [180] there may seem less disadvantage to foreign broker-dealers in permitting the SEC to obtain information directly from the foreign broker-dealers.

Second, as U.S. investors become increasingly sophisticated about foreign securities, they want the ability to speak directly with foreign research analysts and foreign traders. In theory, the demands of U.S. investors to talk to analysts, traders or other employees of foreign broker-dealers could be accommodated by such employees becoming dual employees of the foreign broker-dealer and a U.S. broker-dealer. In practice, it is difficult, at least on a large scale, for non-U.S. employees of foreign broker-dealers to comply with the testing and other requirements imposed on personnel of U.S. broker-dealers, [181] and the maintenance of dual employees overseas may raise branch office, as well as tax and other, issues for both the U.S. and non-U.S. entities. [182]

Finally, and perhaps most importantly, the 1997 Cleary Letter significantly expanded the utility of the exemption from broker-dealer registration provided by Rule 15a-6(a)(3) by permitting qualifying foreign broker-dealers to rely on the exemption in the context of contacts with $100 Million Entities (rather than just the narrowly defined categories of "major U.S. institutional investors" set forth in the Rule). [183] Furthermore, the 1997 Cleary Letter substantially liberalized the chaperoning requirements of the rule by providing that qualifying foreign associated persons may, without the participation of an employee of the chaperoning broker-dealer, (i) engage in oral communications from outside the United States with U.S. institutional investors if such communications take place outside the trading hours of the NYSE and no orders to effect securities transactions are accepted other than those involving foreign securities [184] and (ii) have in-person contacts during visits to the United States with major U.S. institutional investors and $100 Million Entities so long as the number of days on which such in-person contacts occur does not exceed 30 per year and the foreign associated person does not accept orders to effect any securities transactions while in the United States. [185]

p. 14-46

---

p. 14-47

Nonetheless, even after the issuance of the 1997 Cleary Letter, the limitations of Rule 15a-6 and the complicated mechanics of compliance result in continuing requests by U.S.-registered broker-dealers and their non-U.S. affiliates for further relaxation of the rule's requirements. [186]

[h] Certain M&A Activities

In 2013, the staff of the SEC's Division of Trading and Markets issued a no-action letter to a non-U.S. broker offering strategic consultancy to non-U.S. clients in connection with merger and acquisition ("M&A") transactions. [187] The letter allowed the non-U.S. broker, acting on behalf of a non-U.S. client, to contact buyers or sellers in the United States, or the U.S. parent of a non-U.S. buyer or seller (the "U.S. Target"), without registering as a broker-dealer with the SEC. [188] To rely on the letter, the U.S. Target would have to qualify as a major U.S. institutional investor or $100 Million Entity. [189] In addition, the letter allowed the non-U.S. broker to develop and manage the data room and the information process, conduct negotiations on behalf of the non-U.S. client and advise the non-U.S. client on the terms of the transaction, provided (1) the U.S. Target uses the services of an external advisor, such as a broker-dealer, attorney or other professional with relevant experience, or, (2) if the U.S. Target does not use an external advisor, such U.S. Target uses internal or group level personnel with relevant M&A experience to negotiate the transaction and the non-U.S. broker's personnel engaged in any contacts with the U.S. Target in the United States are limited to persons whom the non-U.S. broker determines satisfy the requirements for "foreign associated persons" in Rule 15a-6(a)(3)(ii)(B). [190] In addition, in order to rely on the relief, the non-U.S. broker should not represent or advise

p. 14-47

---

p. 14-48

any U.S. Target or receive, acquire or hold funds and securities in connection with a transaction it engages in with a U.S. Target. [191]

[i] NAFTA

On January 1, 1994, the North American Free Trade Agreement ("NAFTA") went into effect following formal ratification procedures in Canada, Mexico and the United States. Chapter 14 of NAFTA ("NAFTA Chapter 14"), which governs trade and investment in financial services among the three countries, generally requires each of the party countries to provide investors and financial institutions of the other NAFTA countries with treatment no less favorable than the country provides its own investors and financial institutions under like circumstances. In addition, each party country is required to provide "most favored nation" treatment to investors and financial institutions of the other NAFTA countries, defined as treatment no less favorable than it provides to investors and financial institutions of any other country under like circumstances. [192] A party country also must ensure that the obligations of NAFTA Chapter 14 are observed by any of that country's SROs in which membership or participation is required of any investor or financial institution of another NAFTA country. [193]

As a general matter, the requirements of the Exchange Act imposed upon broker-dealers registered with the SEC are not more favorable to broker-dealers that are organized and physically located in the United States than to those that are not; accordingly, NAFTA has not had any significant effect on U.S. regulation of broker-dealers. However, it is possible that a Canadian or Mexican securities firm could challenge certain SEC requirements imposed solely on nonresident broker-dealers, such as the requirement that nonresidents provide the SEC with a power of attorney designating the SEC as its agent for service of process in certain civil suits. [194] Similarly, an argument could be made that certain rules of the SROs that impose special requirements on nonresident broker-dealers violate NAFTA. [195]

These potential challenges to U.S. regulation may be defeated by two overriding limitations in NAFTA Chapter 14: (i) the "prudential carve-out" and (ii) various reservations to the chapter that have been or may be taken by the parties. The prudential carve-out allows the party countries, notwithstanding the obligations set forth in NAFTA Chapter 14, to adopt and maintain any measure

p. 14-48

---

p. 14-49

that is "reasonable" and adopted or maintained "for prudential reasons," such as the protection of investors or the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions and the financial system. [196]

In addition, the United States has "reserved" the right to enforce certain measures of federal law that are not otherwise consistent with NAFTA Chapter 14. Examples include certain provisions of the Exchange Act, [197] the Primary Dealers Act of 1988 [198] and the Advisers Act. [199]

Measures adopted or maintained by state and provincial governments generally are subject to the same NAFTA Chapter 14 standards that apply to federal measures. [200] Consequently, various states have also "reserved" certain provisions of their securities or "blue sky" laws. For example, among various other types of reservations, many states have reserved certain provisions in their laws that deny U.S. branches or agencies of foreign banks exemptions from state broker-dealer and investment adviser registration requirements (exemptions that are generally available to U.S. banks). [201]

p. 14-49

---

p. 14-50

Certain reservations previously taken by a number of states relating to transactions in securities have since been superseded by the NSMIA, which in general preempts many state registration requirements with respect to securities transactions and certain aspects of state broker-dealer regulation. [202] However, the NSMIA has not preempted those state reservations that effectively subject U.S. branches and agencies of foreign banks to state broker-dealer and investment adviser registration requirements.

NAFTA Chapter 14 also provides that the regulation of cross-border financial services may not be made more restrictive than it was on January 1, 1994, the date that NAFTA entered into force (the so-called "standstill" on cross-border services). [203] Canada has taken a reservation against this obligation with respect to cross-border trade in securities services generally, and the United States in turn has taken a reservation against this obligation with respect to its cross-border securities trade with Canada.

[j] Memoranda of Understanding

Concomitant with the growth in international securities trading over the past decade, the SEC has sought to overcome extraterritorial limitations on its ability to gather information located outside the United States regarding possible violations of U.S. securities laws. [204] Bilateral information gathering and sharing agreements between the SEC and foreign financial regulatory authorities, commonly referred to as Memoranda of Understanding ("MOUs"), have helped in this regard by defining and formalizing procedures to request and provide such information. [205]

Since signing its first MOU with Switzerland in 1982 and as of the date this book went to press, [206] the SEC has entered into MOUs, as well as less comprehensive formal information-sharing agreements and training and technical

p. 14-50

p. 14-51

assistance agreements, with foreign authorities in 49 countries. [207] In addition, multilateral organizations, like the Council of Securities Regulators of the Americas and the International Organization of Securities Commissions ("IOSCO"), have adopted resolutions providing for mutual assistance in investigating and gathering information regarding violations of a member nation's securities laws. [208]

The SEC's MOU with the U.K. securities regulatory authorities (the "UK MOU") [209] is one of the most far-reaching of the SEC's MOUs, making assistance available in virtually all types of cases that could arise under the securities and futures laws of the United States and the United Kingdom. [210] Upon request of an authority that is a party to the MOU, it allows each other regulatory authority to provide access to information in its files, to compel testimony and production of information or documents from persons using its subpoena powers, to conduct compliance inspections or examinations of investment businesses and to permit the representatives of the requesting authority to participate in the conduct of the investigations made by the requested authority, all without regard to

p. 14-51

p. 14-52

whether the conduct on which information is sought would constitute a violation of the requested authority's laws or regulations. [211]

While the UK MOU is very broad, in the past, there has been some reluctance from certain other foreign authorities to agree to providing open-ended assistance to SEC investigations of domestic financial entities, particularly where local securities disclosure and bank secrecy laws differ markedly from those in the United States. [212] More recently, however, the trend has moved toward broader cooperation. Both Switzerland and Japan, once examples of such reluctance, have since expanded and reconfirmed their commitment toward cooperation and information sharing.

In 1993, Switzerland amended its fairly restrictive 1987 MOU to include violations of law concerning securities, futures, or options, in other than penal proceedings, including cooperation with formal investigations that may lead to such proceedings. [213] The 1993 Swiss MOU, however, still only extends its commitment to information sharing to the "extent feasible."

In 2002, Japan and the United States signed a Statement of Intent that established a framework of cooperation much like the MOUs the United States has with other countries, extending their commitment to provide the "fullest assistance permissible under the laws of the United States and Japan." [214] That MOU represented a significant departure from the previous Japanese MOU, which had no procedures or guidelines for information requests. [215]

In 2003, IOSCO publicly introduced the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of

p. 14-52

p. 14-53

Information (the "Multilateral MOU"). [216] The Multilateral MOU is the first global multilateral information sharing arrangement among securities regulators. It specifies the particular types of information a signatory is expected to provide to counterparts upon request, including client identifying records from bank and brokerage accounts, bank and brokerage transaction records, and beneficial ownership information of non-natural persons organized in the jurisdiction of the requested authority. [217] There are now 109 signatories to the Multilateral MOU, including the SEC and the CFTC. [218]

Footnotes

9 This section does not deal with the potential applicability of state registration requirements. *See* § 14.12.

10 Section 15(a)(2) of the Exchange Act gives the SEC the power—exercisable "as it deems consistent with the public interest and the protection of investors," either in individual cases or on a general basis, and conditionally or unconditionally—to exempt broker-dealers from the registration requirement.

11 § 3(a)(4) of the Exchange Act (as amended by the Gramm-Leach-Bliley Act, Pub. L. No. 106–102, § 201, 113 Stat. 1338, 1385 (1999)).

12 § 201 of the GLB Act; *see* § 3(a)(4) of the Exchange Act. For a discussion of related changes the GLB Act made to the application of the definition of "dealer" in § 3(a)(5) of the Exchange Act to banks, *see* § 14.03[1][b]. *See also* § 14.03[1][c] (discussing bank "broker" and "dealer" activities after the GLB Act) and ROBERT L. TORTORIELLO, DEREK M. BUSH AND HUGH C. CONROY, JR., GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES (21st ed. 2016) (hereinafter the "GUIDE") Part I.C.

13 12 C.F.R. Part 218; 17 C.F.R. Part 247.

14 *See*, *e.g.*, *UFITEC, S.A. v. Carter*, 142 Cal. Rptr. 279 (Cal. 1977) (finding that "engaging in the business" connotes only regularity of participation, not principal business or income source); *InTouch Global, LLC* (avail. Nov. 14, 1995) (finding that a person will be deemed to be "engaged in the business" if the person engages in securities activities for compensation with sufficient recurrence); *SEC v. Helms*, No. A-13-CV-01036ML, 2015 WL 6438872 (W.D. Tex. Oct. 20, 2015) (finding defendant to be a broker based on participation in a single securities transaction).

15 *See*, *e.g.*, *Ruth Quigley* (avail. July 14, 1973) (registration of persons involved in merger and acquisitions activities may be necessary as these activities often involve a distribution or exchange of securities).

16 *See*, *e.g.*, *AngelList LLC and AngelList Advisors LLC* (avail. Mar. 28, 2013) (granting no-action relief to a company that provides a platform to assist investors in identifying companies that seek capital); *FundersClub Inc. and FundersClub Management LLC* (avail. Mar. 26, 2013) (granting no-action relief to a company operating a website through which members may express investment interest in listed private companies); *Country Business, Inc.* (avail. Nov. 8, 2006) (granting no-action relief to a company that represents sellers of small businesses where, among other things, the company advertises only sales of assets (not securities), does not recommend the transfer of the business through a sale of securities and is not compensated differently if the transaction is ultimately effected through the sale of securities); *CommandTRADE, LP* (avail. Dec. 28, 2005); *Paul Anka* (avail. July 24, 1991) (discussion of "introducing" or "finding" activities not requiring broker-dealer registration); *Victoria Bancroft* (avail. Aug. 9, 1987); *International Business Exchange Corp.* (avail. Dec. 12, 1986); *Miller & Co., Inc.* (avail. Aug. 15, 1977); *Ruth Quigley* (avail. July 14, 1973). *See also* American Bar Association, REPORT AND RECOMMENDATIONS OF THE TASK FORCE ON PRIVATE PLACEMENT BROKER-DEALERS (June 7, 2005), which reviews the activities of, and laws applicable to, finders and recommends a new and more simplified registration category for so-called "private placement broker-dealers." *But see SEC v. Kramer*, 778 F. Supp. 2d 1320 (M.D. Fla. 2011) (alleged "finder" held not to be a "broker" despite receiving transaction-based compensation).

17 *See*, *e.g.*, *In re Blackstreet Capital Management, LLC and Murray N. Gunty*, SEC Release No. 34-77959 (June 1, 2016) (finding that a private equity firm acted as an unregistered broker by receiving transaction-based compensation in connection with the purchase and sale of portfolio companies for funds it advised); *In re Ranieri Partners LLC and Donald W. Phillips*, SEC Release No. 34-69091 (Mar. 8, 2013) (finding that a

private equity firm and one of its executives caused an unregistered broker to violate securities laws by soliciting investors for the firm as a hired consultant without being registered as a broker); *Brumberg, Mackey & Wall, P.L.C.* (avail. May 17, 2010) (denying no-action relief to a company that receives transaction-based compensation); *Hallmark Capital Corp.* (avail. June 11, 2007) (denying no-action relief to a company that facilitates mergers and acquisitions and receives a fee based on the outcome of the transaction); *John W. Loofbourrow Assoc., Inc.* (avail. June 29, 2006) (denying no-action relief with respect to a request by a registered broker-dealer to pay a non-registered entity a finder's fee for referring to it a potential investment banking client, where such fee was to be tied to the ultimate size of the securities offering); *Mike Bantuveris* (avail. Oct. 23, 1975); *May-Pac Management Company* (avail. Dec. 20, 1973).

18 *See M&A Brokers* (avail. Jan. 31, 2014).

19 *M&A Brokers* (avail. Jan. 31, 2014).

20 *See M&A Brokers* (avail. Jan. 31, 2014).

21 Rule 3a4-1 under the Exchange Act provides a nonexclusive safe harbor under which employees and other associated persons of an issuer may participate in sales of an issuer's securities without being deemed brokers. *See generally* SEC Release No. 34-22172 (June 27, 1985) (adopting Rule 3a4-1 under the Exchange Act to provide a conditional exemption from broker registration for certain associated persons of issuers).

22 *See Charles Schwab & Co., Inc.* (avail. Nov. 27, 1996).

23 *See Financial Research Center* (avail. Sept. 27, 1996); *see also GlobalTec Solutions, LLP* (avail. Dec. 28, 2005).

24 *See S3 Matching Technologies LP* (avail. July 19, 2012).

25 *MuniAuction Inc.* (avail. Mar. 13, 2000). In particular, MuniAuction stated that its compensation consisted only of fixed auction hosting fees paid by municipal bond issuers, which fees were not tied to the size or success of the transaction.

26 *MuniAuction Inc.* (avail. Mar. 13, 2000).

27 *MuniAuction Inc.* (avail. Mar. 13, 2000); *see also supra* Notes 17 and 21; *In re Ireeco, LLC and Ireeco Limited*, SEC Release No. 34-75268 (June 23, 2015) (finding that two companies acted as unregistered brokers in connection with sales of securities involving the U.S. government's EB-5 Immigrant Investor Program by actively soliciting over 150 foreign investors for which they were paid fees); *BondGlobe, Inc.* (avail. Feb. 6, 2001) (denying no-action relief based, among other factors, on BondGlobe's participation in the communication of customer orders to registered broker-dealers that license the use of the BondGlobe system). *But see Loffa Interactive Corp., Inc.* (avail. Sept. 12, 2003) (granting no-action relief based, among other factors, on the fact that Loffa provides communications services only after all terms of a securities purchase are set, and that it will not solicit participation in any securities transaction or otherwise take part in any of the financial services offered by any broker-dealer).

28 *MuniAuction Inc.* (avail. Mar. 13, 2000). *See* § 14.10[1] for a discussion of alternative trading systems.

29 *See* SEC Release No. 33-9974 (Oct. 30, 2015), 80 Fed. Reg. 71,387 (Nov. 16, 2015) (hereinafter the "Crowdfunding Release").

30 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,389 (Nov. 16, 2015).

31 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,390 (Nov. 16, 2015).

32 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,390 (Nov. 16, 2015).

33 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,456–71,458 (Nov. 16, 2015).

34 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,461 (Nov. 16, 2015).

35 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,480 (Nov. 16, 2015).

36 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,461 (Nov. 16, 2015).

37 § 3(a)(5) of the Exchange Act (as amended by GLB Act § 202).

38 GLB Act § 202; *see* § 3(a)(5) of the Exchange Act. For a discussion of related changes the GLB Act made to the application of the definition of "broker" to banks, *see* § 14.03[1][a]. *See also* § 14.03[1][c] (discussing bank "broker" and "dealer" activities after the GLB Act).

39 *See* SEC Release No. 34-47364 (Feb. 13, 2003) (hereinafter the "Dealer Release").

40 Section 761 of the Dodd-Frank Act, among other things, also added "security-based swaps" to the definition of "security" in § 3(a)(10) of the Exchange Act.

41 § 3(a)(5)(B) of the Exchange Act.

42 *See*, *e.g.*, *Burton Securities* (avail. Dec. 5, 1977); *see also Acqua Wellington North American Equities Fund, Ltd.* (avail. Oct. 11, 2001) (investing in equity lines of credit and agreeing to buy common stock of a company, absent any of enumerated "dealer" activities, does not require registration as a broker-dealer).

43 *See*, *e.g.*, *United Trust Company* (avail. Sept. 6, 1978) (entity that engages in low volume of municipal securities activity but does so in response to customer requests may be a municipal securities dealer).

44 *Fairfield Trading Corp.* (avail. Jan. 10, 1988); *Continental Grain Company* (avail. Nov. 6, 1987).

45 *Continental Grain Company* (avail. Nov. 6, 1987).

46 *Continental Grain Company* (avail. Nov. 6, 1987).

47 *Continental Grain Company* (avail. Nov. 6, 1987).

48 *Continental Grain Company* (avail. Nov. 6, 1987); *Burton Securities* (avail. Dec. 5, 1977).

49 *Continental Grain Company* (avail. Nov. 6, 1987); *Burton Securities* (avail. Dec. 5, 1977). In *United Trust Company* (avail. Sept. 6, 1978), the SEC refused to grant a no-action request with respect to an entity's status as a municipal securities dealer based in large part on the company's "apparent willingness … to engage in municipal securities activity when requested to do so by customers." By way of contrast, in each of *Continental Grain Company* (avail. Nov. 6, 1987) and *Louis Dreyfus Corporation* (avail. July 23, 1987), the SEC granted a no-action position in the context of requests emphasizing that the subject entities were "under no obligation" to enter quotes, nor would they "ever do so at the request of another party."

50 *Fairfield Trading Corp.* (avail. Jan. 10, 1988); *Robert C. DeFazio* (avail. Dec. 17, 1981); *Burton Securities* (avail. Dec. 5, 1977).

51 *National Council of Savings Institutions* (avail. July 27, 1986); *Robert C. DeFazio* (avail. Dec. 17, 1981); *Burton Securities* (avail. Dec. 5, 1977).

52 *Fairfield Trading Corp.* (avail. Jan. 10, 1988); *Continental Grain Company* (avail. Nov. 6, 1987); *Citicorp Homeowner, Inc.* (avail. Oct. 7, 1987); *Burton Securities* (avail. Dec. 5, 1977).

53 *United Mercantile Bank & Trust Company* (avail. Dec. 4, 1986).

54 *National Council of Savings Institutions* (avail. July 27, 1986).

55 *National Council of Savings Institutions* (avail. July 27, 1986); *United Mercantile Bank & Trust Company* (avail. Dec. 4, 1986). With respect to government securities, the following may be added to the list of activities that ordinarily would not be engaged in by an entity other than a broker-dealer: (i) using an interdealer broker or a broker's broker and (ii) running a matched book of repurchases and reverse repurchases of securities. *Fairfield Trading Corp.* (avail. Jan. 10, 1988); *Continental Grain Company* (avail. Nov. 6, 1987); *International Investment Group, Inc.* (avail. July 23, 1987).

56 Section 3(a)(6) of the Exchange Act defines a "bank" as:

> (A) a banking institution organized under the laws of the United States or a Federal savings association, as defined in section 2(5) of the Home Owners' Loan Act, (B) a member bank of the Federal Reserve System, (C) any other banking institution or savings association, as defined in section 2(4) of the Home Owners' Loan Act, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the

> business of which consists of receiving deposits or exercising a fiduciary power similar to those permitted to national banks under the authority of the Comptroller of the Currency … which is supervised and examined by State or Federal authority having supervision over banks or savings associations.…

57 *See*, *e.g.*, *United States v. Weisscredit Banca, Commerciale E D'Investimenti*, 325 F. Supp. 1384 (S.D.N.Y. 1971); *see also* § 14.03[1][d].

58 *See* § 14.03[1][a] and [b]. For a further discussion of the GLB Act, *see* GUIDE Part IX. B.3.

59 SEC Release No. 34-56501 (Sept. 24, 2007).

60 Under the GLB Act, an "identified banking product" means (i) a deposit account, savings account, certificate of deposit, or other deposit instruments issued by a bank, (ii) a banker's acceptance, (iii) a letter of credit issued or loan made by a bank, (iv) a debit account at a bank arising from a credit card or similar arrangement, (v) a participation in a loan that the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold to "qualified investors" or other sophisticated investors or (vi) any swap agreement, including credit and equity swaps (but only if equity swaps are not sold by the bank directly to any person other than a qualified investor). *See* § 206(a) of the GLB Act.

61 The Dealer Release clarified that this exception would also apply to the definition of "dealer." Furthermore, the SEC stated in the Dealer Release that a riskless principal transaction will count as one transaction toward the annual 500 limit (although the SEC stated that if a "bank acts as an intermediary between one counterparty and multiple counterparties by arranging multiple transactions, the bank must count each of the transactions on the side of the intermediation that involves the largest number of transactions as a separate transaction against the annual 500 transaction-limit"). *See* Dealer Release, 68 Fed. Reg. 8686, 8690 n.38 (Feb. 24, 2003).

62 *See* § 201 of the GLB Act.

63 Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, 120 Stat. 1966 (2006).

64 *See* SEC Release No. 34-56501 (Sept. 24, 2007).

65 12 C.F.R. § 218.

66 The "good faith" exemption is only available if: (i) at the time the contract was created, the bank acted in good faith and had reasonable policies and procedures in place to comply with the definition of "broker" and the related rules and regulations; and (ii) any violation of the broker-dealer registration requirements did not result in "any significant harm, financial loss or cost to the person seeking to void the contract." Regulation R Rule 771, 17 C.F.R. §247.780.

67 As clarified and amended in the Dealer Release, the term "predominantly originated" means that "no less than 85% of the value of the obligations in any pool were originated by: (1) [t]he bank or its affiliates, other than its broker or dealer affiliates; or (2) [b]anks that are members of a syndicate of banks and affiliates of such banks, other than their broker or dealer affiliates, if the obligations or pool of obligations consist of mortgage obligations or consumer-related receivables; (3) [f]or this purpose, the bank and its affiliates include any financial institution with which the bank or its affiliates have merged but does not include the purchase of a pool of obligations or the purchase of a line of business." *See* Dealer Release, 68 Fed. Reg. 8686, 8700-01 (Feb. 24, 2003); Rule 3b-18(g) under the Exchange Act. In addition, the term "originated" means: "(1) [f]unding an obligation at the time that the obligation is created; or (2) [i]nitially approving and underwriting the obligation, or initially agreeing to purchase the obligation, provided that: (i) [t]he obligation conforms to the underwriting standards or is evidenced by the loan documents of the bank or its affiliates, other than its broker or dealer affiliates; and (ii) [t]he bank or its affiliates, other than its broker or dealer affiliates, fund the obligation in a timely manner, not to exceed six months after the obligation is created." *See* Dealer Release, 68 Fed. Reg. 8686, 8700 (Feb. 24, 2003); Rule 3b-18(e) under the Exchange Act.

68 As clarified and amended in the Dealer Release, the term "member of a syndicate of banks" has been

replaced with separate definitions of "member" and "syndicate of banks." The term "member" as it relates to a "syndicate of banks" means "a bank that is a participant in a syndicate of banks and together with its affiliates, other than its broker or dealer affiliates, originates no less than 10% of the value of the obligations in a pool of obligations used to back the securities issued through a grantor trust or other entity." *See* Dealer Release, 68 Fed. Reg. 8686, 8700 (Feb. 24, 2003); Rule 3b-18(c) under the Exchange Act. The term "syndicate of banks" means "a group of banks that acts jointly, on a temporary basis, to issue through a grantor trust or other separate entity, securities backed by obligations originated by each of the individual banks or their affiliates, other than their broker or dealer affiliates." *See* Dealer Release, 68 Fed. Reg. 8686, 8701 (Feb. 24, 2003); Rule 3b-18(h) of the Exchange Act.

69 *See* § 202 of the GLB Act. The Comptroller has taken the position that certain banks may hedge equity derivatives by purchasing, holding and selling the underlying equity securities. *See generally* GUIDE II.E.

70 *See* Dealer Release, 68 Fed. Reg. 8686, 8692 (Feb. 24, 2003) (adopting Rule 15a-11 under the Exchange Act). As originally adopted, Rule 15a-11 under the Exchange Act also provided banks engaging in such activities an exemption from the definition of "broker." In a companion release to the Regulation R adopting release, the SEC redesignated Rule 15a-11 as Rule 3a5-3 and deleted the broker-related provisions of the rule. *See* SEC Release No. 34-56502 (Sept. 24, 2007). The SEC and the Board included the broker exemption for banks engaging in securities lending transactions in Regulation R. *See supra* Note 61.

71 *See* SEC Release No. 34-56502 (Sept. 24, 2007).

72 § 3(a)(6) of the Exchange Act.

73 *See*, *e.g.*, Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,015 n.16 (July 18, 1989) (noting the SEC's treatment of a branch or agency of a foreign bank supervised and examined by a banking authority as a "bank" for purposes of §§ 3(a)(4) and 3(a)(5) of the Exchange Act).

74 N.Y. BANKING LAW § 202-a (McKinney's 2013).

75 N.Y. BANKING LAW § 202-a(1) (McKinney's 2013).

76 N.Y. BANKING LAW § 201-b (McKinney's 2013).

77 *See* 12 U.S.C. § 3102(d).

78 Following enactment of the CFMA in 2000, the definition of "security" in § 3(a)(10) of the Exchange Act was amended to exclude "any non-security based swap agreements." Effective the later of July 6, 2011 or not less than 60 days after adoption of relevant rules or regulations, the Dodd-Frank Act further amended the definition of "security" in § 3(a)(10) of the Exchange Act to include "security-based swaps." § 12.01[1]. The determination of whether certain business activities involve "securities" can raise difficult legal issues. Of course, even entities that effect transactions in financial instruments that are not securities may still be subject to U.S. regulation. For a discussion of the regulation of entities that effect transactions in futures contracts, swaps and other derivatives, *see* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 4.

79 An entity that acts as a dealer in security-based swaps will be required to register with the SEC as an SBSD once the rules regulating such registration are effective. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 6.02.

80 *But see* § 14.08[3][b] (regarding reporting requirements imposed with respect to certain unregistered affiliates of registered broker-dealers pursuant to rules adopted by the SEC under § 17(h) of the Exchange Act and for a discussion of the position advanced by the Government Accountability Office (the "GAO") that the SEC use its authority under this provision to determine whether regulation of such affiliates is warranted).

81 The Exchange Act also provides a mechanism for limited purpose registration as broker-dealers for FCMs whose customer-driven securities activities are limited to certain transactions in security futures products. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.07[2].

82 *See* § 3(a)(17) of the Exchange Act (defining "interstate commerce").

83 *See generally Legacy Motors, Inc.* (avail. July 31, 1991) (rejecting a no-action request with respect to officers, directors and employees of a company due to "absence of a representation that the past securities activities [of the persons] were strictly limited to intrastate transactions"); *Don Chamberlin* (avail. Aug. 10, 1979) (interpreting "exclusively intrastate" to turn principally on the residence of the broker-dealer's customers, including the securities issuer).

84 § 15(a)(1) of the Exchange Act. Broker-dealers that engage in transactions in government securities, however, may have to register under § 15C of the Exchange Act. *See* § 14.03[2][b][ii]. Municipal securities are exempted securities for certain purposes of the Exchange Act, although not for purposes of § 15. Accordingly, nonbank broker-dealers in municipal securities must register under § 15 of the Exchange Act. A bank, or a separately identifiable division or department of a bank, that is engaged in the business of buying or selling municipal securities, otherwise than in a fiduciary capacity, is required to register with the SEC as a "municipal securities dealer" under § 15B of the Exchange Act. *See* §§ 3(a)(30) and 15B(a)(1) of the Exchange Act.

85 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,015 n.21 (July 18, 1989); § 3(a)(3) of the Securities Act. Although the definition of "security" contained in § 3(a)(10) of the Exchange Act by its terms excludes "any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance of not exceeding nine months," the SEC staff has on various occasions expressed the view that the additional requirements applicable to the commercial paper exemption in § 3(a)(3) of the Securities Act should be read into the § 3(a)(10) exclusion. *See*, *e.g.*, *Prescient Markets, Inc.* (avail. Apr. 2, 2001) (in which the SEC staff took the position that a commercial paper trading platform did not have to be registered as a broker-dealer if its registered broker-dealer affiliate took full responsibility for the operation of the platform with respect to § 4(a)(2) commercial paper transactions). Several courts have also taken this approach when analyzing whether a short-term note should be viewed as a "security" for purposes of various provisions of the Exchange Act. *See*, *e.g.*, *Zeller v. Bogue Electric Manufacturing Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973) (holding that Rule 10b-5 under the Exchange Act could apply to a note with less than nine months maturity notwithstanding the definition of a security in the Exchange Act); *UBS Asset Management (New York) Inc. v. Wood Gundy Corp.*, 914 F. Supp. 66 (S.D.N.Y. 1996) (exclusion in § 3(a)(10) "applies only to 'prime quality negotiable commercial paper'"); *SEC v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125, 1132 (9th Cir. 1991) ("[T]he presumption that a note is a security applies equally to notes of less than nine months maturity that are not commercial paper.").

86 *See generally* SEC Release No. 33-4412 (Sept. 20, 1961) (discussing § 13(a)(3) of the Exchange Act and the determining factors of "commercial paper"); § 3.05[3].

87 *See* § 3(a)(12) of the Exchange Act (defining "exempted securities").

88 *See* § 3(a)(34) of the Exchange Act (defining "appropriate regulatory agency").

89 *See* Rule 15a-6 Adopting Release; *see also* SEC Release No. 34-25801 (June 14, 1988) (hereinafter the "Rule 15a-6 Proposing Release"). These two releases discuss, or at least cite, virtually all of the prior significant SEC pronouncements on the U.S. activities of foreign broker-dealers. As indicated in the text, in many cases Rule 15a-6 follows from these prior positions. Certain SEC no-action letters that predate Rule 15a-6, and which are arguably broader than Rule 15a-6, *see*, *e.g.*, *Chase Manhattan Corp.* (avail. July 28, 1987), apparently may still be relied upon since the Rule 15a-6 Adopting Release, at Part IV.A.3, provides that such letters remain valid unless expressly modified or withdrawn. 54 Fed. Reg. 30,013, 30,019 (July 18, 1989).

Foreign broker-dealers intending to offer security futures products to U.S. investors in reliance on Rule 15a-6 will also need to consider U.S. commodities law requirements and exemptions applicable to such activity under the CEA. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 4. Security futures products generally are defined as futures contracts on individual nonexempt securities or narrow-based groups or indices of nonexempt securities. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[c].

90 In 2008, the SEC proposed significant amendments to Rule 15a-6. If adopted, the amendments would have: (i) broadened substantially the categories of U.S. investors with which a foreign broker-dealer may interact without registering as a broker-dealer under the Exchange Act (in particular, references under the current rule, which are discussed further below, to "major U.S. institutional investors" and "U.S. institutional investors" would be replaced by references to "qualified investors" as defined in § 3(a)(54) of the Exchange Act, which includes institutional entities as well as natural persons that have at least $25 million in investments), (ii) effectively eliminated the requirement that a U.S. broker-dealer "chaperone" contacts between a foreign broker-dealer and qualified investors, (iii) substantially reduced the obligation of a U.S. broker-dealer to "intermediate" transactions between a foreign broker-dealer and qualified investors (and, if the foreign broker-dealer conducts a "foreign securities business," as such term is defined in the proposed amendments and, subject to the other conditions specified therein, permit it to provide full-service brokerage and perform related custody activities for qualified investors), and (iv) codified (and, in some respects, expanded) certain aspects of current SEC staff interpretive guidance issued in connection with Rule 15a-6. *See* SEC Release No. 34-58047 (June 27, 2008). This proposal was withdrawn on November 1, 2013, but the SEC noted that it may consider it at a future date. *See* SEC, RIN 3235-AK15 (Fall 2013).

91 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,016 & n.43 (July 18, 1989) (withdrawing prior no-action letters that had permitted unregistered broker-dealers located in the United States to do business exclusively with non-U.S. persons).

92 Rule 15a-6(a)(1) under the Exchange Act.

93 Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,650 (June 23, 1988).

94 The term "general circulation" is not defined in Rule 15a-6. The meaning of the term may, however, be informed by reference to Rule 902(c)(2) of Regulation S under the Securities Act. *See* § 8.02[1][b].

95 *But see The London International Financial Futures Exchange* ("LIFFE") (avail. May 1, 1992) (permitting LIFFE and certain foreign broker-dealers not registered with the SEC to provide qualified institutional buyers information concerning LIFFE-traded options). *See also Tokyo Stock Exchange, Inc.* (avail. Nov. 20, 2006); *Eurex Deutschland* (avail. July 27, 2005); *Borsa Italiana S.p.A.* (avail. Sept. 24, 2004); *EDX London Limited* (avail. Oct. 29, 2003); *Tokyo Stock Exchange, Inc.* (avail. Nov. 15, 2002); *ParisBourse SA* (avail. Dec. 6, 1999); *Tokyo Stock Exchange* (avail. July 27, 1999); *Osaka Securities Exchange* (avail. July 23, 1999); *Mercato Italiano dei Derivati* (avail. Sept. 1, 1998); *Société de Compensation des Marchés Conditionnels* (avail. June 17, 1996); *The London International Financial Futures and Options Exchange* (avail. Mar. 6, 1996); *Hong Kong Futures Exchange Limited* (avail. Sept. 26, 1995).

96 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,021 (July 18, 1989).

97 SEC, Division of Trading and Markets, "Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers," Question 9 (Mar. 21, 2013 (updated Apr. 14, 2014)) (hereinafter, the "2013 15a-6 FAQ").

98 Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,651 (June 23, 1988). However, Rule 15a-6 and the Rule 15a-6 Adopting Release detail circumstances and procedures under which distribution of research reports is permitted without triggering a broker-dealer registration requirement. *See* § 14.03[3][b][iii].

99 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,022 n.103 (July 18, 1989). However, a foreign broker-dealer effecting unsolicited transactions on behalf of a U.S. investor in reliance on Rule 15a-6(a)(1) may send confirmations and account statements directly to the U.S. investor in connection with such transactions. 2013 15a-6 FAQ at Question 3.

100 2013 15a-6 FAQ, Question 2.

101 2013 15a-6 FAQ, Question 2.

102 Rule 15a-6(a)(4)(i) under the Exchange Act. Unlike the treatment of broker-dealers and banks for purposes of "qualified institutional buyer" status in Rule 144A under the Securities Act, there is no requirement that any solicited broker-dealers or banks own securities of a minimum value or, in the case of banks, have a minimum net asset value.

103 *See*, *e.g.*, *Wood Gundy, Inc.* (avail. Dec. 9, 1985) (permitting an unregistered foreign broker-dealer to

execute unsolicited orders received from registered broker-dealers filling orders of their U.S. customers); *Bear Stearns/Sun Hung Kai* (avail. Feb. 6, 1976) (permitting an unregistered foreign broker-dealer to fill its own customers' orders for U.S. securities and to maintain an account for its own customers with a registered broker-dealer).

104 For a discussion of certain consequences that may arise when the foreign and U.S. broker-dealer are affiliated, *see* § 14.04.

105 *See* § 14.03[1][c]. The acknowledgment in Rule 15a-6(a)(4)(i) that banks may act in a broker or dealer capacity codified positions taken in pre-Rule 15a-6 no-action letters. *See*, *e.g.*, *National Westminster Bank PLC* (avail. July 7, 1988); *Security Pacific Corp.* (avail. Apr. 1, 1988).

106 The writing of a derivative instrument by a foreign dealer (or any other entity) that may be characterized as a security may be viewed as the offer and sale of that security requiring registration under the Securities Act unless an exemption is available. *See* § 1.02.

The question also arises whether a foreign dealer is an investment company that, if its securities (including possibly OTC instruments it has written that are classified as securities) are held by more than 100 U.S. persons and such persons do not all satisfy the definition of "qualified purchaser," is required to register with the SEC under the Investment Company Act. *See* § 15.06. Many dealers (or their affiliates engaged in derivative transactions and other financial activities) have assets consisting predominantly of securities, as a result of which they might be classified as investment companies. Section 3(c)(2) of the Investment Company Act excludes broker-dealers from the definition of investment company, but the SEC staff has apparently suggested on at least some occasions, though it would appear without statutory support, that the exclusion applies only to those broker-dealers registered with the SEC.

Section 3(c)(2) of the Investment Company Act also excludes companies whose primary activities include "acting as a market intermediary." A "market intermediary" is any person that regularly holds itself out as being willing contemporaneously to engage in, and that is regularly engaged in, the business of entering into "financial contracts" (*e.g.*, options, swaps and repurchase agreements). *See* § 3(c)(2)(B)(i) of the Investment Company Act.

107 Rule 15a-6(a)(4)(ii) under the Exchange Act. Each of these supranational organizations is also deemed a non-U.S. person for purposes of Regulation S under the Securities Act. *See* Rule 902(k)(2)(vi) under the Securities Act; § 8.02.

108 Rule 15a-6(a)(4)(iii) under the Exchange Act (emphasis added). Although the direct solicitation of certain non-U.S. investors temporarily present in the United States is authorized under Rule 15a-6, such solicitation may be subject to the antifraud or other provisions of the U.S. securities laws. In one case, however, the court found that an alleged offer and sale—through phone calls and facsimiles—of foreign securities by a foreign broker-dealer to a non-U.S. person vacationing in the United States were not sufficient to establish jurisdiction for purposes of the antifraud provisions of the Exchange Act under that court's tests regarding the "conduct" and "effect" of the foreign broker-dealer's activities, even if misrepresentations and reliance thereon occurred in the United States. *See Europe & Overseas Commodity Traders S.A. v. Banque Paribas London* 147 F.3d 118 (2d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999); *see also Interbrew S.A. v. EdperBrascan Corp.*, 23 F. Supp. 2d 425 (S.D.N.Y. 1998). *In Morrison v. National Australian Bank Ltd.*, the Supreme Court replaced the "conducts" and "effects" tests with a "transactional" test (*i.e.*, purchases and sales in the United States or securities listed on U.S. exchanges). The Dodd-Frank Act restored the "conducts" and "effects" tests for actions brought by the SEC or the DOJ and mandated the SEC to study whether such tests should replace the Morrison "transactional" test with respect to private rights of action as well. *See Morrison v. National Australian Bank Ltd.*, 561 U.S. 247 (2010); §§ 929P and 929Y of the Dodd-Frank Act. The SEC released a study in 2012 "on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act," which did not take a position on whether Congress should override the *Morrison* transactional test for private rights of action. *See* SEC, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 AS REQUIRED BY SECTION 929Y OF THE [DODD-FRANK ACT] (Apr.

11, 2012).

109 2013 15a-6 FAQ, Question 1.

110 *See* Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,649 (June 23, 1988) ("[T]he primary responsibility for protecting foreign investors from wrongful conduct of foreign securities professionals properly lies with foreign securities regulators.").

111 *Cf.* SEC Release No. 34-42906 (June 7, 2000) (granting an Order pursuant to § 15(a)(2) of the Exchange Act exempting certain Canadian broker-dealers from the requirements of § 15(a)(1) of the Exchange Act when soliciting or effecting transactions in securities for U.S. residents or those temporarily in the United States with respect to their Canadian Retirement Accounts); *see also* Rule 237 under the Securities Act and Rule 7d-2 under the Investment Company Act; SEC Release No. 33-7860 (June 7, 2000).

112 *See* § 8.02[1][a].

113 *Cleary, Gottlieb, Steen & Hamilton* (avail. Nov. 22, 1995, revised Jan. 30, 1996) (hereinafter the "1996 Cleary Letter"). An "offshore client" is defined for this purpose as (i) any entity not organized or incorporated under the laws of the United States and not engaged in a trade or business in the United States for U.S. federal income tax purposes, (ii) any natural person who is not a U.S. resident, or (iii) any entity not organized or incorporated under the laws of the United States substantially all of the outstanding voting securities of which are beneficially owned by a person described in (i) or (ii) above. A condition of the relief in the 1996 Cleary Letter is that the foreign broker-dealer will obtain written assurance from the U.S.-resident professional fiduciaries that the account is managed for an offshore client. Note that the definition of "offshore client" is not the same as the definition of "non-U.S. person" in Regulation S and, in those cases in which the offshore client definition is narrower than the non-U.S. person definition, a foreign broker-dealer effecting a Regulation S transaction with a U.S.-based adviser for the non-U.S. person will not be able to rely on the relief provided by the 1996 Cleary Letter.

A "foreign security" is defined for purposes of the 1996 Cleary Letter as (i) a security issued by an issuer not organized or incorporated under the laws of the United States when the transaction in such security is not effected on a U.S. exchange or through the Nasdaq system (including a depositary receipt issued by a U.S. bank, but only if it is initially offered and sold outside the United States in accordance with Regulation S), (ii) a debt security (including a convertible debt security) issued by an issuer organized or incorporated in the United States in connection with a distribution conducted outside the United States, or (iii) any OTC derivative instrument on an instrument described in (i) or (ii) above; *provided*, *however*, that debt securities of an issuer organized or incorporated under the laws of the United States do not constitute "foreign securities" if they are offered and sold as part of a "global offering" involving both a distribution of the securities in the United States under a Securities Act registration statement and a contemporaneous distribution outside the United States.

Although the no-action position set forth in the 1996 Cleary Letter is technically applicable only to those SEC-registered broker-dealers cited in the letter and their non-U.S. affiliates, it should be possible for other broker-dealers to rely on the position taken in the letter so long as all other requirements of the letter are met.

114 Rule 15a-6(a)(4)(iv) and (v) under the Exchange Act.

115 Rule 15a-6(a)(4)(v) under the Exchange Act.

116 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,017 & n.51 (July 18, 1989).

117 For purposes of certain of the safe harbor rules under Regulation S, an agency or branch of a U.S. person located outside the United States is a U.S. person unless the agency or branch (i) operates for valid business reasons and (ii) is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation by the relevant foreign jurisdiction. *See* Rule 902(k)(2)(v) under the Securities Act. (Rule 15a-6 under the Exchange Act contains no comparable conditions for agencies or branches permanently located outside the United States to be treated as non-U.S. persons.) In addition, the general statement of territorial jurisdiction of the registration provisions of the Securities Act in Regulation S and the Regulation S safe harbor provisions for "Category 1" issuers permit offers and sales outside the

United States even to U.S. residents. *See* § 8.02[1][c][i].

118 In conjunction with the adoption of Rule 15a-6, the SEC issued no-action letters that permitted foreign broker-dealers to distribute research reports in accordance with Rule 15a-6 without such activity triggering a requirement to register under the Advisers Act. *See*, *e.g.*, *Dean Witter Reynolds (Canada)* (avail. Mar. 1, 1990).

119 *See* Rule 15a-6(b)(4) under the Exchange Act.

"U.S. institutional investor" means: (i) a registered investment company, or (ii) a bank, savings and loan association, insurance company, business development company, small business investment company or employee benefit plan as defined in Rule 501(a)(1) of Regulation D under the Securities Act; a private business development company as defined in Rule 501(a)(2); an organization described in § 501(c)(3) of the I.R.C., as defined in Rule 501(a)(3); or a trust as defined in Rule 501(a)(7). *See* Rule 15a-6(b)(7) under the Exchange Act. U.S. branches and agencies of foreign banks are "banks" for purposes of the definition of U.S. institutional investor. *See* § 14.03[1][d].

120 The SEC Release reproposing Rule 144A, which was issued the same day that Rule 15a-6 was adopted, suggested that the "qualified institutional buyer" and "major U.S. institutional investor" definitions were intended to be identical. *See* SEC Release No. 33-6839 (July 11, 1989), 54 Fed. Reg. 30,076, 30,079 n.17 (July 18, 1989). Further, the Rule 15a-6 Proposing Release had provided that corporations generally could be within the definition of "U.S. institutional investor." *See* Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,654 n.73 (June 23, 1988). The Rule 15a-6 Adopting Release did not explain why the "institutional investor" definition was revised between proposal and adoption. It is thus not clear whether the different treatment of corporations in Rules 144A and 15a-6 was the result of an unexplained SEC policy decision or was inadvertent.

121 *See Cleary, Gottlieb, Steen & Hamilton* (avail. Apr. 9, 1997); *Cleary, Gottlieb, Steen & Hamilton* (avail. Apr. 28, 1997) (hereinafter collectively the "1997 Cleary Letter"). "Aggregate financial assets" include cash, money-market instruments, securities of unaffiliated issuers, futures and options on futures and other derivative instruments. *See* 1997 Cleary Letter. *See also Roland Berger Strategy Consultants* at n.3 (avail. May 28, 2013).

122 *See* 2013 15a-6 FAQ.

123 The Rule 15a-6 Adopting Release emphasized that even "implied" soft dollar arrangements constitute solicitation. Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,023 (July 18, 1989). For a brief description of "soft dollar" arrangements, *i.e.*, the use of brokerage commission payments to compensate for the provision of research, *see* §§ 14.07[1][a] and 16.09.

124 This condition by its express terms applies only to securities that have been the subject of a research report. *But see* the discussion of "solicitation" in § 14.03[3][b][i].

125 A registered broker-dealer "accepts responsibility" by taking "reasonable steps to satisfy itself regarding key statements in the research," or, where limited information is available, making "certain that neither the facts nor the analysis appear inconsistent with outstanding information regarding the issuer." Rule 15a-6 Adopting Release, 54 Fed. Reg. 30013, 30023 n.116 (July 18, 1989). In addition, research prepared by a foreign broker-dealer that is distributed by a U.S. broker-dealer must contain certain additional disclosures required by applicable SRO rules. *See* § 14.07[3][a] for a discussion of these rules.

126 Subject to these conditions, research also may be distributed *via* an electronic database. *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,023 n.114 (July 18, 1989); *see also James Capel* (avail. Dec. 6, 1989) (permitting a foreign broker-dealer to receive a fee for making its research available electronically).

127 Foreign broker-dealers that are affiliated with SEC-registered broker-dealers and that distribute research reports to U.S. investors are, however, subject to the certification requirements of Regulation AC, whereas foreign broker-dealers without such affiliation that issue research reports to U.S. investors solely in reliance on the exemption from registration provided by Rule 15a-6(a)(2) are exempt from Regulation AC's certification requirements. *See* § 14.07[5][a] for a further discussion of Regulation AC.

128 *NASD* (avail. Dec. 5, 1989).

129 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,018 (July 18, 1989). Transactions resulting from the distribution of quotations on such a quotation system would be deemed "unsolicited."

130 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,018–30,019 (July 18, 1989).

131 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,018 n.66 (July 18, 1989). Among the third-party quotation systems as to which the SEC provided relief is one run by Topic Services, Inc., which disseminated quotations of market-makers in securities listed on the Irish Stock Exchange's Stock Exchange Automated Quotations and SEAQ International Systems (the "Topic System"). The Topic System, at the time of the SEC's approval, provided quotations to approximately 40 U.S. subscribers, made up of a mix of registered broker-dealers and large institutional investors. *See generally* SEC Release No. 34-30033 (Dec. 4, 1991). *Cf. London Traded Options Market* (avail. Sept. 4, 1990); SEC Release Nos. 34-28331 (Aug. 13, 1990), 34-25457 (Mar. 14, 1988) (NASD-Stock Exchange of Singapore). *See Topic Services, Inc.* (avail. Oct. 4, 1989); *Topic Services, Inc.* (avail. Dec. 23, 1987); *Topic Services, Inc.* (avail. June 3, 1987); *Topic Services, Inc.* (avail. Aug. 2, 1986). With respect to other third-party systems, *See NASD* (avail. Dec. 5, 1989); *NASD* (avail. Mar. 18, 1988); *NASD* (avail. June 9, 1987); *NASD* (avail. Oct. 22, 1986); *NASD* (avail. May 7, 1986) (NASD-ISE); *see also Topic Services, Inc.* (avail. Nov. 28, 1986).

132 *See* 1997 Cleary Letter.

133 SEC Release No. 34-27080 (July 31, 1989), 54 Fed. Reg. 32,403, 32,404 (Aug. 7, 1989). The SEC's approval for any individual stock exchange linkage will depend upon the SEC being "satisfied that adequate safeguards and procedures have been established and implemented to protect investors and detect fraudulent or manipulative acts or practices." *See* SEC Release No. 34-27080, 54 Fed. Reg. 32,403, 32,404 (Aug. 7, 1989) (July 31, 1989).

134 SEC Release No. 34-35116 (Dec. 19, 1994); SEC Release No. 34-21925 (Apr. 8, 1985).

135 SEC Release No. 34-22442 (Sept. 20, 1985).

136 SEC Release No. 34-23075 (Mar. 28, 1986).

137 The other exchanges are the Australian Stock Exchange, Euronext (Amsterdam, Brussels, Paris), the Hong Kong Exchanges and Clearing Ltd., the Bolsa Mexicana de Valores, the Bolsa de Valores de Sao Paulo, the Tokyo Stock Exchange and the Toronto Stock Exchange. *See* Press Release, NYSE, 10 Leading Equities Exchanges Jointly Announce Global Equity Market Partnership Talks (June 7, 2000).

138 Subsequent to the adoption of Rule 15a-6, the SEC approved the establishment on a pilot basis of the Nasdaq International Service ("Nasdaq International"), an automated trading system that operated from 3:30 A.M. to 9:00 A.M., New York time, and that was primarily intended to accommodate institutional investors wishing to trade U.S. securities when markets are open in Europe. *See* SEC Release No. 34-29812 (Oct. 11, 1991); *see also* NASD Notice to Members 91-70 (Nov. 1991). In connection with the SEC's approval of Nasdaq International, the SEC staff issued a no-action letter permitting U.K. broker-dealers, not themselves registered with the SEC but affiliated with SEC-registered broker-dealers, to participate in Nasdaq International by executing transactions as agents for their SEC-registered affiliates. *See Nasdaq International Service* (avail. Oct. 11, 1991, revised Jan. 11, 1993); *see also* SEC Release No. 34-46589 (Oct. 2, 2002) (extending the expiration of the Nasdaq International pilot program to October 9, 2003). The Nasdaq International pilot program expired in 2003 and the related NASD rules were removed in 2006. *See* SEC Release No. 34–54084 (June 30, 2006).

139 SEC Release No. 34-41199 (Mar. 22, 1999) (granting relief to Tradepoint based on its small volume) (hereinafter the "Tradepoint Release"). Tradepoint Financial Networks plc was renamed "Virt-X plc" and the Tradepoint Stock Exchange was renamed "Virt-X Exchange Limited." *See Virt-X* (avail. June 21, 2001). In 2008, Virt-X changed its name to SWX Europe. As of April 30, 2009, SWX Europe ceased trading and all business was transferred to the SIX Swiss Exchange. *See* SIX Swiss Exchange message no. 20/2009 (Apr. 17, 2009), *available at* http://www.six-swiss-exchange.com/swx_messages/online/swx_message_200904171332_en.pdf.

140 Under the terms of the exemption, as extended by later no-action relief, Tradepoint's exemption is subject to certain conditions, including that: (i) the average daily dollar value of trades involving a U.S. member (measured on a quarterly basis) does not exceed U.S.$40 million, (ii) Tradepoint's worldwide average trading daily volume (calculated on a dollar basis and measured quarterly) does not exceed ten percent of the average daily volume on the London Stock Exchange, (iii) Tradepoint only offers trading in securities that are both eligible to be traded on the London Stock Exchange and listed by a competent European listing authority in a European Union member state, Norway or Switzerland, and (iv) Tradepoint provides the SEC with a quarterly certification that no trades by U.S. members have been effected in Swiss blue chip securities (in which Tradepoint was expected to obtain a substantial market share through an arrangement with the Swiss Stock Exchange). In addition, Tradepoint must comply with a number of additional conditions, including recordkeeping and reporting requirements, SEC access to books and records, SEC access to real-time quotes and trading information, procedures to ensure the nondisclosure of confidential information, compliance with U.S. trading halts and cooperation with SEC investigations. *Virt-X* (avail. June 21, 2001).

141 *See supra* Note 119. In 2012, the SEC provided no-action relief to the foreign affiliate of a U.S.-registered broker-dealer whereby such foreign affiliate could, through a chaperoning arrangement with the U.S.-registered broker-dealer, engage in certain merger and acquisition activities with certain U.S. customers who, despite having at least $100 million in assets, did not meet the definition of major U.S. institutional investor in Rule 15a-6 or $100 Million Entities in the 1997 Cleary Letter. *See Ernst & Young Corporate Finance (Canada) Inc.* (avail. July 12, 2012). The SEC's relief was limited to situations in which the customer had $100 million in total assets (not just financial assets) and the merger and acquisition activities involved a private placement and resulted in the transfer of control of an entire company or business unit. *See Ernst & Young Corporate Finance (Canada) Inc.* (avail. July 12, 2012).

142 *See Chase Manhattan Corp.* (avail. July 28, 1987); *see generally* § 14.03[3][a].

143 According to the Rule 15a-6 Adopting Release, the chaperoning broker-dealer may not be a bank, even if the bank is acting in a broker or dealer capacity. *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,026 (July 18, 1989). This statement was made in recognition of the fact that banks were at the time exempt from the definitions of "broker" and "dealer" under the Exchange Act. Presumably, since banks now no longer enjoy a blanket exemption from the definitions of "broker" and "dealer," a bank registered as a broker or dealer would be eligible to act as the chaperoning broker-dealer for this purpose (however, as a practical matter, bank registration as a broker or dealer is unlikely). *See* § 14.03[1][a]–[c].

144 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,024 & 30,025 n.149 (July 18, 1989).

145 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,024 n.133 (July 18, 1989). A registered broker-dealer likewise could serve, consistent with its responsibilities as discussed in § 14.03[3][c][ii], as the chaperoning broker-dealer for any number of qualifying foreign broker-dealers.

146 Rule 15a-6 Adopting Release.

147 Rule 15a-6(a)(3)(i)(B) under the Exchange Act. This condition is subject to the limitation that it will not be deemed to have been violated if the qualifying foreign broker-dealer uses its best efforts to obtain requested information, including seeking government assistance and consent of its customers where necessary, but is prevented from providing it by applicable foreign law or regulation. However, if not legally able to respond to the SEC's request for information because of a "blocking statute" or otherwise, a qualifying foreign broker-dealer may have its "qualifying" status and its ability to rely on the Rule 15a-6(a)(3) exemption revoked by the SEC. Revocation would be prospective only, and would be by notice and hearing to which ordinary procedural rights would attach.

148 *See* Rules 15a-6(a)(3)(iii)(C) and (D) and 15a-6(b)(2) under the Exchange Act. The information that the chaperoning broker-dealer must obtain with respect to the qualifying foreign broker-dealer's personnel is specified in Rule 17a-3(a)(12) under the Exchange Act and the review the chaperoning broker-dealer must perform is substantially the same as it would perform for its own personnel. In particular, the chaperoning broker-dealer must determine that these persons are not subject to a "statutory disqualification" (as defined

at § 3(a)(39) of the Exchange Act) and have not been the subject of any foreign sanction "substantially equivalent" to those that would require statutory disqualification. Rule 15a-6(a)(3)(ii)(B) under the Exchange Act; *see* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,028 (July 18, 1989); *see also* Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,653 n.70 (June 23, 1988). *See generally* § 14.08[1].

149 *See* Rule 15a-6(a)(3)(iii)(B) under the Exchange Act; 1997 Cleary Letter.

150 *See* Rule 15a-6(a)(3)(ii) under the Exchange Act. This condition of participation by a chaperone applies to visits within the United States to major U.S. institutional investors even though no similar condition applies when the solicitation is done from outside the United States. Participation by the chaperone may be in person or by telephone. *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,029 n.191 (July 18, 1989).

151 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,028 n.179 (July 18, 1989).

152 *See* 1997 Cleary Letter. The 30-day limit is not applied to the foreign broker-dealer as a whole, but separately to each foreign associated person. *See* 2013 15a-6 FAQ, Question 17.

153 *See* Rule 15a-6(a)(3)(i)(A) and (iii)(A)(1) under the Exchange Act.

154 *See* Rule 15a-6(a)(3)(iii)(A) under the Exchange Act.

155 To the extent required by foreign law or as required by a firm's internal policies and procedures applicable to its global business operations, a foreign broker-dealer may send confirmations and account statements directly to U.S. counterparties. However, the chaperoning broker-dealer maintains the obligation to make sure that confirmations and account statement sent to the investor comply with all applicable U.S. requirements. Such statements must clearly identify the U.S. broker-dealer on whose behalf the document is sent. *See* 2013 15a-6 FAQ, Question 4.

156 The margin regulations provide that a registered broker-dealer may arrange for a foreign person (including a foreign broker-dealer) to extend credit for the purpose of purchasing or carrying securities, subject to compliance with the Board's margin regulations applicable to the borrower and lender. *See* § 14.07[6][a]. Note, however, that credit arranged by the registered broker-dealer may be subject to the restrictions of § 11(d)(1) of the Exchange Act. *See* § 14.07[6][c].

157 Rule 17a-7 under the Exchange Act provides that a registered broker-dealer located outside the United States either must maintain all Exchange Act-required records in the United States or provide the SEC with a written undertaking to send its records to the SEC promptly upon the SEC's request. However, the Rule 15a-6 Adopting Release states that all Rule 15a-6-required records must be kept in the United States. Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,029 & n.198 (July 18, 1989).

The 2013 15a-6 FAQ states that the chaperoning broker-dealer must comply with Rules 17a-3 and 17a-4, discussed at § 14.08. While the chaperoning broker-dealer may obtain this information from the foreign broker-dealer or another source, it is responsible for the accuracy of its books and records. *See* 2013 15a-6 FAQ, Question 16.

158 The net capital and customer protection rules are discussed at § 14.07[2]. The responsibilities of the chaperoning broker-dealer include taking net capital charges for any failed transactions. *See* 2013 15a-6 FAQ, Question 15. Note that the customer protection rule provides for the use of designated foreign control locations, so foreign securities need not actually be kept in the United States. *See* Rule 15c3-3(c)(4) under the Exchange Act. *See also* 2013 15a-6 FAQ, Questions 10, 11, 13, 14 and 15. The chaperoning broker-dealer may be a registered introducing broker-dealer as long as the chaperoning broker-dealer has in effect a fully disclosed carrying agreement with another registered broker-dealer that has agreed to comply with the financial responsibility rules. *See* 2013 15a-6 FAQ, Question 12.

159 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,025 & n.150 (July 18, 1989). In addition, under the 1997 Cleary Letter, transactions involving foreign securities, *See supra* Note 121, or U.S. Government securities effected in reliance on Rule 15a-6(a)(3) may now be cleared and settled through the direct transfers of funds and securities between the U.S. investor and the qualifying foreign broker-dealer in situations where the qualifying foreign broker-dealer is not acting as the custodian of the funds or securities

of the U.S. investor. *See* 1997 Cleary Letter. Moreover, in countries whose laws and regulations make some of the above-listed activities illegal or highly impractical for the chaperoning broker-dealer to perform, the SEC has shown a willingness to grant relief on a firm-by-firm, country-by-country basis. *See*, *e.g.*, *Morgan Stanley India Securities Pvt. Ltd.* (avail. Dec. 20, 1996) (staff would not recommend enforcement where chaperoning broker-dealer barred by the law of India from holding funds and securities on behalf of its U.S. customers transacting in Indian securities and Indian trades generally are not entered onto the chaperoning broker-dealer's books and records).

160 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,025 (July 18, 1989).

161 *See generally* § 14.07[1][a].

162 *See* Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,654 (June 23, 1988).

163 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,025 (July 18, 1989).

164 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,026 (July 18, 1989). The release states that "if the registered broker-dealer ignores indications of irregularity that should alert the registered broker-dealer … that the foreign broker-dealer is taking advantage of U.S. customers or otherwise violating U.S. securities laws, … the registered broker-dealer's role in the trades may give rise to possible violations of the federal securities laws."

165 *See* Treas. Reg. § 401.7; *see also* 55 Fed. Reg. 27,461 (July 3, 1990) (adopting Treasury exemptive rule); 55 Fed. Reg. 7733 (Mar. 5, 1990) (proposing Treasury exemptive rule). Additional exemptive action was necessary as it is the Treasury, rather than the SEC, that had authority to exempt government securities broker-dealers from Exchange Act registration. *See* § 15C(a)(5) of the Exchange Act. (Rule 15a-6 does by its terms, however, apply to municipal securities activities.)

166 *See* 1997 Cleary Letter.

167 Treasury's exemptive rule differs from Rule 15a-6 in two respects. First, a foreign government securities broker-dealer may, in making use of Treasury's conditional exemptions, enter into a chaperoning relationship not only with a registered broker-dealer but also with a registered government securities broker-dealer or with a financial institution that has given notice of its government securities broker-dealer activities to the appropriate regulatory agency. Second, a foreign government securities broker-dealer that has established a chaperoning relationship with a registered broker-dealer must disclose that fact in any research reports concerning government securities that the foreign broker-dealer distributes to major U.S. institutional investors and $100 Million Entities.

168 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,021 (July 18, 1989).

169 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,021 (July 18, 1989).

170 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,021 & n.94 (July 18, 1989); *see* § 14.11[2] regarding penalties for violation of the Exchange Act.

171 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,021 n.94 (July 18, 1989).

172 SEC Release No. 34-27018 (July 11, 1989), 54 Fed. Reg. 30,087, 30,090 (July 18, 1989).

173 The SEC briefly revived the concept of reliance on home-country regulation in a concept release regarding the regulation of exchanges and alternative trading systems. SEC Release No. 34-38672 (May 23, 1997). In that release, the SEC suggested that one approach to regulating the activities of foreign markets—as opposed to foreign broker-dealers—in the United States would be to rely on the foreign markets' home-country regulation. SEC Release No. 34-38672 (May 23, 1997).

174 *See*, *e.g.*, Ethiopias Tafara & Robert Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007); Erik R. Sirri, Director, SEC Division of Market Regulation, Trading Foreign Shares (Mar. 1, 2007); Roel C. Campos, Commissioner, SEC, SEC Regulation Outside the United States (Mar. 8, 2007) (identifying "thorny issues [that] must be resolved" before implementing mutual recognition); Annette L. Nazareth, Commissioner, SEC, Remarks Before the Brown Spring Forum: Economics, Entrepreneurship & Technology (Apr. 28, 2007); Christopher Cox, Chairman, SEC, Address to the Security Traders Association 11th Annual Washington Conference (May 9, 2007);

Paul S. Atkins, Commissioner, SEC, Remarks before AmCham Germany (May 30, 2007); *see also* Edward F. Greene, *Resolving Regulatory Conflicts between the Capital Markets of the United States and Europe*, 2 CAPITAL MARKETS L.J. 5 (Winter 2007); Edward F. Greene, *Beyond Borders: Time To Tear Down the Barriers to Global Investing*, 48 HARV. INT'L L.J. 85 (Winter 2007); Edward F. Greene, *Beyond Borders Part II: A New Approach to the Regulation of Global Securities Offerings* (SEC Historical Society Paper, May 2007).

175 Press Release, SEC, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 25, 2008). The Australian mutual recognition agreement has not yet been used by the SEC.

176 Press Release, SEC, Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement (May 29, 2008); Press Release, SEC, Statement of the European Commission and the [SEC] on Mutual Recognition in Securities Markets (Feb. 1, 2008).

177 *See*, *e.g.*, CFTC Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013) (Adopting a policy that, if the CFTC has determined that certain laws and regulations of a foreign jurisdiction are comparable to and as comprehensive as a corresponding category of U.S. laws and regulations, entities or transactions in that foreign jurisdiction that comply with those foreign laws and regulations will be deemed in compliance with such corresponding category of U.S. laws and regulations.); CFTC Rule 23.160, allowing swap dealers and major swap participants to satisfy certain margin obligations to non-U.S. persons by posting margin as required by foreign regulations where the CFTC has issued a "comparability determination" with respect to the foreign jurisdiction's requirements (§17 C.F.R. 23.160); Commission Implementing Decision (EU) 2016/377 of 15 March 2016, 2016 O.J. (L 70) 32 (European Union decision implementing equivalence treatment for U.S. central clearing counterparties registered with the CFTC).

Although the shape of the British exit from the European Union is currently unknown, it is possible that it will further expand the acceptance by the European Union of equivalent foreign regulation, which could lead U.S. regulators (including the SEC) to also consider expanding their recognition of equivalent or comparable foreign regulation.

178 *See* § 14.03[3][c][i].

179 *See* § 14.04[2].

180 *See* § 14.03[3][i].

181 *See* § 14.08[1].

182 *See* § 14.04[2].

183 *See* 1997 Cleary Letter.

184 "Foreign security," for this purpose, is defined by reference to the 1996 Cleary Letter. *See* § 14.03[3][b][ii][C]; *supra* Note 113.

185 In addition, the 1997 Cleary Letter clarifies that a foreign broker-dealer may initiate follow-up contacts with major U.S. institutional investors and $100 Million Entities to whom it has furnished research reports without violating the limitations of Rule 15a-6(a)(2)(ii), if such follow-up contacts occur in the context of a "chaperoning" relationship between a foreign broker-dealer and a U.S. intermediary broker-dealer under paragraph (a)(3) of the rule.

186 Although several prior Regulatory Flexibility Agendas published by the SEC had included a specific reference to consideration of a revision to Rule 15a-6 to focus on the types of securities that are sold by non-U.S. broker-dealers to allow institutional investors to take advantage of the efficiencies of foreign markets, the most recent Regulatory Flexibility Agendas have omitted this item and certain SEC staff members have indicated that further consideration of Rule 15a-6 is not anticipated in the near term. *See*, *e.g.*, SEC Release No. 34-50445 (Sept. 20, 2004); SEC Release No. 34-46512 (Dec. 9, 2002); SEC Release No. 34-45627 (Mar. 22, 2002); SEC Release No. 34-44909 (Oct. 5, 2001); SEC Release No. 34-44154 (Apr. 5, 2001). On the other hand, renewed interest in a "mutual recognition" approach, *see* § 14.03[3][f], may lead the SEC to reconsider its position on making further changes to Rule 15a-6.

187 *Roland Berger Strategy Consultants* (avail. May 28, 2013).

188 In the letter, the staff noted that such contact might include telephone calls, e-mails, and related mailing of general pitch materials regarding the proposed transaction. *See Roland Berger Strategy Consultants* (avail. May 28, 2013).

189 *See Roland Berger Strategy Consultants* (avail. May 28, 2013).

190 *See Roland Berger Strategy Consultants* (avail. May 28, 2013).

191 *See Roland Berger Strategy Consultants* (avail. May 28, 2013).

192 NAFTA, Art. 1406.

193 NAFTA, Art. 1402.

194 *See* § 14.06[1][b].

195 *See* § 14.06[2][b] (regarding certain special requirements imposed by U.S. SROs on nonresident broker-dealers).

196 NAFTA, Art. 1410(1); *see*, *e.g.*, SEC Release No. 34-52209 (Aug. 4, 2005), 70 Fed. Reg. 46,557, 46,558 n.18 (Aug. 10, 2005) (approving changes to NASD Rule 2790 over the objection that it unduly burdened Canadian mutual funds in violation of NAFTA on the ground that "the [SEC] believes that the Rule is grounded in investor protection concerns and is not intended to unduly burden foreign investment companies").

197 *See* Rule 15c3-3(a)(7) under the Exchange Act (permitting broker-dealers whose principal place of business is in Canada to maintain required reserves at a Canadian-regulated bank while requiring broker-dealers whose principal place of business is in any other country to maintain reserves in the United States).

198 *See* 22 U.S.C. §§ 5341–5342 (prohibiting foreign firms from being designated as primary dealers in U.S. government debt obligations unless the home country of the foreign firm accords to U.S. firms the same competitive opportunities as are accorded to domestic firms in the underwriting and distribution of government debt instruments in the firm's home country).

199 The Advisers Act generally requires foreign banks wishing to engage in securities advisory services with the public in the United States to register with the SEC, while domestic banks are generally exempt from registration. (Pursuant to the GLB Act, the Advisers Act was amended, effective May 12, 2001, to require U.S. domestic banks, or departments or divisions thereof, to register with the SEC to the extent they serve as investment advisers to registered investment companies.) *See* § 16.03[2][a].

The United States has also taken reservations for certain provisions of the Trust Indenture Act, the CEA, legislation regulating the provision of surety bonds for U.S. government contracts (31 U.S.C. § 9304) and several banking statutes. *See* NAFTA, Annex VII(A)—United States.

200 The principal obligations of NAFTA Chapter 14 do not apply to existing measures (as of January 1, 1994) maintained by local (*e.g.*, municipal) governments. NAFTA, Art. 1409(1)(a)(iii). Local governments may not, however, enact new measures after NAFTA's entry into force that violate the obligations of NAFTA Chapter 14.

201 However, state law registration of federally licensed branches of foreign banks may be preempted. *See*, *e.g.*, Comptroller, Interpretive Letter No. 590, Fed. Banking L. Rep. (CCH) ¶83,415 (June 18, 1992) (stating that Illinois restrictions on the establishment of Federal branches do not limit the authority of the Comptroller to license Federal branches of foreign banks in Illinois). For a discussion of the federal broker-dealer push-out rules, *see* § 14.03[1][c].

202 *See* §§ 3.02[8][a] and 14.12.

203 NAFTA, Art. 1404.

204 For example, while the SEC has broad powers to subpoena witnesses and evidence, it cannot serve or enforce its subpoenas abroad. *See* § 21(b) under the Exchange Act; *CFTC v. Nahas*, 738 F.2d 487 (D.C. Cir. 1984); *SEC v. Zanganeh*, 470 F. Supp. 1307 (D.D.C. 1978). In addition, foreign banks or other financial record-holding institutions are often forbidden by their domestic laws from divulging information to the SEC.

See § 11.10[4].

205 Congress granted the SEC the legislative authority to gather and provide information and access to its nonpublic records to foreign securities regulatory authorities by amending the Exchange Act; it now allows the SEC to conduct investigations and compel the testimony of witnesses and the production of documents in the United States on behalf of such authorities, even if the alleged conduct would not constitute a violation of U.S. law. *See* §§ 21(a)(2) and 24(c) of the Exchange Act.

206 MOU to Establish Mutually Acceptable Means for Improving Law Enforcement in the Field of Insider Trading (Aug. 31, 1982), reprinted in 22 I.L.M. 1 (1983) (the "1982 Swiss MOU"). The 1982 Swiss MOU was an interim measure to address problems of insider trading because at the time, insider trading was not specifically a violation of Swiss law. Subsequent to the passage of a Swiss insider trading law in 1988, the Swiss MOU ceased to be in effect. In 1987, Switzerland and the United States signed a new MOU (the "1987 Swiss MOU") that provides procedures for collecting information using the 1977 Treaty for Mutual Assistance in Criminal Matters between the Swiss Confederation and the United States. 27 U.S.T. 2019, T.I.A.S. 8302 (entered into force Jan. 23, 1977); MOU, U.S.—Switzerland (Nov. 10, 1987), *reprinted in* 19 SEC. REG. & L. REP. (BNA) 1729 (Nov. 13, 1987). *See infra* Note 213 and accompanying text for discussion of the further amended 1993 Swiss MOU.

207 Argentina, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, Cayman Islands, Chile, China, Costa Rica, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hong Kong, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Japan, Jersey, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Mexico, The Netherlands, Norway, Poland, Portugal, Romania, Russia, Singapore, Slovak Republic, South Africa, Spain, Sweden, Switzerland and the United Kingdom. In addition, the SEC has information sharing arrangements with the European Commission, the College of Euronext Regulators, the Inter-American Development Bank and the United Nations Economic Commission for Latin America and the Caribbean. *See* Office of International Affairs, Cooperative Arrangements with Foreign Regulators, http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml.

208 *See* Office of International Affairs, Bilateral Information Sharing Arrangements, *The SEC Speaks in 2004* (Mar. 2004).

209 MOU on Exchange of Information Between the SEC and the CFTC and the United Kingdom Department of Trade and Industry and Securities and Investment Board (the "SIB," now the FSA) on Matters Relating to Securities, SEC Release No. IS-323 (Sept. 30, 1991); *see also* MOU between the SEC and the FSA (as of 2013, the Financial Conduct Authority (FCA)) Concerning Consultation, Cooperation and the Exchange of Information Related to Market Oversight and the Supervision of Financial Services Firms (Mar. 14, 2006).

210 Michael D. Mann, Joseph G. Mari & George Lavdas, *Developments in International Securities Law Enforcement and Regulation*, in CORPORATE LAW AND PRACTICE (Practising Law Institute, 1994).

211 *See supra* Note 7 regarding the extent of SEC asserted authority. The SEC has, in addition, concluded a number of agreements with U.K. financial regulators within the framework of the U.K. MOU, including a joint statement with the CFTC and the U.K. FSA (as of 2011, the FCA) setting forth an agenda for oversight of the OTC derivatives market and a joint initiative with the FSA (as of 2013, the FCA) to assess the global activities of major international securities firms. *See generally* Michael D. Mann, The SEC's International Enforcement Program and Bilateral and Multilateral Initiatives, in CORPORATE LAW AND PRACTICE (Practising Law Institute, 1996). *See also* MOU between the SEC, CFTC, Bank of England and Financial Services Authority (predecessor of the FCA) dated October 27, 1997 relating to the sharing of supervisory information and cooperation in emergency oversight.

212 *See generally* Jill E. Asch, *Comment, Bank Secrecy: A Barrier to the Prosecution of Insider Trading*, 4 EMORY INT'L L. REV. 185 (Spring 1990).

213 Switzerland-United States: Exchange of Letters Concerning the Treaty on Mutual Assistance in Criminal Matters (Nov. 3, 1993), *reprinted in* 33 I.L.M. 168 (1993).

214 Press Release, SEC, SEC, CFTC and Japanese Financial Services Agency Sign Information Sharing Agreement (May 17, 2002) (announcing the signing of Statement of Intent Concerning Cooperation,

Consultation and the Exchange of Information between Japan and the United States).

215 Press Release, SEC, MOU of the SEC and the Securities Bureau of the Japanese Ministry of Finance on Sharing Information (May 23, 1986), *reprinted in* 25 I.L.M. 1429 (1986), as amended by Amendment to the Statement of Intent (Jan. 16, 2006).

216 Press Release, SEC, SEC Announces IOSCO Unveiling of Multilateral Agreement on Enforcement Cooperation (Oct. 31, 2003).

217 IOSCO, Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (May 2002, revised May 2012).

218 IOSCO, List of Signatories to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange Of Information, https://www.iosco.org/about/?subSection=mmou&subSection1=signatories (last visited Oct. 7, 2016).

U.S. Regulation of the International Securities and Derivatives Markets, § 14.04, SEPARATELY ORGANIZED AND REGISTERED U.S. AFFILIATES

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

Notwithstanding Rule 15a-6 and SEC no-action relief granted in connection therewith, the range of U.S. securities activities an unregistered foreign broker-dealer is permitted to undertake remains limited. However, since SEC regulation of a broker-dealer is of the legal entity only and not of an affiliated group, it is possible for an international financial organization to establish a separately incorporated and SEC-registered broker-dealer affiliate that can carry out activities in the United States without subjecting the rest of the organization to SEC registration and regulation. [219]

[1] Regulation of SEC-Registered Affiliates

Registration of a U.S. broker-dealer affiliate by an international financial organization does not of itself increase the activities that a foreign unregistered broker-dealer that is part of that organization or its personnel may undertake in the United States. Nonetheless, the existence of a registered U.S. broker-dealer affiliate can facilitate the unregistered broker-dealer's undertaking of its U.S.-related activities. The registered U.S. broker-dealer affiliate can act as the chaperoning broker-dealer that is necessary for a qualifying foreign broker-dealer to take advantage of the conditional exemptions provided by Rule 15a-6 under the Exchange Act. [220] The registered affiliate can also provide the review and approval and satisfy the other requirements necessary to permit a non-U.S.

p. 14-54

broker-dealer to disseminate research in the United States. [221] The foreign unregistered broker-dealer and the SEC-registered broker-dealer may also trade with each other, both for their own accounts and for the accounts of their respective customers. [222]

A number of aspects of the relationship between a foreign broker-dealer and its affiliated U.S. broker-dealer may raise legal issues. In addition to the question of whether foreign broker-dealers can enter into transactions involving ongoing contractual relationships with U.S. investors, [223] such issues include the use of dual employees, the extent to which the U.S. and foreign broker-dealers can trade with discretion for the account of the other, the extent to which U.S. activity is attributed to the foreign broker-dealer and therefore raises the risk that the foreign broker-dealer is carrying out activities within the United States and the extent to which the foreign broker-dealer may be subject to U.S. taxes in respect of its business with U.S. investors.

[2] Dual Employees

A number of international broker-dealer organizations with both SEC-registered and foreign unregistered entities use personnel that are employees both of the foreign broker-dealer and of the U.S. registered broker-dealer ("dual employees") in contacts with U.S. investors. This practice was approved in the Rule 15a-6 Adopting Release in instances in which the dual employees were "subject to the registered broker-dealer's supervision and control and satisfied all U.S. SRO qualification standards" and were "stationed outside the United States." [224] Where the personnel in question are stationed inside the United States,

p. 14-54

p. 14-55

are registered under the auspices of the registered broker-dealer with the appropriate SRO, are subject to the supervision and control of the registered broker-dealer and their activities and transactions are on behalf of, and recorded on the books of, the registered broker-dealer, the practice of dual employment likewise would seem to comport with the requirements of the Exchange Act. However, failure of proper supervision and control by, or of proper attribution of the activities to, the registered broker-dealer could result in difficulties for the registered broker-dealer for failure to supervise its employees properly and for the foreign broker-dealer (and the employee) for failure to register under the Exchange Act. [225]

[3] Relations Between Registered and Unregistered Affiliates

Rule 15a-6 under the Exchange Act permits registered U.S. broker-dealers and unregistered foreign broker-dealers, whether affiliated or not, to trade with each other. [226] In connection with such transactions, the U.S. broker-dealer may be acting as agent or as riskless principal in transactions ultimately between a U.S. customer and a foreign broker-dealer. However, the SEC has expressed concern about dealing activities of foreign broker-dealers in the United States carried out through U.S. affiliates that are effectively controlled by the foreign dealer. In this regard, the SEC stated in the Rule 15a-6 Adopting Release that it

> does not intend this exemption to permit the foreign broker-dealer *to act as a dealer* in the United States through an affiliated registered broker-dealer. The … [SEC] recognizes that dealers in foreign markets may transmit securities positions to U.S. broker-dealer affiliates after the foreign markets close, so that the U.S. affiliates can continue trading those securities. If, however, the foreign broker-dealer *controlled* the registered broker-dealer's *day to day market-making activities* by explicit restrictions on the U.S. broker-dealer's ability to execute orders against the foreign broker-dealer's positions or to take independent positions, *the foreign broker-dealer could be considered a dealer subject to U.S. broker-dealer registration requirements*. [227]

A similar concern likely would arise if a U.S.-registered broker-dealer were acting as a dealer, even with the ability to take independent positions, as to securities positions that were held offshore by an entity that was not a *bona fide* "foreign dealer" within the meaning of Rule 15a-6, which requires that the dealer be a "non-U.S. resident person." [228] Among the factors that might be relevant to whether a dealer is properly characterized as "foreign" are the nature and level of its activities outside the United States and whether it would be deemed to be carrying out its activities within the United States, for example, by virtue of the fact that actual control over its activities or a portion thereof was exercised by persons in the United States. Certainly a U.S.-registered broker-dealer conducting dealer activities with complete discretion as to securities positions held by an unregistered U.S. affiliate would raise serious questions regarding the broker-dealer registration obligation of that affiliate.

In a 1992 release, the SEC expressed concern about U.S. broker-dealers that arranged trades in U.S. stocks with U.S. institutional customers, which trades were then shown as having been "executed" on the books of a foreign affiliate. [229] This release expressed the view that such transactions are "'overseas' in name only," and are executed overseas to evade U.S. trade reporting requirements, exchange fees or other regulations. Following this SEC statement, the NYSE adopted Rule 410B requiring, among other things, that trades in NYSE-listed securities in the United States that are arranged by an NYSE member but executed by a foreign affiliate be reported to the exchange. [230]

Other factors that may appropriately be the subject of consideration in determining whether activities are carried out within the United States include allocations of profit and loss or capital.

[a] Citicorp/Vickers Exemptive Order

p. 14-56
p. 14-57

The single precedent cited by the SEC in connection with its stated concern regarding foreign broker-dealer control of a registered broker-dealer was its 1986 exemptive order to Citicorp and its indirect subsidiary Vickers da Costa Securities, Inc. ("Vickers"), a registered broker-dealer. [231] The order permitted various Citicorp subsidiaries that were unregistered foreign broker-dealers ("Citicorp's Foreign Dealers") and Vickers to enter into an arrangement in which Vickers would serve as broker, or as "riskless principal," in trades ultimately between Vickers' U.S. customers and Citicorp's Foreign Dealers. [232]

The aspect of the Vickers exemptive order cited in the Rule 15a-6 Adopting Release related to the ability of Vickers to act as a Nasdaq market-maker in certain securities. A Nasdaq market-maker in a security must stand ready to continuously buy and sell such security for its own account. [233] However, due to the banking law restrictions then applicable to Vickers as a subsidiary of a bank affiliate, Vickers was not permitted to maintain a position in equity securities. Accordingly, Vickers could act as a Nasdaq market-maker only by immediately passing each long or short position it took to one of Citicorp's Foreign Dealers. The SEC exemptive order approving the Vickers arrangement provided that for each security in which Vickers acted as a Nasdaq market-maker, Citicorp's Foreign Dealers would place with Vickers standing buy/sell orders in a size large enough to permit Vickers to fulfill its market-making responsibilities. The orders were to be placed each week before the opening of trading in the United States. All standing buy/sell orders would contain broad price parameters (either 10% of the market price as of the close at the end of the preceding week or $2 per share, whichever was greater) and give Vickers discretion to execute trades within those parameters. [234] The SEC's exemptive order also provided that Citicorp's Foreign Dealers were "not permit[ted]" to alter their buy/sell orders during the course of the week; however, "in response to significant market changes … [Vickers could] request additional instructions." [235]

p. 14-57
p. 14-58

The most plausible interpretation of the SEC's citation to Vickers in the Rule 15a-6 Adopting Release is that it was intended to indicate that, even following adoption of Rule 15a-6, the degree of control possessed by Citicorp's Foreign Dealers over Vickers was so great that, absent specific additional relief, these dealers would be required to register with the SEC. This is particularly the case since the Vickers exemptive order itself provided, as the Rule 15a-6 Adopting Release notes, various "regulatory safeguards" not included in Rule 15a-6 intended to limit the degree of "control" Citicorp's Foreign Dealers had over Vickers. [236]

Another aspect of the Vickers arrangement was not mentioned in the Rule 15a-6 Adopting Release. For securities not quoted on Nasdaq, the SEC exemptive order permitted Vickers to enter quotations into the daily "pink sheets," which provide a quotation medium for these securities. [237] The Vickers exemptive order did not place explicit restrictions upon Citicorp's Foreign Dealers changing through the day the price and size parameters of orders for these non-Nasdaq securities.

[b] Security Pacific No-Action Letter

Between the issuance of the Vickers exemptive order and the adoption of Rule 15a-6, the SEC issued several no-action letters to U.S. and foreign banking groups proposing that group members that were registered U.S. broker-dealers would act as agents in transactions between the registered broker-dealer's U.S. customers and its unregistered foreign broker-dealer affiliates where there was no contact between the U.S. customers and the foreign affiliates. These banking groups received no-action letters rather than exemptive orders. Moreover, as previously quoted, the SEC stated specifically in the Rule 15a-6 Adopting Release that, subject to avoiding a foreign broker-dealer's "control" over an affiliated U.S. broker-dealer's market-making activities, a foreign broker-dealer can "transmit" its close-of-business securities positions to an affiliated U.S. broker-dealer, which "can continue trading those securities." [238] Consequently, it seems quite clear that, had Rule 15a-6 been effective at the time the no-action letters were issued, the rule would have made recourse to no-action relief unnecessary.

p. 14-58

p. 14-59

For this reason it is instructive to describe the significant aspects of the SEC's letter to Security Pacific Corporation ("Security Pacific"), the no-action letter describing the widest range of activity in the United States by a registered broker-dealer acting on behalf of its unregistered foreign affiliates, to illustrate a situation that even pre-Rule 15a-6 did not raise SEC "control" concerns as Vickers did. [239]

The Security Pacific no-action letter permitted Security Pacific's registered broker-dealer subsidiary, Burns Fry Hoare Govett ("BFHG"), to act either as agent (broker) or as riskless principal [240] in executing orders placed with it by foreign dealer affiliates. These orders could be specific as to price and volume or could set price and volume parameters. BFHG was to execute as placed the orders that were specific as to price and volume and to execute the other orders as it deemed appropriate within the given parameters (which could be changed at any time).

Unlike Vickers (with respect to securities held on the books of its affiliated foreign dealers), BFHG did not propose to act as a market-maker. BFHG stated that it would not (i) quote a market in those securities or publish such quotes or (ii) advertise or otherwise make known a willingness to buy and sell those securities (except as riskless principal) on a continuing basis. Further, the SEC's letter provided that "where standing buy and sell orders in a security are held by [BFHG, BFHG would not]… execute orders of any of its U.S. customers against those standing orders." [241] While the terms of the no-action letter did not permit BFHG to offer "to buy and sell simultaneously on a continuing basis" [242] on behalf of its foreign dealer affiliates, the SEC apparently did not object to BFHG changing the position it took on behalf of its foreign affiliates from the buy to the sell side, or *vice versa*, of any given security within the course of a day. [243]

Footnotes

219 *But see* § 14.08[3][b].

220 *See* § 14.03[3][c].

221 *See* § 14.03[3][b][iii].

222 *See* § 14.03[3][b][ii]; *see also NASD* (avail. Oct. 11, 1991) permitting certain foreign broker-dealers to act as agent for their affiliated SEC-registered broker-dealers in entering quotations on the Nasdaq International Service. *But see* § 14.03[3][b][ii][A] (regarding issues that may arise where a transaction results in an ongoing contractual relationship between a U.S. customer and a foreign broker-dealer).

223 *See* §14.03[3][b][ii][A].

224 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,017 (July 18, 1989); *see also* NYSE Information Memo No. 91-9 (Mar. 21, 1991) (instituting "Series 17" examination for associated persons of NYSE members who are employed by a U.K. broker-dealer and have passed a qualifying examination in the United Kingdom); NASD Notice to Members No. 91-28 (May 1991) (same). Any foreign office from which employees of a U.S. broker-dealer contact U.S. investors, however, could be subject to regulation and inspection as a "branch office" of the U.S. broker-dealer. *See* § 14.11[1]; *see also* SEC Release No. 34-52402 (Sept. 9, 2005) and SEC Release No. 34-52403 (Sept. 9, 2005) (uniform definition of "branch office" adopted by NYSE and NASD); NASD Notice to Members 06-12 (Mar. 2006) and NYSE Information Memo 06-13 (Mar. 22, 2006) (joint interpretative guidance relating to the uniform branch office definition).

225 *See*, *e.g.*, *O'Brien and Credit Suisse First Boston, LLC*, SEC Release No. 34-51764 (May 31, 2005) (sanctioning Credit Suisse First Boston ("CSFB") for failure to supervise a trader who was located in its New York office, but reported to a supervisor located in an office of an Australian affiliate of CSFB where that supervisor was not a CSFB employee and had not passed any U.S. supervisory licensing exams).

226 *See* Rule 15a-6(a)(4)(i) under the Exchange Act.

227 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 (July 18, 1989) (emphasis added); *see also* § 14.08[2].

For markets in certain securities, including particularly U.S. Treasury securities and Japanese and other government securities, but also extending to other "books" of fixed income securities and the most widely traded equity securities, trading takes place on markets other than the principal domestic markets for the securities. For some securities, there is even 24-hour trading, with activity moving from New York to Tokyo to London affiliated broker-dealers as one market closes and the next opens. For other securities there is trading across the business hours of London and New York. These activities require having one affiliate trading securities positions maintained on the books of another.

228 The term "foreign broker or dealer" is defined as "any non-U.S. resident person (including any U.S. person engaged in business as a broker or dealer entirely outside the United States, except as otherwise permitted by [Rule 15a-6])… whose securities activities, if conducted in the United States, would be described by the definition of 'broker' or 'dealer' in [the Exchange Act]." Rule 15a-6(b)(3) under the Exchange Act.

229 *See* SEC Release No. 34-30920 (July 14, 1992), 57 Fed. Reg. 32,587, 32,592 (July 22, 1992).

230 *See* NYSE Information Memo No. 92-32 (Nov. 13, 1992); NYSE Rules, Rule 410B.

231 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 n.205 (July 18, 1989); *Citicorp* (avail. Sept. 14, 1986).

232 *See* GUIDE IX.A and XI.E.

233 *See* Nasdaq OMX Stock Market Rules, Rules 4613 and 4751(C)(2).

234 As the Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 n.205 (July 18, 1989), makes clear, from a securities law point of view, the greater the trading discretion allowed Vickers and the lesser the control by Citicorp's Foreign Dealers over Vickers, the stronger the argument that Citicorp's Foreign Dealers need not register as dealers with the SEC. However, the greater the trading discretion allowed Vickers, the stronger the potential argument that Vickers would be engaged in dealing activities in the United States that might be prohibited by applicable banking law. In fact, it has been reported that opposition from the Board led to a determination not to implement the Vickers arrangement. *See generally* GUIDE IX.A and XI.E.

235 *Citicorp* (avail. Sept. 14, 1986).

236 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 n.205 (July 18, 1989); *Citicorp* (avail. Sept. 14, 1986). The Vickers exemptive letter contained, in addition to the conditions regarding foreign dealers' control over Vickers, a number of other conditions not included in Rule 15a-6, including that Vickers maintain its net capital at a level higher than ordinarily required by the SEC's net capital rule, apparently to take into account some measure of credit risk from Vickers' exposure to Citicorp's Foreign Dealers. The exemption also contained conditions similar to those required of qualifying foreign broker-dealers under Rule 15a-6, as discussed in § 14.03[3][c].

237 *See* § 3.01, Note 32 for a discussion of pink sheets.

238 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 (July 18, 1989).

239 *See Security Pacific Corp.* (avail. July 7, 1988). In 1987, Chase Manhattan Corp. received a no-action letter permitting it to conduct a narrower range of activity than was later afforded to Security Pacific. *See Chase Manhattan Corp.* (avail. July 28, 1987). Subsequent to the issuance of the Security Pacific letter, the SEC issued substantially identical no-action letters to *National Westminster Bank PLC* (avail. July 7, 1988) and *The Bank of Montreal* (avail. June 20, 1989).

240 The Board, however, did not permit the registered broker-dealer to act as riskless principal on behalf of its foreign dealer affiliates, stating that such an activity would fall within the dealing prohibitions of the Glass-Steagall Act. Letter from William W. Wiles, Secretary of the Board, to Dan C. Aardal, Assistant General Counsel, Security Pacific Corp. (Apr. 18, 1988). *See* GUIDE XI.E.

241 *Security Pacific Corp.* (avail. July 7, 1988).

242 Compare the SEC's description of the Vickers arrangement in the Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 n.205 (July 18, 1989), which is the source of the quoted language.

243 That BFHG could change sides during the course of a day is indicated by, among other things, the fact that

BFHG's foreign dealer affiliates were not explicitly restricted in their ability to change their orders to BFHG during the course of a day, and that BFHG was to report daily to its foreign affiliates "net changes" (presumably meaning buys netted against sells in a security) in their respective accounts.

U.S. Regulation of the International Securities and Derivatives Markets, § 14.05, INTRODUCTION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

A foreign entity that establishes an affiliate to engage in activities requiring SEC broker-dealer registration (or determines to engage in such activities itself) will subject the affiliate (or itself) to the most comprehensive and detailed regulatory regime that exists for securities market participants under the U.S. securities laws. [244] The substantive requirements can extend into all areas of a registered broker-dealer's business; the recordkeeping requirements are comprehensive; and audit and inspection by both the SEC and SROs [245] are more frequent and detailed than anything to which other market participants are subject. Further, registered broker-dealers are subject to closer scrutiny, and have greater affirmative obligations, with respect to the prevention of fraudulent and manipulative activity than other market participants. The regulation of registered broker-dealers also extends to their finances and accounting, and therefore officers and employees and outside advisers with financial and accounting expertise are required to cope with the regulatory scheme.

Responsibility for monitoring compliance with the regulatory scheme begins with the registered broker-dealer itself, which is required to institute internal control, supervisory and procedural systems. Primary outside oversight is provided by the SROs, which are responsible for enforcing compliance by their members with the securities laws. Each registered broker-dealer has a designated SRO (the "designated examining authority") charged with primary responsibility for conducting on-site inspections and other reviews of the broker-dealer, including financial and books and records reviews. The SEC also has the power to, and regularly does, conduct audits and inspections, sometimes in coordination with the firm's designated examining authority or other SRO. Both the SROs (subject

p. 14-61

to SEC review) and the SEC may discipline registered broker-dealers for failure to conform to the regulatory scheme. [246]

Footnotes

244 Broker-dealers effecting customer transactions in security futures products are also subject to registration and other requirements under the CEA. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 4. Additionally, under Title VII of the Dodd-Frank Act, dealers in swaps and security-based swaps will be required to register with the CFTC and the SEC as swap and security-based swap dealers, respectively. *See* SEC Release No. 34-75611 (Aug. 5, 2015), 80 Fed. Reg. 48,964 (Aug. 14, 2015); CEA § 4s(b)(5); Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613 (Jan. 19, 2012); *see also* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 5.02 (regarding swap dealers) and Chapter 6 (regarding security-based swap dealers).

245 *See* text accompanying *infra* Note 269.

246 Broker-dealers in government securities are subject to a specialized scheme of regulation, the most notable provisions of which are found in § 15C of the Exchange Act and applicable U.S. Treasury Department ("Treasury") rules and regulations. *See*, *e.g.*, Treas. Reg. §§ 400–50. The regulation of government securities broker-dealers is in many respects comparable to, although not as extensive as, that of broker-dealers in nonexempted securities. The Treasury regulations incorporate many of the compliance

requirements contained in the SEC's rules applicable to broker-dealers in other securities. Certain of the more important features of the government securities regulatory scheme are touched upon in the footnotes to this Part B.

There are also certain specialized aspects of the municipal securities regulatory scheme, including a requirement that banks, or identifiable departments or divisions of banks, that are dealers in municipal securities register pursuant to § 15B of the Exchange Act. Broker-dealers and banks (or separately identifiable departments or divisions thereof) engaging in activities in municipal securities, or persons providing advice to or on behalf of municipal entities (or obligated persons) with respect to municipal financial products or municipal securities issuances or soliciting municipal entities (or obligated persons), that require registration under § 15 or § 15B of the Exchange Act must also comply with the rules promulgated by the Municipal Securities Rulemaking Board. Participation by non-U.S. financial organizations in the municipal securities market is quite limited and, accordingly, this Part B does not further discuss the specialized aspects of municipal securities regulation.

Registered broker-dealers providing investment advice that is not solely incidental to the conduct of their business as brokers or dealers or for which they receive special compensation also may be required to register as investment advisers with the SEC under the Advisers Act. *See* § 202(a)(11)(C) of the Advisers Act; § 16.03[2][b].

See also infra Note 247.

U.S. Regulation of the International Securities and Derivatives Markets, § 14.06, REGISTRATION PROCESS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.06 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

In order to register as a broker-dealer with the SEC, [247] the broker-dealer must also become a member of a national securities association (unless it confines its activities to transactions on national securities exchanges of which it is a member). [248]

[1] SEC Registration and FINRA Membership

p. 14-62

The only existing national securities association is the Financial Industry Regulatory Authority, Inc., or "FINRA." [249] SEC registration and FINRA membership is a combined process that entails the filing of an application, [250] which includes extensive information regarding the proposed business of the broker-dealer (the "Applicant"), its personnel and how it will comply with applicable regulatory requirements. The application process enables the SEC and FINRA to prevent those with histories of violations of the securities laws or comparable offenses, or that are not otherwise qualified, from registering as broker-dealers. [251]

[a] Elements of the Application

p. 14-62

p. 14-63

Key elements of the application package include:

- advance reservation of a name, subject to FINRA approval; [252]
- application fees funded to a CRD general account from which registration fees will be paid; [253]
- the Uniform Application for Broker Dealer Registration ("Form BD"), discussed below, used by the SEC, SROs and the 50 states;
- an executed entitlement program agreement for access to FINRA's web-based systems; [254]
- a list of all "associated persons" [255] of the Applicant, a Uniform Application for Registration or Transfer ("Form U-4") for each person that will act in a

p. 14-63

p. 14-64

registered representative or principal capacity for the Applicant and fingerprint cards for all associated persons of the Applicant; [256]
- a Uniform Branch Office Registration form ("Form BR") for all branch offices of the Applicant; and
- a New Member Application form ("Form NMA"). [257]

Additional information submitted electronically on Form NMA and related attachments includes, among other things: [258]

- a detailed business plan;
- documentation of certain regulatory or criminal proceedings against, adverse licensing or registration

determinations with respect to, investigations of, or remedial actions imposed on, the Applicant or any of its associated persons;

- copies of final or proposed contracts with banks, clearing entities or service bureaus, and a general description of any other final or proposed contracts;
- a description of the nature and source of the Applicant's capital, with supporting documentation;
- a description of the Applicant's financial controls;
- descriptions of the Applicant's communications, supervisory, recordkeeping and operational systems;
- copies of the Applicant's compliance policies, written supervisory procedures and continuing education programs; and
- a description of the number, experience, qualifications and responsibilities of supervisors and principals.

Form BD, required to register with the SEC and FINRA, requires the disclosure of certain basic information regarding the broker-dealer, including:

- name, address and telephone number of the broker-dealer;

p. 14-64

---

p. 14-65

- form of business organization of the broker-dealer; [259]
- names of officers and directors of the broker-dealer;
- names and addresses of all affiliates (including those located outside the United States) engaged in the securities or investment advisory business;
- proposed lines of business of the broker-dealer;
- information regarding any disciplinary action taken against the broker-dealer and/or its "control affiliates," [260] including, among others, sanctions for violations of U.S. or non-U.S. criminal laws and securities laws and sanctions imposed by the United States or a foreign government, court, regulatory agency or securities exchange for conduct relating to securities activities or for fraudulent conduct; and
- descriptions of any clearing or recordkeeping arrangements. [261]

The business plan to be filed with the application must set forth all material aspects of the Applicant's business, including an estimate of projected monthly income and expenses for its first year of business, a balance sheet and supporting schedules and a net capital computation. [262] The business plan should provide a description of the Applicant's business activities and marketing plan, its organizational structure, its personnel, its office facilities and branch office structure (if applicable), the technology, communications and operational systems to be employed, contingency plans in the event of systems failures, disaster recovery plans and systems security procedures.

p. 14-65

---

p. 14-66

The procedures to be filed with the application include the Applicant's written supervisory procedures, internal operating procedures (including operational and internal controls), internal inspections plan, written approval process and qualifications investigations procedures. The written supervisory and compliance procedures should detail who will have responsibility for compliance with various regulatory requirements, including such areas as recordkeeping; transaction review; new account documentation; review of advertising and communications; and execution, clearance and settlement procedures. These procedures should also contain, among other things, the Applicant's policies with respect to money laundering, insider trading and confidentiality.

[b] Foreign Applicants

An Applicant for registration as a broker-dealer need not be located in the United States. However, a nonresident Applicant must provide the SEC with an irrevocable consent and power of attorney designating the SEC as its agent for service of process in any civil suit subject to U.S. jurisdiction that: (i) accrues during the period in which it is registered as a broker-dealer, (ii) arises out of its activities as a broker-dealer and is subject to U.S. jurisdiction and (iii) is founded on the Securities Act, the Exchange Act, the Trust Indenture Act, the Investment Company Act or the Advisers Act. [263] A copy of the consent to service must also be forwarded to the CRD with the Form BD application. [264] Nonresident registered broker-dealers are required to keep copies of all Exchange Act required books and records at a location in the United States or must undertake to provide the SEC promptly with all requested records. [265]

[c] Approval Process

After all required documentation, and any other information requested, has been submitted to, and reviewed by, FINRA, an interview will be arranged between the broker-dealer's senior management (generally including, at a minimum, the broker-dealer's president and chief financial officer) and the FINRA analysts assigned to review the application.

The purpose of the interview is to assure FINRA that the broker-dealer's senior management understands its regulatory and compliance responsibilities and has the necessary business experience to engage in the business activities proposed. In addition, if the broker-dealer employs any technology vital to its

p. 14-66

p. 14-67

business plan (*e.g.*, if the broker-dealer is going to operate an electronic trading platform), FINRA may request a demonstration of such technology.

Following the pre-membership interview, FINRA will issue a decision as to whether membership will be granted or denied. Written notification as to whether the application has been approved will be sent to the Applicant within 30 days after the later of the conclusion of the pre-membership interview and the submission to FINRA of any required additional information. Subject to limited exceptions, FINRA is required to process new membership applications within 180 calendar days from the date of filing. [266]

Assuming the application for SEC registration and FINRA membership has been approved by FINRA, the broker-dealer will be required to sign a "new membership agreement." The new membership agreement sets forth the parameters of the broker-dealer's permitted activities, which are based on the broker-dealer's business plan and can be the subject of detailed negotiations with FINRA. Business operations will only be permitted to commence after FINRA has received the executed new membership agreement.

The SEC does not automatically approve applications for broker-dealer registration. However, the SEC must within 45 days of receipt of a completed application either grant the application or institute proceedings to determine whether it should be denied. [267] In addition, the SEC may for good cause extend such proceedings by 90 days.

Section 15(b)(4) under the Exchange Act lists a variety of offenses for which the SEC may discipline broker-dealers and which also may be used as a basis for delaying approval of, or denying, an application for registration (or, alternatively, for which the SEC may place limits upon the activities of a broker-dealer once registered). Such offenses include having undertaken activities requiring registration prior to registering, having filed a false or misleading Form BD, having been convicted in the United States or abroad of one of a number of enumerated offenses or having been found by a U.S. or foreign financial regulatory authority to have committed a securities law violation.

[2] SRO Membership

As discussed above, even if registered with the SEC, a broker-dealer generally may not commence securities activities until it becomes a member of FINRA. [268] In addition to joining FINRA, a registered broker-dealer may become

p. 14-67

p. 14-68

a member of one or more of the SEC-registered national securities exchanges, such as the NYSE and the Nasdaq Stock Market.

FINRA and the national securities exchanges are industry self-regulatory membership organizations, known collectively as "SROs," that are required by the Exchange Act to regulate their member broker-dealers' compliance with both the rules of the SEC and their own rules. Thus, a broker-dealer's membership in, and resulting regulation by, one or more SROs is a crucial element of the U.S. broker-dealer regulatory scheme. [269]

[a] SRO Membership Requirements

Membership in an SRO requires meeting its employee licensing requirements [270] and other standards. Prospective members of an SRO must of course also pay the organization's fees and, in the case of a national securities exchange, obtain membership or the right to trade on that exchange (traditionally referred to as having a "seat" on the exchange).

[b] Members Residing Outside the United States

There is no requirement that a FINRA member have an office in the United States. However, a "foreign FINRA member" must: (i) keep all records and reports required by the SEC and FINRA in English, keep its accounts in U.S. dollars and have available a person fluent in English to assist FINRA in examinations, (ii) reimburse FINRA for additional examination expenses due to the fact that FINRA inspectors must travel further to examine the member, and (iii) clear all transactions with other FINRA members through a registered broker-dealer, registered clearing agency or bank located in the United States, except where the counterparty agrees otherwise. [271]

[c] Designated Examining Authority

FINRA is the "designated examining authority" for all securities firms doing business with the public in the United States. The designated examining authority for a newly registered broker-dealer is required by the SEC, within six months of the broker-dealer's registration, to examine the new broker-dealer as to its compliance with applicable financial responsibility rules and, within a year

p. 14-68

p. 14-69

of the new broker-dealer's registration, to conduct a full inspection of the broker-dealer as to its compliance with all securities laws. [272] Further, the designated examining authority has continuing primary responsibility for the regulatory oversight of that broker-dealer's activities.

Footnotes

247 The registration process discussed in this section does not apply in the case of FCMs that become broker-dealers for the limited purpose of dealing or effecting customer transactions in security futures products through the notice registration procedures available under § 15(b)(11) of the Exchange Act. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.07[2].

248 *See* § 15(b)(8) of the Exchange Act.

Registered government securities broker-dealers are also required to become members of a national securities association (or national securities exchange). *See* § 15C(e) of the Exchange Act. Government-noticed financial institutions (as defined below), which are not required to register with the SEC as brokers or dealers, are not required to become members of a national securities association (or national securities exchange).

249 In 2007, the SEC approved the consolidation of the NASD and the member regulation, arbitration and enforcement functions of the NYSE into a single SRO known as FINRA. *See* SEC Release 34-56145 (July 26, 2007). FINRA is now responsible for regulating all securities firms that do business with the public, including with respect to professional training, testing and licensing of registered persons, arbitration and mediation. FINRA is also responsible, by contract, for regulating, at least in part, Bats BZX Exchange, Bats BYX Exchange, C2 Options Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, Bats EDGA Exchange, Bats EDGX Exchange, International Securities Exchange, ISE Gemini, NASDAQ BX, NASDAQ PHLX, Nasdaq Stock Market, National Stock Exchange, New York Stock Exchange, NYSE Arca and NYSE MKT. Finally, FINRA is responsible for operating industry utilities, such as trade reporting facilities and other OTC operations. In 2010, NYSE Euronext and FINRA entered into an agreement whereby FINRA assumed responsibility for performing market surveillance and enforcement functions, although the NYSE will remain ultimately responsible for oversight of FINRA's performance. *See* Press Release, FINRA and NYSE Euronext, FINRA and NYSE Euronext Complete Agreement for FINRA to Perform NYSE Regulation's Market Oversight Functions (June 14, 2010).

FINRA is now in the process of creating a new consolidated rulebook "intended to achieve, to the extent practicable, substantive harmonization" of the NYSE and NASD rules. *See* SR-NYSE-2007-22 (Feb. 27, 2007); SEC Release No. 34-56142 (July 26, 2007); FINRA Information Notice, Rulebook Consolidation Process (Mar. 12, 2008). The rule proposals will substantially conform the NYSE rules to those of the NASD (although in certain instances the industry committees that were part of the process recommended that FINRA instead adopt the corresponding NYSE rule). The harmonization process is expected to continue until there is a single rulebook. In the interim, FINRA has incorporated into its rulebook certain existing NYSE rules (referred to as the Incorporated NYSE Rules) and will apply them solely to NYSE members in accordance with existing NYSE guidance regarding their application. As the consolidation process is ongoing, this book will refer to the FINRA rule, if consolidated, and to the NASD rule or Incorporated NYSE rule, if not yet consolidated.

250 Generally, applications for registration with the SEC and membership with FINRA are required to be filed through an electronic process to the Central Registration Depository ("CRD"), which is operated by FINRA.

251 Section 15C(a) of the Exchange Act similarly requires government securities broker-dealers that are not either registered broker-dealers under Exchange Act § 15(a) or "financial institutions" to register with the SEC. A government securities broker-dealer that is a "financial institution" need not register with the SEC; however, it must give notice of its government securities activities to the "appropriate regulatory agency."

The term "financial institution" includes both "banks" (as defined in § 3(a)(6) of the Exchange Act) and foreign banks. *See* § 3(a)(46) of the Exchange Act. Government securities broker-dealers registered with the SEC pursuant to § 15C of the Exchange Act are hereinafter referred to as "registered government securities broker-dealers." Financial institutions that are government securities broker-dealers and have given notice of such activities to the appropriate regulatory authority are referred to herein as "government-noticed financial institutions." *See* § 14.03[1][a]–[c] for a discussion of the changes to the broker-dealer registration requirements with respect to banks following the enactment of the GLB Act.

252 Before filing a new membership application ("Form NMA"), the Applicant must apply to FINRA's Department of Registration and Disclosure to reserve a proposed name, subject to certain prohibited names. *See* 18 U.S.C. § 709. Upon approval, the name will be reserved for 120 days and the Form NMA should be filed during this name-reservation period. In general, if an application or amendment is not received within the 120 days, the name reservation is cancelled automatically unless the Applicant applies for and receives an extension.

253 FINRA requires applicants to fund, *via* electronic funds transfer, the general account from which the application, examination, state and other registration fees will be drawn. An Applicant must also submit registration fees for the states in which it will conduct business, as well as all licensing and registration fees for each associated person (as defined below).

254 *See* NASD Rule 1013, FINRA MANUAL. *See generally* FINRA, Registration and Qualification, *available at*

http://www.finra.org/industry/registration-qualification (last visited Oct. 11, 2016).

255 For purposes of the application, the term "associated person" means: (i) a natural person registered under FINRA Rules, or (ii) a sole proprietor, or any partner, officer, director, branch manager of the Applicant, or any person occupying a similar status or performing similar functions, (iii) any company, government or political subdivision or agency or instrumentality of a government controlled by or controlling the Applicant, (iv) any employee of the Applicant, except any person whose functions are solely clerical or ministerial, (v) any person directly or indirectly controlling the Applicant whether or not such person is registered or exempt from registration with FINRA, (vi) any person engaged in an investment banking or securities business controlled directly or indirectly by the Applicant whether such person is registered or exempt from registration with FINRA, or (vii) any person who will be or is anticipated to be a person described in (i) through (vi) above. NASD Rule 1011(b), FINRA MANUAL.

256 *See* § 14.07[3][b].

257 These forms should be submitted at the same time as the Form BD, to FINRA's Department of Registration and Disclosure. FINRA will provide access to the Firm Gateway upon notification that an Applicant's hard-copy forms have been processed. The Firm Gateway provides access to other required forms and is used to prepare and submit forms and documents for a new member application.

258 *See* NASD Rule 1013(a)(1), FINRA MANUAL.

259 There is no requirement that an Applicant have a particular form of organization; corporations, partnerships, limited liability companies, sole proprietorships and individual persons may register. In the case of an Applicant that is a corporation, the Applicant must disclose the identity of all persons who own directly more than 5% of the Applicant's voting shares. If such 5% share owners are not subject to the reporting requirements of the Exchange Act, the Applicant must disclose the identity of all persons who in turn own 25% of the voting shares of such 5% share owners. Applicants must also disclose whether such direct and indirect owners are individuals, domestic entities or entities incorporated or domiciled in a foreign country. For a discussion of the required disclosure of corporate share owners on Form ADV (for registration of investment advisers under the Advisers Act), which is comparable to Form BD, *see* § 16.04.

260 The term "control affiliate" is defined to include those who hold, or have the power to sell or direct the sale of, 25% or more of any class of voting security of a broker-dealer and certain of its officers and each of its directors. *See* Form BD, Explanation of Terms.

261 The Form BD must be amended as necessary to keep it current (even after the broker-dealer's application has been approved by the SEC) and all changes in information must be promptly reported to the SEC. *See* Rule 15b3-1 under the Exchange Act.

262 The business plan and other supporting information submitted to FINRA as part of the membership process are kept confidential.

263 Rule 15b1-5 under the Exchange Act.

264 *See* SEC Release No. 34-31660 (Dec. 28, 1992).

265 Rule 17a-7 under the Exchange Act; *see also* § 14.08[3].

266 Typically, the clock will not begin to run with respect to this time frame unless the application, when filed, is substantially complete, and, indeed, an application that is not substantially complete when filed will likely be rejected.

267 § 15(b)(1) of the Exchange Act.

268 *See* § 14.06[1].

269 *See* §§ 6(b)(2) and 6(c) of the Exchange Act (regulating national securities exchanges) and §§ 15A(b)(3) and 15A(g) of the Exchange Act (regulating FINRA); *see also* § 19(g) of the Exchange Act (requiring SROs to regulate their member broker-dealers).

270 *See* § 14.07[3][b].

271 NASD Rule 1090, FINRA MANUAL.

272 *See* Rule 15b2-2 under the Exchange Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 14.07, SUBSTANTIVE REGULATION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.07 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

Registered broker-dealers are subject to the most detailed substantive regulation of all U.S. securities industry participants. This regulation is intended to protect both securities customers and securities markets. While a comprehensive review of such regulation is beyond the scope of this book, this section summarizes the principal aspects of substantive regulation in certain important areas: fraud against customers and insider trading, financial responsibility, activities regulated by SROs, anti-money laundering requirements, research analyst conflicts of interest and borrowing and lending by broker-dealers. [273]

[1] Antifraud Regulation

The general prohibitions against fraudulent activity and manipulation discussed elsewhere in this book of course apply to registered broker-dealers. [274] In addition, antifraud provisions have been applied against registered broker-dealers in distinct ways to prohibit a variety of activities *vis-à-vis* customers, and registered broker-dealers are also subject to some important additional procedural requirements designed to increase broker-dealers' own efforts to police against and prevent insider trading. [275]

[a] Fraud Against Customers

Sections 10(b), 15(c)(1) and 15(c)(2) of the Exchange Act and the rules thereunder prohibit, in broad language, the use of fraudulent, manipulative or

p. 14-70

deceptive devices in connection with the purchase or sale of securities by broker-dealers. [276] Broker-dealers may be found to have committed fraudulent practices if, for example, they fail to send proper confirmations meeting the SEC's requirements, [277] sell (or purchase) a security at a price not related to the market price or with an excessively high mark-up (or mark-down), [278] recommend securities to a customer without having a reasonable basis for the recommendation, [279] churn a customer's account, [280] violate the financial responsibility rules or, unless an exemption is available, sell low-priced stocks of small companies ("penny stocks") except through procedures designed to ensure that the security is a suitable investment for the customer. [281]

Some of these antifraud prohibitions derive from specific provisions of the Exchange Act or the rules thereunder. However, in many cases the courts and the SEC have based antifraud actions on the grounds that a broker-dealer owes a special level of duty to its customers. This duty has been described as a "fiduciary" duty of the sort that an agent owes its principal, but in the broker-dealer context this agency law analysis has been applied even where the broker-dealer is acting

p. 14-70

p. 14-71

as principal, at least where the customer is not sophisticated. [282] Another justification for imposing such a duty on a broker-dealer has been the theory that when a broker-dealer "hangs out its shingle," it is making an implied representation that it will deal fairly with its customers; a breach of this implied representation thus gives rise to liability for antifraud violations (the so-called "shingle theory"). [283] Under this theory, which would apply whether the broker-dealer were acting as agent (broker) or principal (dealer), if a broker-dealer charges too much, recommends a security without a reasonable basis or otherwise breaches its implied representation that it will deal fairly, an antifraud violation has occurred. Whatever the theory, the consequences for broker-dealers are clear: behavior perceived as unfair or over-reaching risks being found fraudulent.

A number of practices involving the division of brokerage commissions have been the subject of examination as to whether a broker-dealer's customers are receiving both fair treatment in, and full disclosure of, the division of the commissions that they paid. Among the commission arrangements that have been questioned are:

- "soft dollar" arrangements, in which an investment adviser uses commission dollars to compensate a broker for research or execution-related services provided to the adviser by the broker; [284]
- "directed brokerage," whereby an account fiduciary (such as a pension plan sponsor) directs an investment adviser to route brokerage business to a

p. 14-71

p. 14-72

  specified broker-dealer, which in turn agrees to compensate the account through cash payments, the provision of services or otherwise; [285] and
- "payment for order flow," [286] whereby cash payments and other incentives are provided by executing dealers, exchanges and other trading systems that execute customer orders to brokers who direct their own customers' orders to the dealer, exchange or other system that makes the payment. [287]

In addition, § 15 of the Exchange Act was amended by the Dodd-Frank Act to permit the SEC to promulgate rules providing that the standard of conduct applicable to broker-dealers in connection with providing personalized investment advice about securities to retail customers "and such other customers as the [SEC] may by rule provide" shall be the fiduciary standard under § 211 of the Advisers Act applicable to investment advisers, and to provide the SEC with enforcement authority (including sanctions) to enforce such standard. [288] As amended by the Dodd-Frank Act, § 15(k) of the Exchange Act also clarifies that commission-based compensation or other standard compensation in and of itself is not sufficient to establish violation of the standard of conduct as applied to broker-dealers and that broker-dealers do not have a duty of care or loyalty to such customer on an ongoing basis after providing them with personalized investment advice about securities. [289] In 2013, the SEC requested data and information relating to the benefits and costs of implementing various standards of

p. 14-72

p. 14-73

conduct for broker-dealers and investment advisers, including a uniform fiduciary standard of conduct. [290] The SEC has not yet proposed a rule pursuant to its authority under § 15(k) of the Exchange Act, and it is not expected that any action will be taken in this regard during the remainder of Chair White's tenure. [291]

In April 2016, however, the Department of Labor issued a final rule defining who is a "fiduciary" of an employee benefit plan under ERISA or an individual retirement account ("IRA") or other plan under the tax code by reason of providing investment advice to the plan or account or its participants or beneficiaries. [292] The rule expands the investor protections afforded by ERISA and the Bankruptcy Code by expanding the circumstances in which a broker-dealer would be considered to be a fiduciary, especially in respect of smaller plans and IRAs that participate in the retail market for retirement products. The rule is designed to address conflicts of interest that arise from compensation paid to financial service providers that could affect their advice to clients. Generally, the rule will require broker-dealers to substantially limit the types of conversations that they may have with clients that might constitute "investment advice" or, alternatively, restructure fee and compensation arrangements, and take other steps, to minimize the impact of those arrangements on the advice given. The rule has been and continues to be controversial, especially as it results in the establishment of a new fiduciary standard for brokers and investment advisers

p. 14-73

p. 14-74

not by the SEC or FINRA but by the Department of Labor. The rule applies only to ERISA plans and IRAs, but the structural changes required will likely affect practices with respect to other retail clients. The final rule was effective June 7, 2016, but it will not be applicable until April 10, 2017 in order to provide plans and their affected financial service providers an additional transition period. [293]

[b] Prevention of Insider Trading

The general antifraud provisions of § 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit the purchase or sale of securities by certain persons while knowingly in possession of material nonpublic information relating to those securities in breach of a duty owed to shareholders of the corporation or the source of the information. [294] The general prescription to avoid liability for insider trading has been to disclose the inside information or to abstain from trading until it becomes public.

However, certain financial institutions, particularly full-service broker-dealers that engage in both customer and proprietary sales, trading activities and corporate finance activities, frequently find themselves in possession of inside information regarding corporate finance clients. They thus have had to devise mechanisms to protect against "use" of the inside information in their other activities in order to avoid having to stop sales, trading and research activity in the securities in question. [295] As a result, procedures have been developed by

p. 14-74

p. 14-75

broker-dealers and their counsel that generally include (i) “restricted” [296] and "watch" [297] lists made up of securities concerning which inside information has been received somewhere in the organization and (ii) "information barrier" mechanisms (sometimes referred to as "Chinese Walls") to restrict dissemination of inside information. Information barriers involve procedural restrictions on the dissemination of information and, where appropriate, physical separations and restrictions between departments of an organization, particularly between corporate finance personnel and research, sales and trading personnel. [298] Information barriers are designed to regulate, and permit the tracing of, the transmission of inside information. With this combination of procedures, a broker-dealer can attempt to restrict the flow of inside information and trading activity, so that in certain circumstances the broker-dealer can continue certain activities in a security as to which a portion of the organization possesses inside information. These procedures were also originally used to bolster a defense against a charge of insider trading on the basis that the information in question had not been improperly "used."

The SEC moved toward making information barriers mandatory in 1980 when it adopted Rule 14e-3 under the Exchange Act, making it unlawful to engage in trading of securities while "in possession of" information regarding an undisclosed tender offer. [299] Although use by the purported violator no longer had

p. 14-75

p. 14-76

to be demonstrated as an element of the offense, a demonstration by the defendant that appropriate information barrier procedures were in place and that the inside information was not in fact used was made an affirmative defense. [300]

The Insider Trading and Securities Fraud Enforcement Act of 1988 (the "Insider Trading Act") [301] took the next step by making information barriers and related procedures mandatory for broker-dealers generally. Broker-dealers are required to "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of [the broker-dealer's] business, to prevent the misuse … of material, nonpublic information." [302] An insider trading violation by any person directly or indirectly controlled by the broker-dealer will result in a finding of liability against the broker-dealer if the SEC can demonstrate that the broker-dealer "knowingly or recklessly failed to establish, maintain or enforce any policy or procedure required … and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation." [303] This law caused most broker-dealers that had not adopted procedures, or that had relied on informal procedures, to adopt and distribute written information barrier and other compliance procedures and to move further toward physical separation of and restricted physical access to departments in possession of sensitive information.

In addition to requiring that broker-dealers institute procedures to prevent insider trading, the Exchange Act provides the SEC with rulemaking authority to mandate the adoption of specific procedures. [304] Pursuant to this authority, the

p. 14-76

p. 14-77

SEC's Division of Trading and Markets (at that time, the Division of Market Regulation) released a report in 1990 (the "1990 Information Barrier Report") summarizing its review of the adequacy of broker-dealers' existing information barrier procedures. [305] The review determined that broker-dealers' information barrier procedures "generally [were]… well conceived and conscientiously executed" and thus concluded that the SEC should not then use its rulemaking authority to require broker-dealers to adopt uniform procedures. [306] Although the 1990 Information Barrier Report endorsed a flexible approach to information barrier procedures, it also concluded that the minimum elements of acceptable information barrier procedures include the following:

- substantial control (preferably by the compliance department) of interdepartmental communications;
- the review of employee trading through the effective maintenance of some combination of watch, restricted and rumor lists;
- memorialization of information barrier procedures; and
- the heightened review or restriction of proprietary trading while the firm is in possession of material nonpublic information.

Surveillance of firm, customer and employee trading was said by the report to be the "single most significant element" of information barrier procedures. [307]

The 1990 Information Barrier Report also emphasized the role of the SROs in ensuring that their members' internal procedures are adequate. Responding to the report, the NYSE and the NASD published for their members a joint statement containing certain minimum elements of adequate broker-dealer information barrier procedures. [308] In addition to emphasizing the need for formal written procedures incorporated within a firm's operating manual, [309] the joint statement

p. 14-77

p. 14-78

encouraged the use of restricted and watch lists, with adequate written standards governing their use. The joint statement also emphasized the need for continuing employee education and training regarding applicable federal and state law and the requirements of SROs, as well as the firm's own procedures to prevent the misuse of material nonpublic information. [310] A firm's practices in this regard should provide that policy statements are provided or made available to employees, including revisions to such policies, and that each employee sign an attestation as to his or her understanding of those policies.

The nature of procedures adopted by individual firms has varied. In particular, procedures have appropriately varied depending on the nature of a firm's activities and its access to material nonpublic information. A firm that engages only in mutual fund brokerage may have very simple procedures. A "boutique" broker-dealer engaging in merger and acquisitions advisory activity would normally be expected to have procedures in place to police employee trading and physical safeguarding of inside information and have distributed rules restricting transmission of material nonpublic information. However, such a firm's activities, and therefore its appropriate procedures, might not extend to customer or firm principal trading. The most complex procedures have, of course, been devised by full-service institutions, whose rules commonly involve physical separation of personnel, physical safeguarding of information, restriction of communications between corporate finance, research and sales and trading personnel, review of firm, employee and customer trading for indications of unusual activity, maintenance of "restricted" and "watch" lists, detailed procedures regarding violations and possible violations or regarding seeking appropriate exceptions to procedures involving legal and compliance personnel and many other safeguards. [311]

[c] Prevention of Fraudulent Short Sales

p. 14-78

p. 14-79

In addition to the generally applicable antifraud provisions of the Exchange Act, [312] broker-dealers are subject to specific requirements in connection with effecting short sales [313] designed to prevent them from being used for fraud or manipulation. Until 2007, the price at which a broker-dealer (or other person) could effect short sales was restricted by the Rule 10a-1 "tick test," adopted in 1938 and designed to restrict short sellers from effecting short sales in an exchange-traded security when the price of that security is declining, and similarly designed price tests imposed by the SROs. In 2007, after the results of a pilot program indicated that the short sale restrictions had little effect on liquidity and price efficiency, [314] the SEC eliminated Rule 10a-1 and the tick test and prohibited the SROs from imposing price tests on the short sale of any security. [315] However, in 2010, the SEC adopted new short sale restrictions in Rule 201 of Regulation S HO in response to the rapid and steep price declines in securities during the fall of 2008. Among other things, under the short sale price restrictions, a circuit breaker triggers any time a stock has dropped 10% in one day—prohibiting short selling in that security unless the price is above the current national best bid. [316]

Broker-dealers also remain subject to specific requirements under Exchange Act Regulation S HO [317] that are designed to prevent abusive "naked"

p. 14-79

p. 14-80

short sales [318] and to address extended "fails to deliver." [319] Under Regulation S HO, broker-dealers must mark all sales of equity securities "long" or "short." [320] A sale may be marked "long" only if the seller owns the security and the broker-dealer reasonably expects to have physical possession or control of the security by the settlement date of the transaction; all other sales must be marked "short" or "short exempt." [321] If a sale is marked "long," the broker-dealer generally must make delivery when due and cannot use borrowed securities to do so. [322] Broker-dealers generally may not accept or execute short sales of equity securities without borrowing or entering into a *bona fide* arrangement to borrow the security or having reasonable grounds to believe the security can be borrowed in time for delivery. [323] Finally, Regulation S HO imposes additional

p. 14-80

p. 14-81

delivery requirements on broker-dealers that are participants in registered clearing agencies. Subject to certain limited exceptions, such broker-dealer participants must purchase or borrow securities to close out any fail to deliver positions by no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position. [324] Broker-dealers subject to this close-out requirement are also generally prohibited from effecting short sales in the relevant security without borrowing or entering into a *bona fide* agreement to borrow the security. [325]

[2] SEC Net Capital and Other Financial Responsibility Rules

Registered broker-dealers are subject to capital and other financial rules intended to protect their own customers [326] against financial failure of the broker-dealer, as well as to protect market participants generally by preventing a chain reaction of failures that might otherwise occur in a highly interrelated financial system when one financial intermediary fails. [327]

Section 15(c)(3) of the Exchange Act requires that broker-dealers conform to the SEC's rules on "financial responsibility" and related matters including "custody and use of customers' securities and … [cash] balances." [328] Under that

p. 14-81

p. 14-82

provision of the Exchange Act, the SEC has adopted (i) the "customer protection rule" (Rule 15c3-3), which governs a broker-dealer's handling of customer funds and securities, and (ii) the "net capital rule" (Rule 15c3-1), which regulates the minimum liquid net assets and maximum debt/equity ratio of a broker-dealer. [329] These rules go well beyond requiring balance-sheet solvency of a broker-dealer. They are intended to assure that a broker-dealer's customer-related assets are protected and that these assets are sufficient to pay its obligations to its customers even in a forced and rapid liquidation during difficult market conditions and in periods of limited liquidity. [330]

In the event that a broker-dealer fails and lacks sufficient assets to repay its customers, SIPA provides for the availability of limited protection to compensate a broker-dealer's customers for certain losses. [331]

While the SEC's net capital and other financial responsibility rules are far too detailed to be considered in full, we discuss certain of their principal areas of coverage below.

[a] SEC Customer Protection Rule

The customer protection rule is intended to separate a firm's activities on behalf of its customers from the risks of the firm's proprietary underwriting and dealing activities by requiring that a broker-dealer hold its customers' assets apart from its own, and thus not put customer assets at risk in the broker-dealer's business. [332] The rule has two parts, one dealing with the treatment of customer securities and the other requiring the broker-dealer to make deposits into a special account intended to benefit its customers.

[i] *Customer Securities and PAB Account Securities*

p. 14-82
p. 14-83

The customer protection rule requires a broker-dealer to make a daily determination to ensure that it has possession or "control" [333] of all fully paid securities and "excess margin securities" [334] of its customers. [335] Effective in 2014, this obligation was extended to include fully paid and excess margin securities in accounts containing the proprietary securities and cash of other broker-dealers ("PAB accounts"), except for the PAB accounts of other broker-dealers that did not object after receiving written notice that the carrying broker-dealer

p. 14-83
p. 14-84

would be able to use their securities in the ordinary course of its business. [336] Broker-dealers with customer or PAB account securities that should be, but are not, within their possession or control must take action to obtain possession or control. Generally, a broker-dealer must buy in, or otherwise obtain, fully paid or excess margin securities carried on its books as "fails to receive" [337] for more than 30 days. [338] As trades in markets outside the United States may require a longer period to settle than those in the United States, the SEC staff has provided that in the case of fails to receive of foreign-settled, foreign-issued securities a broker-dealer may, in certain circumstances, take a charge to its net capital rather than buying in undelivered securities. [339]

This part of the customer protection rule is supplemented by Rules 8c-1 and 15c2-1 under the Exchange Act, which among other restrictions require that customer margin securities (*i.e.*, those securities that a broker-dealer is not required to keep in its possession or control) may not be subjected to any lien greater in amount than the amount that a broker-dealer's customers collectively owe the broker-dealer. For purposes of these rules, a broker-dealer's "customers" include other broker-dealers whose accounts it carries. [340]

[ii] *Customer Reserve Account and PAB Reserve Account*

The second part of the customer protection rule requires a broker-dealer to make two weekly computations in accordance with a "Reserve Formula." [341] The first computation determines how much money the broker-dealer is holding that is either customers' money or money the broker-dealer has obtained from the use of customer securities that are not in the broker-dealer's possession or control ("customer credits"). From these customer credits, the broker-dealer subtracts the

p. 14-84
p. 14-85

amount of money that it is owed by its customers or in customer-related transactions ("customer debits"). [342] If a broker-dealer's customer credits are in excess of its customer debits, the broker-dealer must deposit cash or "qualified securities" [343] representing the excess in a special reserve bank account for the exclusive benefit of customers (commonly called the "customer reserve account"). The second computation is an essentially identical calculation with respect to the broker-dealer's PAB accounts to determine an amount that must be maintained in a special reserve bank account for the exclusive benefit of PAB account holders (commonly called the "PAB reserve account"). [344]

The effect of the two parts of the customer protection rule, and of Rules 8c-1 and 15c2-1 under the Exchange Act, is to create a system in which the excess of the amount a broker-dealer owes to its customers and PAB account holders (or to others in connection with their securities positions) over the amount customers and PAB account holders owe to the broker-dealer (or third parties owe to the broker-dealer in connection with the customers' and PAB account holders' securities positions) is placed in segregated bank accounts, and securities belonging to customers and PAB account holders generally are either kept in the broker-dealer's control or used to secure loans not greater in amount than the aggregate amount the broker-dealer has loaned its customers or PAB account holders on such securities.

[b] SEC Net Capital Rule

p. 14-85

p. 14-86

The term "net capital" as used in the SEC's net capital rule does not refer to capital in the ordinary accounting sense of the word but only to that portion of a broker-dealer's net assets that are considered under the rule to be liquid and immediately available to meet the obligations of the broker-dealer. [345] The net capital rule requires that registered broker-dealers maintain regulatory "net capital" in a specified minimum amount, [346] calculated in accordance with the "basic" or the "alternative" method discussed below. [347] The effect of the net capital rule is to limit a broker-dealer's ability to use financial leverage and ensure that its liquid assets are sufficient to meet its obligations. [348]

p. 14-86

p. 14-87

Under the "basic" method of calculation, a broker-dealer is generally required to maintain liquid net capital in an amount not less than one-fifteenth of its unsecured indebtedness (as defined in the net capital rule, "aggregate indebtedness"). [349] The consequence of this requirement is that the broker-dealer is required to have a cushion of net liquid assets equal to one-fifteenth of its aggregate indebtedness. Under the "alternative" method of calculation, a broker-dealer is required to maintain net capital equal to the greater of $250,000 or 2% of the aggregate of the debit items as calculated in the reserve formula described in § 14.07[2][a][ii]. The consequence of this requirement is that the broker-dealer is required to cover the amount it owes to its customers with a combination of the amount it deposits in its reserve accounts and the amount that its customers owe to it, calculated in each case in accordance with the customer protection rule, plus a cushion of liquid net capital equal to 2% of what its customers owe to it.

Most broker-dealers calculate their net capital requirement by the basic method; however, the largest broker-dealers (and often smaller broker-dealer affiliates within the same holding company organization) typically calculate by the alternative method. [350] Whichever method a broker-dealer uses to calculate net capital, the minimum amount of net capital that a broker-dealer must maintain, taking into account its aggregate indebtedness or debits, is referred to herein as its "minimum capital requirement."

[i] *Method of Computation*

The computation of net capital by both the basic and alternative methods begins with net worth, as determined under U.S. GAAP. [351] In computing net

p. 14-87

p. 14-88

worth, the broker-dealer's securities and commodities positions are marked to the market. To that number are added back satisfactorily subordinated liabilities that generally must, among other requirements, have a term of at least one year. [352] The value of the broker-dealer's assets is then discounted to reflect conservative assumptions about its ability quickly to convert its assets into cash during an environment of difficult liquidity. Nonfinancial and illiquid assets (goodwill, furniture and fixtures, buildings, prepaid expenses and exchange seats) are deducted in their entirety. Certain operational and bookkeeping charges are also deducted. Most unsecured receivables are treated as illiquid assets and deducted from net worth. These deductions leave a remainder consisting of virtually only cash and securities. [353]

The net capital rule requires a broker-dealer to take a 100% charge to its net worth for its securities positions that cannot be sold and payment received reasonably promptly. Thus, securities that have no "ready market," such as certain restricted private placement securities, may have zero value for net capital purposes. [354]

p. 14-88

p. 14-89

Broker-dealers are also required to reduce their net worth in the calculation of net capital by certain percentages (commonly called "haircuts") of the market value of their securities and financial assets that do have a ready market. [355] Haircuts are deducted to provide a margin of safety against losses that may be incurred by broker-dealers in liquidating their securities positions; the amount of the haircut depends on the nature, term and liquidity of the security.

p. 14-89

p. 14-90

For example, these haircuts range from no haircut at all for U.S. and Canadian government bonds maturing in less than three months [356] to 15% of the market value of equity and noninvestment grade bond positions. [357] Contractual commitments to buy or sell securities are viewed as positions in the securities themselves but with limited offset against other positions. [358]

After all the required deductions have been taken, a broker-dealer with positive net capital has more than one dollar of liquid assets for each dollar of liabilities (except for those liabilities properly subordinated to customers and other creditors). Of course, it is not enough that a broker-dealer have positive net capital; the broker-dealer's net capital must exceed its minimum net capital requirement. [359]

[ii] *Early Warning Requirements*

p. 14-90

p. 14-91

In addition to the minimum net capital requirement, the net capital rule and the rules of the SROs specify early warning levels below which a broker-dealer's net capital may not fall without adverse consequences. [360] For example, a broker-dealer computing net capital on the alternative method may not withdraw equity capital in any form to pay shareholders if its net capital is less than the greater of 5% of its debits computed in accordance with the reserve formula or (if also registered under the CEA) 7% of the funds required to be segregated pursuant to the CEA. [361]

The well-publicized closing of the registered broker-dealer Drexel Burnham Lambert ("Drexel") was preceded by large withdrawals of capital from Drexel by its parent holding company, which was not a registered broker-dealer. Shortly thereafter, the holding company filed for bankruptcy. In the wake of these events, the SEC adopted amendments to the net capital rule that require, under certain circumstances, a registered broker-dealer to notify the SEC two business days before withdrawing capital for the benefit of an owner, employee or affiliate. [362] The SEC issued only one order under these amendments before modifying the provision in 2013. [363] As amended in 2013, Rule 15c3-1(e)(3) gives the SEC authority to restrict withdrawals, advances and loans "under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors" for a period of up to 20 business days if the SEC finds that the withdrawals, advances or loans could "be detrimental to the financial integrity of the broker or dealer or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities." [364]

These net capital rule amendments pertain specifically to transactions between a broker-dealer and its affiliates. The amendments provide that "any transaction" between a broker-dealer and an affiliate that "results in a diminution of the [broker-dealer's] net capital shall be deemed to be an advance or loan of net capital" [365] and thus could require, subject to the other provisions in the rule amendments, the prior approval of the SEC. In 2013, the SEC amended the net capital rule to require that a broker-dealer treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it or that is contributed with the intent to withdraw the capital within one year. [366]

[iii] *Alternative, Risk-Based Requirements for Broker-Dealers Subject to Consolidated Supervision*

In 2004, the SEC amended the net capital rule to permit a broker-dealer that maintains $1 billion of "tentative net capital" [367] and $500 million of net capital to apply to the SEC for a conditional exemption from the net capital rule that would allow the broker-dealer to use an alternative, risk-based method for calculating deductions from net capital for market and derivatives-related credit risk. [368] In order to qualify for the exemption, the broker-dealer must comply with certain enhanced net capital, early warning, recordkeeping, reporting and other requirements, and must implement and document an internal risk management system.

In addition—until the program ended in 2008—the broker-dealer's holding company and affiliates (referred to collectively as a "consolidated supervised entity" ("CSE")) were required to consent to group-wide supervision by the SEC and comply with certain other requirements through its CSE Program. Under the CSE Program, the holding company, depending on whether it had a principal regulator (as defined in the rules), was required, among other things, to provide the SEC with information regarding its activities and risk exposures; consent to SEC examination of its nonregulated affiliates; and as part of its reporting requirements, compute, on a monthly basis, group-wide allowable capital and allowances for market, credit and operational risk in accordance with standards adopted by the Basel Committee on Banking Supervision. However, after the near collapse of Bear Stearns and the collapse of Lehman Brothers (two of the

p. 14-92

---

p. 14-93

five CSE investment bank holding companies), [369] the SEC terminated the CSE Program entirely. [370] The remaining CSE holding companies have converted into bank holding companies and are now subject to consolidated supervision by the Federal Reserve, rather than the SEC. The broker-dealers originally owned by CSE holding companies continue to use the alternative, risk-based computation method to compute net capital but the SEC has instructed these broker-dealers to take standardized net capital charges on certain less liquid asset-backed securities positions. [371]

[iv] *Solvency Requirement*

In 2013, the SEC amended Rule 15c3-1(a) to require that, in addition to maintaining net capital no less than its minimum net capital requirement, the broker-dealer must otherwise not be "insolvent." [372] By making solvency a requirement of Rule 15c3-1, the SEC required a broker-dealer to cease conducting a securities business upon insolvency. The SEC defined "insolvent" in Rule 15c3-1(c) to mean circumstances in which the broker-dealer (1) is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate such broker-dealer or its property or to apply for the appointment or election of a receiver, trustee, or liquidator or similar official for such broker or dealer or its property; (2) has made a general assignment for the benefit of creditors; (3) is insolvent within the meaning of Section 101 of the United States Bankruptcy Code, or is unable to meet its obligations as they mature, and has made an admission to such effect in writing or in any court or before any agency of the United States or any State; or (4) is unable to make such computations as may be necessary to establish compliance with Rule 15c3-1 or Rule 15c3-3.

[c] Securities Investor Protection Act

p. 14-93
p. 14-94

One primary purpose of SIPA is to detail procedures for the liquidation of failed broker-dealers. [373] The second major purpose of SIPA is to provide limited insurance to customers of failed broker-dealers. Such insurance is provided through the Securities Investor Protection Corporation ("SIPC"), [374] a membership corporation that registered broker-dealers are generally required to join, [375] and the SIPC fund created through SIPC's assessments on its member broker-dealers. [376]

SIPA provides that customers of a failed broker-dealer have priority over other unsecured creditors in the distribution of the broker-dealer's customer-related property. Each "customer" of a failed broker-dealer is entitled to receive all of that customer's "customer name securities" and a ratable share of all "customer property" held by the failed broker-dealer. [377]

p. 14-94
p. 14-95

The SIPC fund will pay the unsatisfied portion of any claim of a customer up to $500,000, up to $250,000 of which can be for cash the customer had on account with the broker-dealer. [378] Banks, brokers and dealers (each as defined in the Exchange Act) are not eligible to collect SIPC fund insurance. [379] However, a broker-dealer or bank that can establish that assets held with a failed broker-dealer were for the benefit of its own customers will be deemed to stand in the shoes of its customers, and thus would be entitled (to the extent its own customers were so entitled) to SIPC fund insurance. [380]

[3] Self-Regulatory Organizations

As noted above, regulation of broker-dealers by SROs is a crucial element of the broker-dealer regulatory scheme. SROs themselves register with the SEC under the Exchange Act and are subject to substantial SEC regulation. [381] SRO

p. 14-95
p. 14-96

proposals to amend their rules generally must be submitted for approval to the SEC. [382] In addition, the SEC has the authority, by rule and in accordance with procedures specified in the Exchange Act, to abrogate, add to and delete from an SRO's rules. [383]

The Exchange Act requires SROs to enforce their own rules and the U.S. securities laws generally against their members. [384] All resulting disciplinary proceedings of an SRO against a broker-dealer or associated person must meet certain standards intended to guarantee due process [385] and the results of such proceedings are subject to SEC review. [386]

[a] SRO Regulation of Broker-Dealers

SROs all have rules that govern conduct by members in order to protect investors, securities markets and the trading markets operated by the SRO in question. [387] While most of the SROs' rules are detailed and focus on specific behavior, the SROs also have general injunctions requiring "fair," "just" or otherwise proper behavior in terms that are less explicit than those found in the securities laws or the SEC's rules. For example, FINRA Rule 2010 provides that members shall in the conduct of their business "observe high standards of commercial honor and just and equitable principles of trade." [388] Such rules have been used, as discussed below, as the authority for enforcing very specific standards of behavior and for carrying out significant disciplinary proceedings against members.

p. 14-96
p. 14-97

While there are 20 active securities exchanges that are registered under the Exchange Act [389] and function as SROs, the most important SRO with respect to broker-dealer regulation is FINRA. [390] The following discussion will focus on FINRA rules, but the rules of any other SROs of which a broker-dealer is a member must of course also be followed. While FINRA rules are far too detailed to be considered in full, certain of their principal areas of coverage are worth noting.

[i] *FINRA Rules*

Many of the most important FINRA rules and interpretations derive from FINRA Rule 2010, which requires members, in the conduct of their business, to "observe high standards of commercial honor and just and equitable principles of trade." In many respects, this rule has been interpreted to produce results with respect to customer protection that are similar to those of the "shingle theory" under the antifraud provisions of the securities laws applicable to broker-dealers. [391] In some cases, however, FINRA rules (including NASD rules and Incorporated NYSE rules), including FINRA Rule 2010, and interpretations of those rules go beyond the SEC's positions under the securities laws.

p. 14-97

p. 14-98

Certain FINRA rules regulate activities in connection with public securities distributions. FINRA Rule 5110 governs the amount of underwriting compensation that an underwriter may receive in connection with a public offering of securities, [392] FINRA Rule 5130 prohibits an underwriter from selling new issues of equity securities to certain categories of "restricted persons," [393] while FINRA Rule 5131 restricts underwriters from selling new issues of equity securities to certain executive officers or directors of public companies and covered nonpublic companies and from engaging in certain other activities in connection with such new issues. [394] Price maintenance in fixed price public offerings is governed by FINRA Rule 5141, intended to prevent broker-dealers from giving price advantages to certain customers in such offerings (*e.g.*, by giving discounts to institutional but not retail customers) or failing to make a *bona fide* offering of the securities to the public (*e.g.*, by selling the securities to "related persons" of the broker-dealer). [395]

Many of FINRA's Rules cover subjects such as discretionary accounts and activities in connection with the distribution of investment company securities, in which FINRA members are particularly likely to be involved with retail customers. [396] FINRA Rule 2111 requires that members have a reasonable basis to believe that securities they recommend to a customer are suitable for the customer, based on information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. [397]

p. 14-98

p. 14-99

FINRA Rule 5310 requires that the broker-dealer use reasonable diligence to obtain a price for the customer that is as favorable as possible under prevailing market conditions (often referred to as the duty of "best execution"), [398] and FINRA Rules 2121 and 2122, respectively, require that prices and commissions charged in over-the-counter securities transactions be "fair" [399] and that charges for services be reasonable and not unfairly discriminatory. [400] Additionally, the SEC adopted rules in 2000 to improve public disclosure of order execution and routing practices. [401] These rules are intended to spur more vigorous competition among market participants to provide the best prices for investor orders. Certain rules provide the authority for more specific interpretations. For example, FINRA Rule 2121 regarding prices and commissions is the authority for detailed interpretations promulgating the so-called "5% policy," to the effect that sales to customers at mark-ups in excess of 5% over the inter-dealer price are almost always excessive and that, depending on the circumstances, lower mark-ups may

p. 14-99

p. 14-100

also be excessive. [402] Other important activities covered in the FINRA Rules include the following:

- margin limitations on the extension of credit to customers; [403]
- the sending of advertising materials to customers; [404]
- special rules governing the sale of particularly complex or risky products to customers, including options, warrants, investment company securities, variable contracts of investment companies, limited

partnership interests, collateralized mortgage obligations and security futures; [405]

- members trading as principal while holding an order from a customer on the same side for the security in question; [406]
- members' trading activities that occur in anticipation of the firm's issuance of research reports regarding a security; [407] and
- member's publication or circulation of transactions and quotations. [408]

FINRA has separate rules governing, among other things, relations between its member broker-dealers, arbitration, trade reporting and settlement. [409]

FINRA rules are in certain respects more demanding than those of the SEC. For example, while the SEC's Rule 15c3-1 generally permits broker-dealers to have aggregate indebtedness that is 15 times net capital, [410] FINRA generally does not permit its member broker-dealers to have aggregate indebtedness in excess of 12 times net capital. [411] Further, FINRA may in fact require

p. 14-100

---

p. 14-101

its members to have more capital than its written rules require. FINRA requires that its members impose initial and maintenance margin requirements on their customers' securities-related borrowings, while the Board's rules under the Exchange Act impose only an initial margin requirement. [412] In addition, FINRA members generally cannot disseminate research reports or make recommendations regarding publicly outstanding equity or noninvestment grade debt securities of their direct or indirect parent companies or other "material associated persons" (as defined in Rule 17h-1T under the Exchange Act). [413] FINRA also reserves the right to disapprove of the outside activities of the controlling persons of a member so as to ensure that these persons will, among other things, not be subject to conflicts of interest. [414] Furthermore, FINRA imposes minimum qualification requirements for high-level personnel. [415] The NYSE and the other exchanges also, of course, have detailed rules governing exchange trading and settlements.

Effective in 2017, FINRA has established a streamlined set of rules for "capital acquisition brokers" ("CABs"). Capital acquisition brokers register as broker-dealers with the SEC but elect to be subject to FINRA's CAB Rules (rather than FINRA's regular rules) and to limit their activities to one or more of:

(A) advising an issuer, including a private fund, concerning its securities offerings or other capital raising activities;

(B) advising a company regarding its purchase or sale of a business or assets or regarding its corporate restructuring, including a going-private transaction, divestiture or merger;

(C) advising a company regarding its selection of an investment banker;

(D) assisting in the preparation of offering materials on behalf of an issuer;

(E) providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services;

p. 14-101

---

p. 14-102

(F) qualifying, identifying, soliciting, or acting as a placement agent or finder (i) on behalf of an issuer in connection with a sale of newly-issued, unregistered securities to institutional investors or (ii) on behalf of an issuer or a control person in connection with a change of control of a privately-held company; [416] and

(G) effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company, in accordance with the terms and conditions of an SEC rule, release, interpretation or "no-action" letter that permits a person to engage in such activities without having to register as a broker or dealer pursuant to § 15(b) of the Exchange Act. [417]

FINRA's CAB Rules differ from FINRA's regular rules principally by elimination of FINRA rules that would not be applicable to a FINRA member engaged only in the limited business of a capital acquisitions broker; however, there are some potential material advantages to operating under the CAB Rules, including:

p. 14-102

p. 14-103

- Capital acquisition brokers are not subject to FINRA Rules 2121 and 2122, which require FINRA members to charge fair prices and commissions for securities transactions and levy charges for other services that are reasonable and not unfairly discriminatory. Capital acquisition brokers are, however, subject to FINRA Rule 2010, which requires members to observe high standards of commercial honor and just and equitable principles of trade; [418]
- Capital acquisition brokers are subject to a streamlined rule relating to communications with the public that does not prohibit communications from including predictions or projections of performance; [419] and
- The supervisory rules applicable to capital acquisition brokers do not require annual compliance meetings, review and investigation of securities transactions, specific documentation and supervisory procedures, internal inspections or CEO certification about compliance procedures. [420]

There are also some material disadvantages to operating under the CAB Rules, most notably the limitation on the capital acquisition broker's business activities and a prohibition on any person associated with a capital acquisition broker engaging in any securities transaction outside the regular course or scope of that person's employment with the capital acquisition broker (other than investing on his or her own behalf and transactions among immediate family members for which no associated person received selling compensation). [421] This means that capital acquisition broker personnel generally could not be dual employees with another broker, bank or financial institution unless they did not participate in any securities transactions for that other broker, bank or financial institution.

[b] SRO Regulation of Broker-Dealer Personnel

The SEC does not, for the most part, directly regulate the competence or background of broker-dealer personnel, but rather assigns that responsibility to the SROs. The failure of a broker-dealer to register and qualify its personnel in accordance with applicable SRO rules is, however, a violation of Rule 15b7-1 under the Exchange Act that can subject the broker-dealer to fines of up to

p. 14-103

p. 14-104

$100,000 per violation. [422] FINRA is the primary regulator of the employees of registered broker-dealers. FINRA's rules generally require that any person engaged in the investment banking or securities business of a member firm register with FINRA, [423] and its rules apply to the activities of each "associated person of a member" as well as of each member broker-dealer. [424] FINRA also prescribes four general levels of competency for associated persons of FINRA members: (i) "principals," who generally are officers and other management and supervisory personnel who have taken and passed the FINRA's General Securities Principal ("Series 24") Examination, (ii) "registered representatives," who include other employees of FINRA member firms whose functions are not solely clerical or ministerial and who have taken and passed FINRA's General Securities Representative Examination ("Series 7"), (iii) "research analysts," who include employees of FINRA member firms whose primary functions are the preparation of research reports or whose name appears on research reports and who have taken and passed FINRA's Series 7 Examination and FINRA's Research Analyst Qualification ("Series 86/87") Examination; [425] and (iv) "operations professionals," who generally are personnel performing or supervising certain enumerated "back office" functions and persons with authority materially to commit a member firm's capital to such functions and who have taken and passed FINRA's Operations

Professional Qualification (Series 99) Examination. [426]

Each FINRA member, with very limited exceptions, must have at least two registered principals (who must pass a qualification examination for principals)

p. 14-104

p. 14-105

actively engaged in the member's business with respect to each aspect of the member firm's investment banking and securities business. [427] Large firms have many supervisory and management level personnel registered as principals. Principals must be responsible for supervision, solicitation, conduct of business and training. The firm's chief financial officer (or an individual with equivalent responsibilities) must take and pass the Financial and Operations Principal Examination ("Series 27") and register as the member's financial and operations principal (commonly referred to as a "FinOp"). [428] FINRA also requires a member to designate a chief compliance officer and for that officer to be Series 24-licensed. [429] In addition, depending upon the nature of its business, a FINRA member may be required to have other "limited principals"; for example, "registered options and security futures principals" are required if the FINRA member engages in an options or security futures business with the public. [430]

Each associated person of a FINRA member generally must individually register with FINRA by having the member complete Form U4. [431] The form requires information concerning the position that the associated person will have with the broker-dealer, the person's employment and personal history for the past ten years and whether the person has ever been charged or involved with an investment-related crime or comparable crime involving personal dishonesty or is otherwise subject to "statutory disqualification." [432] The required registration of associated persons allows FINRA to serve as the central depository for information on associated persons of its members. [433]

In addition to completing Form U4, the associated persons of a broker-dealer generally must pass one or more qualifying examinations, depending on the types of securities business or investment banking in which they are involved and the level of their responsibilities. Despite certain efforts to ease the burden of the examination process and the number of qualifications necessary to operate

p. 14-105

p. 14-106

across international borders, preparation for these examinations can be time-consuming and thus personnel of foreign broker-dealers have in many instances been discouraged from taking the examinations and qualifying as employees of a U.S. broker-dealer. [434]

All registered broker-dealer personnel are also required to complete a two-part continuing education program. [435] The program, which has been approved by the SEC, focuses on current compliance, regulatory, ethical and sales-practice standards. FINRA administers the industry-wide regulatory element of the program *via* computer-based training to broker-dealer personnel in their second year of registration and every three years thereafter, while each broker-dealer is required to implement an ongoing in-house education program to keep its employees up to date on job and product-related subjects. [436] While broker-dealer personnel are not subject to grades or examination with respect to this program, failure to complete the regulatory element of the continuing education program may result in an associated person's FINRA registration being terminated. In addition, failure by a broker-dealer or individual employee to comply with the education program may subject such broker-dealer or employee to disciplinary action. [437]

p. 14-106

p. 14-107

When terminating an associated person of a FINRA member, broker-dealers are required to file a Form U5 (Uniform Termination Notice for Securities Industry Registration). This form requires broker-dealers to state the reason for the employee's termination, and if the termination is for misconduct, the broker-dealer must give details regarding this misconduct. [438] Broker-dealers that, in accordance with this requirement, candidly state the basis of dismissal have, however, faced legal actions by dismissed employees for libel or other torts, leading some broker-dealers to support legislation that would grant legal immunity from such claims for broker-dealers acting in good faith. [439] In 2007, the New York Court of Appeals ruled that an employer's statements on a Form U5 are protected by an absolute privilege in defamation lawsuits. [440]

[4] Anti-Money Laundering Compliance Obligations

SEC-registered broker-dealers are subject to a variety of anti-money laundering (or "AML") compliance obligations under the Bank Secrecy Act of 1970 (the "BSA"), [441] as amended by the USA PATRIOT Act (the "PATRIOT Act") [442] and as implemented in regulations adopted by the Financial Crimes Enforcement Network ("FinCEN") (in some cases jointly with the SEC) [443] and in rules adopted by SROs. This section briefly summarizes the most noteworthy of these compliance obligations.

[a] Background

Before the PATRIOT Act was enacted, U.S. broker-dealers that were not affiliates of banking organizations were not subject to the core AML compliance obligations that applied to commercial banks and their affiliates under the BSA.

p. 14-107

p. 14-108

Although many other countries with leading financial centers applied AML compliance obligations to investment banking firms, it was unclear to what extent U.S. broker-dealers were vulnerable to money laundering. Most broker-dealers do not regularly accept cash or other monetary instruments, and many broker-dealers have policies against accepting cash. [444]

At the same time, broker-dealers were subject to criminal money laundering laws and to BSA reporting requirements relating to large currency transactions. Broker-dealers also were permitted to file suspicious activity reports ("SARs") under the BSA on a voluntary basis (and many large broker-dealers routinely did so). As a result, many large broker-dealers had adopted AML programs before they were required to do so under the PATRIOT Act.

[b] Anti-Money Laundering Program Requirements

Under § 352 of the PATRIOT Act, all SEC-registered broker-dealers must establish an AML program. [445] Under FinCEN's regulations implementing § 352, a broker-dealer is deemed to be in compliance with § 352 if it complies with the AML requirements of an applicable SRO. [446] Accordingly, FINRA adopted Rule 3310, which requires its broker-dealer members to develop and implement AML programs that contain the key elements identified in § 352. [447] A broker-dealer subject to the AML program requirements of FINRA must adopt written policies and procedures reasonably designed to ensure that it not be used to launder money. The broker-dealer also is required under FINRA Rule 3310 to provide for

p. 14-108

p. 14-109

periodic independent testing of its AML program, designate an AML compliance officer and provide ongoing training to employees. [448]

[c] Suspicious Activity Reporting Requirements

As required by the PATRIOT Act, FinCEN has promulgated suspicious activity reporting requirements for registered broker-dealers. [449] Broker-dealers currently are required to file SARs on FinCEN Form 111 for any transaction conducted or attempted by, at or through a broker-dealer involving at least $5,000, where the broker-dealer knows, suspects or has reason to suspect that the transaction (or pattern of transactions): (i) involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity as part of a plan to violate or evade any federal law or regulation or transaction reporting requirement, (ii) is designed to evade BSA regulatory requirements, (iii) has no business or apparent lawful purpose, or is not the type of activity in which the particular customer would normally be expected to engage and for which the broker-dealer upon examination knows of no reasonable explanation, or (iv) involves use of the broker-dealer to facilitate criminal activity. [450]

A broker-dealer that files a SAR is generally prohibited from disclosing the fact that a SAR was filed, or any information that would reveal the existence of a SAR, to any person, including any person involved in the reported transaction. [451] This confidentiality requirement does not, however, prevent broker-dealers from sharing SARs with their parent companies and with other affiliates that are also subject to SAR regulation and a written confidentiality agreement with respect to maintaining the confidentiality of SARs. [452] In addition, under the

p. 14-109

p. 14-110

BSA, broker-dealers benefit from a general safe harbor from liability (*e.g.*, defamation liability) for filing a SAR. [453] Although at least one court has suggested that this safe harbor requires that the reporting institution have a "good faith suspicion," [454] the weight of judicial authority has rejected this requirement. [455]

[d] Customer Identification Programs

As part of their broader AML program, registered broker-dealers are required to adopt a written Customer Identification Program ("CIP"). [456] A CIP must include procedures for (i) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable, (ii) maintaining records of the information used to verify the person's identity, including name, address, and other identifying information, and (iii) determining whether the

p. 14-110

p. 14-111

person appears on any lists of known or suspected terrorists or terrorist organizations provided to the broker-dealer by any governmental agency. [457] These procedures are not required for certain classes of customers, such as financial institutions (as defined in the BSA) that have a federal functional regulator (or, in the case of state banks, a state regulator), entities with publicly traded shares and certain governmental entities. [458] The CIP rules that apply to broker-dealers, issued jointly by FinCEN and the SEC, contain specific requirements relating to permissible documentary and nondocumentary methods for verifying a customer's identity, recordkeeping requirements, procedures for checking customer names against government lists, and providing notice to customers regarding the collection of identifying information. [459]

The CIP rule for broker-dealers permits broker-dealers to rely on certain types of BSA-regulated financial institutions (including affiliates) to perform the procedures required under the broker-dealer's CIP. Such reliance must be "reasonable under the circumstances," and only BSA-regulated financial institutions that are required to adopt an AML program under § 352 of the PATRIOT Act are eligible. [460] In addition, the financial institution must enter into a contract requiring it to certify annually to the broker-dealer that the financial institution has

p. 14-111

p. 14-112

implemented its AML program, and that it (or its agent) will perform specified requirements of the broker-dealer's CIP. [461]

[e] Customer Due Diligence

In May 2016, FinCEN issued a final rule (the "Final CDD Rule") formalizing regulatory expectations regarding customer due diligence and introducing a new requirement for broker-dealers to identify and verify the identity of the beneficial owners of their legal entity customers. [462] Specifically, the Final CDD rule will impose a requirement on broker-dealers to identify and verify the identity of certain of their legal entity customers' "beneficial owners," defined as: (i) each individual directly or indirectly owning 25% or more of the entity's equity interests, and (ii) a single individual with significant responsibility to control, manage or direct a legal entity customer. [463] The deadline for compliance with the requirements of the Final CDD Rule is May 2018. [464]

The Final CDD Rule includes certain exemptions and exclusions, including not requiring beneficial ownership diligence for certain types of publicly traded companies, pooled investment vehicles, regulated financial institutions and trusts. [465] FinCEN has also indicated that, to the extent that existing guidance allows a broker-dealer to treat an intermediary (and not the intermediary's customers) as its customer for CIP purposes, the broker-dealer should treat the intermediary as its legal entity customer for purposes of the beneficial ownership requirement. [466] For example, a broker-dealer that appropriately maintains an omnibus account for an intermediary may treat the intermediary, and not the

p. 14-112

p. 14-113

underlying clients, as its legal entity customer for purposes of the beneficial ownership requirement. [467] Additionally, when the Final CDD Rule applies to a broker-dealer's relationship with a legal entity customer, formal reliance on another financial institution to perform the beneficial ownership diligence is possible under the same conditions that apply to reliance for CIP purposes. [468]

[f] Information Sharing Requirements

FinCEN's rule implementing § 314(a) of the PATRIOT Act (the "Information Sharing Rule") gives FinCEN the power to request, on its own behalf and on behalf of federal, state, local and certain foreign law enforcement authorities, information regarding suspected terrorists or money launderers from broker-dealers and other BSA-regulated financial institutions. [469] A financial institution that receives such a request is required to search its records to determine whether it maintains or has maintained any account (within the last 12 months) or has engaged in certain transactions (within the last 6 months) for or on behalf of the named subject or subjects of the request. [470] The Information Sharing Rule clarifies that a financial institution need not take further action with respect to an account or transaction that may be related to a suspected money launderer and that, unless otherwise specified, information requests are not continuing in nature.

The Information Sharing Rule also implements § 314(b) of the PATRIOT Act, which permits financial institutions to share information with each other regarding known and suspected terrorists and money launderers, upon prior

p. 14-113

p. 14-114

notice to FinCEN (which notice is effective for one year, subject to renewal). Before sharing information under the Information Sharing Rule, a financial institution must take reasonable steps to verify that the other financial institution with which it intends to share information has submitted its own notice to FinCEN under § 314(b). [471] Section 314(b) and the Information Sharing Rule also provide a safe harbor protecting financial institutions from liability under U.S. federal, state and local law for sharing information or failing to notify the subject of the shared information. [472]

[g] Private Banking and Correspondent Account Due Diligence

Under § 312 of the PATRIOT Act, [473] broker-dealers and other BSA-regulated financial institutions are required to perform due diligence, and in some cases enhanced due diligence, on non-U.S. persons for whom the financial institution "establishes, maintains, administers, or manages" a "private banking account" in the United States. [474] The financial institution is required to take reasonable steps to ascertain the identity of the nominal and beneficial owners of, and sources of funds deposited into, the account. In addition, the financial institution is required to conduct enhanced scrutiny of any account requested or maintained by or on behalf of a senior foreign political figure (also referred to as a "politically exposed person" or "PEP"), or any of his or her immediate family members or close associates in order to detect and report transactions that may involve the proceeds of foreign corruption.

Under § 312, broker-dealers and other BSA-regulated financial institutions are also required to perform due diligence, and in some cases enhanced due diligence, with respect to "correspondent accounts" for non-U.S.

persons. [475] The definition of "correspondent account" for purposes of the PATRIOT Act is extremely broad—far exceeding any conventional understanding of the term

p. 14-114

p. 14-115

"correspondent banking account." [476] "Correspondent account" is defined to mean "an account established for a foreign financial institution to receive deposits from, or to make payments or other disbursements on behalf of, the foreign financial institution, or to handle other financial transactions related to such foreign financial institution." [477] The term "account" in the definition of "correspondent account" is defined for broker-dealers to mean "any formal relationship established with a broker or dealer in securities to provide regular services to effect transactions in securities, including, but not limited to, the purchase or sale of securities and securities loaned and borrowed activity, and to hold securities or other assets for safekeeping or as collateral." [478]

In 2005, FinCEN adopted final rules implementing § 312 of the PATRIOT Act, replacing the interim rule that had been in effect since 2002. [479] FinCEN adopted the statutory definition of "correspondent account," but modified the due diligence requirement to be more risk-based. Under the final rule for correspondent accounts for foreign financial institutions and private banking accounts, broker-dealers must establish a due diligence program that includes appropriate, specific, risk-based and, where necessary, enhanced policies, procedures and controls reasonably designed to detect and report known or suspected money laundering activity through or involving any correspondent account or private banking account. [480]

In August 2007, FinCEN adopted rules requiring "enhanced" due diligence for correspondent accounts of foreign banks operating under (i) an offshore banking license, (ii) a license issued by a country designated as noncooperative with international AML principles by an intergovernmental group or organization of which the United States is a member and with which designation the U.S. representative to the group or organization concurs or (iii) a license issued by a country designated by the U.S. Treasury Department as warranting special measures due to money laundering concerns. [481]

[h] Foreign Shell Bank Prohibition and Correspondent Account Recordkeeping Requirements

p. 14-115

p. 14-116

Registered broker-dealers are prohibited under § 313(a) of the PATRIOT Act [482] from establishing, maintaining, administering or managing a correspondent account in the United States for or on behalf of any "foreign shell bank" (*i.e.*, a foreign bank that does not have a physical presence in any jurisdiction), unless the foreign bank is a so-called "regulated affiliate." [483] Broker-dealers also must take "reasonable steps" to ensure that a correspondent account maintained for a foreign bank is not used by the foreign bank indirectly to provide banking services to a foreign shell bank (other than a regulated affiliate).

Under § 319(b) of the PATRIOT Act, registered broker-dealers must maintain records identifying the owners and designated U.S. agents for service of process of foreign banks for which they maintain a correspondent account. Records regarding the foreign bank's owners are not required for foreign banks whose shares are publicly traded or that report ownership information to the Board on Form FR Y-7 (which thus excludes most foreign banks with U.S. banking operations). [484]

FinCEN has not mandated a specific method by which broker-dealers must comply with the shell bank prohibition or the correspondent account recordkeeping requirements of the PATRIOT Act. However, FinCEN has promulgated a form of certification that can be used as a safe harbor for compliance with these provisions. In order to satisfy the safe harbor, the certification must be renewed every three years. [485]

[5] Research Analysts and Research Reports

FINRA Rule 2241 addresses the publication of research reports analyzing equity securities by FINRA members and the conduct of research analysts responsible for preparing such reports. The rule requires members to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to the preparation,

p. 14-116

p. 14-117

content and distribution of research reports, public appearances by research analysts and the interaction between research analysts and nonresearch personnel. Among other things, these policies and procedures must:

- prohibit prepublication review, clearance or approval of research reports by persons engaged in investment banking services and restrict such review by personnel not responsible for their preparation, content and distribution;
- restrict input by the investment banking department into research coverage decisions to ensure that research management independently makes final decisions regarding research coverage;
- prohibit persons engaged in investment banking activities from supervising or controlling research analysts, retaliating against them as a result of unfavorable research reports or public appearances, directing them to engage in sales or marketing efforts related to an investment banking services transaction, or directing them to engage in any communication with a current or prospective investment banking customer; [486]
- limit determination of the research department budget to senior management (excluding management engaged in investment banking activities) and prohibit compensation based on specific investment banking transactions or contributions to investment banking activities; [487]
- establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from the review, pressure or oversight by persons engaged in investment banking activities or other persons (including sales and trading personnel) who might be biased in their judgment or supervision;
- define periods during which the member must not publish research reports or allow public appearances by research analysts, including a minimum of ten days following the date of any initial public offering by the subject company if the member participated as underwriter or dealer in the offering and a

p. 14-117

p. 14-118

  minimum of three days following the date of any secondary offering if the member acted as manager or co-manager of the offering; [488]
- restrict or limit research analyst trading in securities covered by the research analyst (and any derivatives or funds whose performance is materially dependent on the performance of such securities), including ensuring that research analysts and related personnel do not benefit from knowledge of the content or timing of the research report before the intended recipients have a reasonable opportunity to act on the information in the report, prohibiting research analyst accounts from trading in a manner inconsistent with a research report or recommendation and prohibiting research personnel from purchasing or receiving pre-IPO securities from issuers engaged in the business that the research analyst follows;
- prohibit explicit or implicit promises of favorable research, recommendations or specific research content as an inducement for the receipt of business or compensation;
- restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity, such as participation in pitches or other solicitations of investment banking services, participation in road shows or other marketing on behalf of an issuer related to an investment banking services transaction; and

- prohibit prepublication review of a research report by a subject company (*i.e.*, a company whose equity securities are the subject of the report) for purposes other than verification of facts.

In addition to requiring members to identify and manage conflicts of interest, Rule 2241 requires FINRA members to establish, maintain and enforce written policies and procedures reasonably designed to ensure that purported facts in research reports are based on reliable information and any recommendation, rating or price target has a reasonable basis and is accompanied by a clear explanation of the valuation method used and a fair presentation of the risks that may impede its achievement. Equity research reports are also required to include:

- specific information regarding the member firm's rating system;
- graphical representations of the member's historic rating or price target for the subject company and subject company's share price;

p. 14-118

p. 14-119

- disclosure regarding any financial interest the research analyst or any member of the analyst's household has in the subject company;
- disclosure if the research analyst received any compensation based on the member's investment banking revenue;
- disclosure if the member or its affiliates managed or co-managed a public offering for the subject company in the last twelve months, received any investment banking or other compensation from the subject company in the last twelve months or expects to receive investment banking compensation from the subject company in the next three months;
- disclosure if the member or its affiliates beneficially own 1% or more of any class of common equity of the subject company or if the member is making a market in the subject company's securities;
- disclosure if the research analyst received any compensation from the subject company in the previous twelve months;
- disclosure of any other material conflict of interest of the research analyst, member firm or any associated person of the member with the ability to influence the content of the research report. [489]

These disclosures must either appear on the front page of the research report or the front page must refer to the page on which they can be found (although compendium reports covering six or more companies may direct the reader in a clear manner to where they can be found). [490]

If a FINRA member distributes [491] research reports prepared by a person other than the member (including research reports prepared by a foreign affiliate of the member), Rule 2241 provides that each such third-party research report:

p. 14-119

p. 14-120

- must be reviewed and approved by a registered principal or supervisory analyst;
- may not be distributed if the FINRA member knows or has reason to know the research is not objective or reliable;
- unless it is an independent third party research report, [492] must be reviewed in accordance with policies and procedures reasonably designed to ensure that that the third-party research report does not contain any untrue statement of material fact or other false or misleading information that should be known from reading the report or is known based on information otherwise possessed by the FINRA member;
- is accompanied by disclosure of any material conflict of interest that can be reasonably be expected to have influenced the choice of third-party research provider or the subject company of the report; and

- is clearly labeled as a third-party research report so that there is no confusion on the part of the recipient as to the person or entity that prepared the research report. [493]

Finally, Rule 2241 requires FINRA members to notify its customers if it intends to terminate its research coverage of a company and to accompany that notice by a final research report (or its reasons for terminating coverage if providing a final research report is impractical). [494]

p. 14-120

p. 14-121

Any associated person of a FINRA member who functions as a research analyst must pass the Research Analyst Qualification ("Series 86/87") Examination or qualify for an exemption or waiver therefrom. [495] Research analysts must be supervised by a research principal who, in addition to passing the General Securities Principal ("Series 24") Examination, also must have passed either Part II of the Research Analyst ("Series 87") Exam-Regulation or the NYSE Supervisory Analyst ("Series 16") Examination. [496]

Effective in early 2016, new FINRA Rule 2242 applies to debt research many of the same requirements that apply to equity research. There are, however, several important differences between FINRA's debt and equity research rules. Most significantly, Rule 2242 exempts from many of its requirements debt research reports that a FINRA member provides solely to certain institutional investors who have consented to receiving institutional research that is not subject to the independence and disclosure standards applicable to debt research reports provided to retail investors. In addition, Rule 2242 extends many provisions of Rule 2241 designed to address conflicts of interest with the member's investment banking department to also apply to the principal trading and sales and trading departments. Finally, the research analyst qualification and registration requirements currently apply only to equity research analysts, although FINRA is considering whether debt research analysts should be subject to the same or similar requirements.

[a] SEC Regulation AC

In 2003, the SEC adopted Regulation Analyst Certification ("Regulation AC"). [497] Regulation AC requires that research analysts make certain certifications with respect to the views expressed by them in research reports and public

p. 14-121

p. 14-122

appearances relating to both debt and equity securities. In particular, a research analyst is required to certify in a research report distributed to U.S. persons that (i) the views expressed in the research report accurately reflect the analyst's personal views on any and all subject securities or issuers discussed therein, and (ii) either (a) no part of the analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report ("related compensation"), or (b) all or part of the analyst's compensation consists of related compensation. If the analyst received any related compensation, the research report must also disclose the amount, source and purpose of that compensation and include cautionary language that the receipt of related compensation could influence the recommendation. [498]

A record containing similar disclosures must also be maintained by the broker-dealer employing the analyst (or circulating to U.S. persons research reports prepared by the analyst) in connection with any public appearances made by the analyst during the prior quarter. [499] In cases where the analyst does not provide, or is unable to make, certifications of the type set forth in clauses (i) and (ii)(a) in the preceding paragraph with respect to public appearances, the broker-dealer must notify its designated examining authority of that fact and include, for 120 days after the notification is made, disclosure in research reports prepared by the analyst that the analyst did not provide the required certifications. [500]

[b] Other Developments

In October 2003, a settlement agreement was entered by the U.S. District Court for the Southern District of New York with respect to enforcement actions by the SEC, NYSE, NASD, NASAA, the Attorney General of the State of New York and various state securities regulators (collectively, the "Regulators") against ten of the largest investment banking firms (the "settling firms") (the "Global Research Settlement"). The Global Research Settlement relates to charges by the regulators that the settling firms were engaged in acts and practices that created or maintained inappropriate influence by investment banking

p. 14-122

p. 14-123

personnel over equity research analysts, which created conflicts of interest that were not adequately managed or disclosed. While neither admitting nor denying the allegations made, the settling firms agreed to pay the regulators an aggregate of approximately $1.4 billion, a portion of which is comprised of civil penalties and disgorgement in connection with prior activities and the remainder of which was to be used to fund investor education programs and to pay for the procurement of independent research. [501]

In addition, the settling firms (i) agreed to (a) comply with significant restrictions relating to the interaction between the investment banking and equity research departments of their respective firms, (b) make certain additional disclosures to research recipients regarding (among other things) potential conflicts of interest resulting from investment banking activities, and (c) procure and make available to U.S. customers independent, third-party research on the common stock of certain issuers (collectively, the "forward-looking aspects of the Global Research Settlement"), [502] and (ii) entered into a voluntary agreement restricting allocations of securities in so-called "hot IPOs" (*i.e.*, those initial public offerings where the securities begin trading at a premium in the secondary market) to executive officers and directors of public companies (the "IPO Allocation Initiative").

The forward-looking aspects of the Global Research Settlement and the IPO allocation restrictions agreed to by the settling firms have had a significant impact on the way securities offerings are conducted, even for those firms not

p. 14-123

p. 14-124

party to the Global Research Settlement or the IPO Allocation Initiative. In particular, these requirements have served as a basis for additional rulemaking by the SEC and the SROs. [503] Moreover, many firms not parties to the Global Research Settlement have concluded that it is appropriate, from a "best practices" point of view, to adopt many, if not all, of the forward-looking aspects of the Global Research Settlement and the IPO allocation restrictions in order to minimize the likelihood of future regulatory action or civil litigation in connection with their own research analyst and investment banking practices. In addition, certain local governmental and municipal authorities and institutional investors with fiduciary obligations (*e.g.*, pension plans) have insisted that other firms comply with some or all of the forward-looking aspects of the Global Research Settlement and the IPO Allocation Initiative as a condition of doing business with them. [504] The Global Research Settlement and SRO research rules also focused renewed attention on the relationship between issuers and analysts. [505]

It is also important to view the structural reforms and other forward-looking aspects of the Global Research Settlement in the context of the other

p. 14-124

p. 14-125

existing and proposed regulations regarding research analyst conflicts of interest discussed above. The Global Research Settlement requirements are in addition to, and do not replace, these other regulations and, in the event of any inconsistency, the more restrictive provision (or relevant part of the provision) will control. The Global Research Settlement does, however, provide that if the SEC adopts a rule or approves an SRO rule or interpretation with the stated intent to supersede any of the provisions of the Global Research Settlement, that rule or interpretation will govern and will supersede the relevant settlement provision. [506] To date, no such rule or interpretation has been adopted; instead, the SEC has reinforced the continuing applicability of the Global Research Settlement. [507]

It is also important to note that not all aspects of the Global Research Settlement are still in place. The settling firms' obligation to make available independent, third-party research was subject to a five-year limitation and expired on July 31, 2009. The settlement also contains a provision that allows the parties to modify the order, subject to court approval, unless the SEC believes such a modification to be against the public interest. In 2010, the settling firms and the SEC agreed to a proposal that, among other things, would have removed the firewall between research analysts and investment bankers, permitting communication between the two groups without the presence of legal counsel. The district court approved some of the proposal, but rejected the modification that would have removed the firewall. [508]

[6] Margin Rules—Restrictions on Lending and Borrowing

p. 14-125
p. 14-126

[a] Regulation T

The Exchange Act provides that broker-dealers and members of a national securities exchange may not "extend or maintain credit or arrange for the extension … of credit to or for any customer … on any security" (other than an exempted security or a security futures product) in contravention of such rules as are adopted by the Board. [509]

The basic purpose of this provision and the Board's rules thereunder (which are known as the "margin regulations") [510] is to control the amount of credit available in the economy for financing transactions in securities. The margin regulations stem from the belief that an excessive injection of credit had contributed to the stock market run-up that preceded the 1929 stock market crash. It was also thought that an excessive amount of loans used to finance securities dealings had diverted capital from other more productive sectors of the economy. Margin regulations may also protect individual investors against securities speculation in excess of their resources and deter lenders, especially broker-dealers, from imprudent credit practices. [511] However, these were

p. 14-126
p. 14-127

secondary considerations, if not incidental results, in the adoption of these regulations. [512]

The Board margin regulation applicable to broker-dealers is Regulation T. [513] Regulation T imposes initial margin requirements for all "purpose credit" (defined as credit used to purchase, carry or trade in any security, whether debt or equity and whether publicly or privately traded) and specifies the collateral that may be used to satisfy such margin requirements (generally either exempted securities or "margin securities" [514]). In addition, Regulation T establishes payment rules in connection with securities transactions. Pursuant to amendments adopted by the Board in 1996, Regulation T also permits broker-dealers to arrange for the extension or maintenance of credit to or for any customer by third parties, provided the broker-dealer does not willfully arrange credit that violates margin regulations applicable to such third-party lenders or the customer (*i.e.*, Regulations U and X). [515]

[i] *Account Structure*

Regulation T requires that all transactions between a broker-dealer and a customer [516] be recorded in one of the broker-dealer's Regulation T "accounts." More specifically, Regulation T requires that each transaction be recorded in the

p. 14-127
p. 14-128

broker-dealer's "margin account" [517] unless it is eligible for one of three special purpose accounts.

Loans to customers that are used to finance the purchase, trading or carrying of equity securities generally are recorded in the margin account. The rule of lending in the margin account, very simply stated, is that a broker-dealer may not extend credit to a customer unless the loan value of the customer's securities (as determined in accordance with Regulation T) in the margin account is sufficient to secure the amount of the credit.

Regulation T imposes only an initial margin requirement. In other words, no matter how low the value of the customer's securities collateralizing the broker-dealer's loan falls after the extension of the loan, no additional margin is required. [518] The requirements for credit used to finance a long position in a security in the margin account are summarized below:

Security	***Required Margin***
Marginable equity securities	50% of market value
Exempted and other nonequity securities	“Good faith”
Exchange-traded and OTC options	Determined by relevant options exchange or SRO
Other securities	100% of market value

Regulation T also prescribes margin requirements for short positions in a security: 100% of the market value of the security sold short plus any "good faith margin" in the case of an exempted security or other nonequity security; 150% of the market value in the case of equity securities; and the amount specified by the relevant options exchange or SRO in the case of exchange-traded and OTC options, respectively. [521]

p. 14-128

p. 14-129

Generally, to extend credit and to determine a customer's position in a margin account, freely convertible foreign currency may be treated at its U.S. dollar equivalent, provided that the currency is marked to market daily. [522] To the extent that there is a margin deficiency in a foreign currency/foreign securities position, it may be aggregated with the remainder of the customer's account.

A "margin call" on a customer generally must be satisfied within one "payment period" [523] after any deficiency in the customer's margin account is created or increased by new transactions. [524] If the customer does not make up the deficiency in the allotted time, the broker-dealer is required to cure the deficiency by selling securities in the account, subject to a *de minimis* exception. [525]

In addition to the margin account, Regulation T provides for three special purpose accounts in which certain transactions can be recorded: a "cash account," a broker-dealer credit account and a "good faith account." [526] Securities may be purchased in the customer's cash account if the customer has the funds needed to pay for the securities in the account or the customer agrees to make promptly full cash payment for the security before selling it and does not contemplate selling the security before making such payment. [527] A broker-dealer is generally required to obtain full cash payment for securities purchased in a cash account within one payment period, but a customer may be allowed a longer

p. 14-129

p. 14-130

period to pay in certain special circumstances. Up to 35 calendar days is allowed to pay for securities purchased in a delivery versus payment (commonly known as "DVP") transaction, provided that delivery is delayed beyond one payment period because of the mechanics of the transactions (and not because of the customer's unwillingness or inability to pay for the purchased securities). [528] Another special circumstance applies to customer purchases of foreign securities in a foreign market. A customer is generally not required to pay for a foreign security purchased in a cash account until one day after the date on which settlement is required to occur by the rules of the relevant foreign securities market, provided that this period does not exceed 35 calendar days. [529]

Securities may be sold in a customer's cash account (or purchased by a broker-dealer from a customer) only if the security is held in the account at the time of sale or if the broker-dealer accepts in good faith the customer's statement that the customer owns the security and will "promptly" (which is generally understood to mean within one payment period) deposit it in the account. As a result, short sales cannot be effected in the cash account.

The good faith account may be used, among other purposes, to finance transactions in securities entitled to "good faith" margin and to extend nonpurpose credit. A written statement of the customer's intent on Board Form T-4 that discloses the specific reason for the borrowing must be obtained prior to any extension of nonpurpose credit other than to finance commodities and foreign exchange transactions. Broker-dealers may also use the good faith account to borrow and lend securities entitled to "good faith" margin (such as nonequity securities). In contrast, equity securities generally may be borrowed or loaned under Regulation T only with a "permitted purpose" unless the lending entity is an "exempted borrower." [530]

[ii] *Margin Securities*

Historically, "margin securities" (*i.e.*, those securities, other than exempted securities, that a broker-dealer is permitted to accept as collateral satisfying a margin requirement for a purpose loan) were largely limited to securities registered under the Securities Act or the Exchange Act and publicly traded in the United States. [531] However, in recent years the Board has gradually broadened the definition of "margin security," particularly with respect to nonequity and foreign securities. In the amendments to Regulation T adopted by the Board in 1997

p. 14-130

p. 14-131

(the "1997 Regulation T Amendments"), [532] for example, the Board amended the definition of "margin security" to include any nonequity security. The 1997 Regulation T Amendments also discontinued the Board's previous practice of qualifying over-the-counter stocks as margin securities through inclusion in a periodically published list of "OTC margin stocks," replacing it with a simple test under which any security listed on the Nasdaq Stock Market is deemed to be a margin security. [533] Further, in an effort to facilitate participation by U.S. broker-dealers in international securities transactions, Regulation T includes in the definition of "margin security" certain "foreign margin stocks" issued outside the United States that are deemed to have a "ready market" for purposes of the SEC's net capital rule. [534]

[iii] *Exempted Borrowers*

In accordance with the amendments made by the NSMIA to §§ 7 and 8 of the Exchange Act, Regulation T 's scope provisions now exclude credit extended by one broker-dealer to another where the creditor broker-dealer has made a good faith determination that the borrower is an "exempted borrower." [535] A broker-dealer is an "exempted borrower" if a substantial portion of its business consists of transactions with persons other than brokers or dealers. [536] "Exempted borrower" status may be established, among other things, by qualifying for one or more of three nonexclusive safe harbors based on the broker-dealer's number of active customer accounts and gross revenues from customer business. [537] A similar amendment to the scope provision of Regulation U also excludes from Regulation

p. 14-131

p. 14-132

U credit extended to an exempted borrower. [538] The effect of these changes, taken as a whole, has been to allow broker-dealers that qualify as exempted borrowers to borrow against any securities from any lender, without regard to the Board's margin requirements (which otherwise may be 50% or higher). [539]

[iv] *Portfolio Margining*

In the 1997 Regulation T Amendments, the Board amended Regulation T 's scope provision to allow compliance with any portfolio margining system approved by the SEC as an alternative to compliance with Regulation T. [540] Provisions for portfolio margining systems have been adopted by FINRA and the Chicago Board Options Exchange ("CBOE"). [541] Instead of specifying a fixed margin percentage for individual securities positions, portfolio margining assesses initial and maintenance margin levels based on the risk of a portfolio of positions related to the same underlying instrument, taken as a whole, using theoretical pricing models approved by the SEC [542] and certain assumed fluctuations in the market price of the underlying instrument. This calculation allows qualifying accounts to recognize offsets between positions within each portfolio, possibly reducing margin requirements substantially. [543]

[b] SRO Margin Rules

p. 14-132
p. 14-133

Broker-dealers must comply not only with Regulation T, but also with the margin requirements of any SRO of which they are members. The principal SRO margin requirements are contained in FINRA Rule 4210.

One major difference between Regulation T and the margin rules of the SROs, including FINRA Rule 4210, is that the SROs' rules impose a maintenance margin requirement, whereas Regulation T prescribes only an initial margin requirement. [544] In addition, the margin rules of the SROs impose substantially higher margin requirements on certain securities and are in certain other respects more restrictive than those that apply under Regulation T. For example, FINRA Rule 4210 generally imposes a margin requirement of 6% on U.S. Treasury securities with 20 years or more to maturity, whereas Regulation T requires only "good faith" margin. [545] This and similar SRO margin requirements have been a significant factor in motivating U.S. broker-dealers to arrange securities financing for their customers with a foreign affiliate rather than extending credit directly, although the increased level of leverage available in portfolio margin accounts has reduced the level of arranged financing activity.

[c] Credit in Connection with a Distribution

Section 11(d)(1) of the Exchange Act generally prohibits a broker-dealer participating in the "distribution" [546] of a "new issue" [547] of securities from

p. 14-133
p. 14-134

lending against such securities until 30 days after the completion of the broker-dealer's participation in the distribution. [548] This restriction is intended to manage the potential conflict of interest that may arise if a broker-dealer makes credit available to induce a person to whom it has a fiduciary obligation (*i.e.*, its customer) to purchase securities that the broker-dealer has a significant interest in selling. [549] One result of this restriction is that, without special relief from the SEC, partly paid securities cannot be publicly offered in the United States in a primary offering, or, in some cases, in a secondary offering. [550]

Footnotes

273 In addition, the SEC has promulgated rules pursuant to the GLB Act regarding the privacy of consumer financial information to which registered broker-dealers and certain other entities regulated by the SEC must adhere. *See* SEC Release No. 34-42974 (June 22, 2000, amended by SEC Release No. 34-50781 (Dec. 2, 2004)) (adopting Privacy of Consumer Financial Information (Regulation S-P)) and SEC Division of Investment Management Staff Responses to Questions About Regulation S-P (Jan. 23, 2003); *see also* SEC Release No. 34-61003 (Nov. 16, 2009) (adopting a safe harbor model privacy form to provide disclosures under the GLB Act privacy rules).

274 *See generally* § 11.

275 Transactions in security futures products are also subject to the antifraud and antimanipulation provisions of the CEA. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.02[4][a].

276 Broker-dealers are subject to sanctions for fraudulent acts under a number of federal statutes in addition to the Exchange Act, including the Securities Act, the mail fraud sections of the U.S. criminal code and the Racketeer Influenced and Corrupt Organizations Act ("RICO"). *See*, *e.g.*, *Escott v. Barchris Construction*, 283 F. Supp. 643 (S.D.N.Y. 1968) (relating to liability under the Securities Act); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir.) (unpublished order), *cert. denied*, 464 U.S. 863 (1983) (relating to mail fraud charge against the employee of a registered broker-dealer); *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, *reh'g denied*, 483 U.S. 1056 (1987) (relating to RICO claims brought against registered broker-dealer). *See generally* § 11.

277 *See* Rule 10b-10 under the Exchange Act.

278 *See* Rule 15c1-8 under the Exchange Act. Mark-ups over 10% are considered, absent adequate disclosure, *per se* fraudulent by the SEC and lower mark-ups may be fraudulent in certain circumstances. *See In the Matter of Ernest E. Suwara Thomas W. Carpenter Dean Witter Reynolds, Inc.*, SEC Release No. 34-18623 (Apr. 6, 1982). FINRA rules require members to charge fair prices and commissions and a FINRA policy guideline provides that mark-ups in excess of 5% are generally not permitted and mark-ups lower than 5% may also, depending on the circumstances, be deemed excessive. *See* FINRA Rule 2121 and supplemental material thereto, FINRA MANUAL (discussed at § 14.07[3][a][i]). The SEC has stated that FINRA's "5% mark-up policy" is not applicable in determining whether a mark-up violates § 10(b) of the Exchange Act. *See*, *e.g.*, *In re D.E. Wine Investments, Inc.*, SEC Release No. 34-43929 (Feb. 6, 2001); *In re Lehman Brothers Inc.*, SEC Release No. 34-37673 (Sept. 12, 1996).

279 *See*, *e.g.*, *Clark v. John Lamella & Co.*, 583 F.2d 594 (2d Cir. 1978).

280 *See*, *e.g.*, *Costello v. Oppenheimer & Co.*, 711 F.2d 1361 (7th Cir. 1983); *Newburger v. Gross*, 563 F.2d 1057 (2d Cir. 1977). Rule 15c1-7 under the Exchange Act specifically characterizes as fraudulent and manipulative the execution of transactions that are "excessive in size or frequency in view of the financial resources and character" of a customer's discretionary account. Further, successful claims have been brought against broker-dealers for churning even nondiscretionary accounts over which they were found to have exercised substantial *de facto* control. *See*, *e.g.*, *Eros v. SEC*, 742 F.2d 507 (9th Cir. 1984).

281 *See* Rules 15g-1 through 15g-9 under the Exchange Act.

282 *See*, *e.g.*, *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); *In re Trots & Co.*, 12 S.E.C. 531, 535 (1942). *But see* Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016) (discussed below).

283 *See*, *e.g.*, *In re Trots & Co.*, 12 S.E.C. 531 (1942); *see also In re Duke & Duke*, 6 S.E.C. 386, 388–89 (1939); *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 435 (2d Cir. 1943). *See generally Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969); Randall W. Quinn, *Deja Vu All Over Again: The SEC's Return to Agency Theory in Regulating Broker-Dealers*, 1990 COLUM. BUS. L. REV. 61.

284 *See* § 16.09 for a more detailed discussion of soft dollar arrangements in the context of the regulation of investment advisers. While the issues that arise in connection with soft dollar arrangements are generally in the first instance the concern of investment advisers, a broker-dealer involved in impermissible soft dollar arrangements, in circumstances where the broker-dealer should have been alerted to a possible violation by the adviser of its fiduciary duties, may risk liability under general antifraud principles. *Cf.*, *e.g.*, SEC Release No. 34-16679 (Mar. 19, 1980) ("aiding and abetting" liability); *see also* § 11.04[2][b].

In 2006, the SEC issued an interpretive release that circumscribes the use of soft dollars and reflects changes in industry practice and technology. The release states that the analysis of permissible brokerage and research services under the "soft dollars" safe harbor of § 28(e) of the Exchange Act requires a three-step process, involving (i) the application of eligibility criteria, (ii) the investment adviser's lawful and appropriate use of the brokerage and research services, and (iii) the investment adviser's good-faith determination that the commissions paid are reasonable in the light of the value of the services received. *See* SEC Release No. 34-54165 (July 18, 2006).

285 In situations in which the relevant account is that of a pension plan subject to ERISA, each of these commission arrangements may raise significant questions thereunder. *See* § 16.09 for a description of directed brokerage arrangements. Directed brokerage also raises in the first instance issues not for the broker-dealer but for the fiduciary directing a customer's account. As with soft dollar arrangements, broker-dealers that participate in directed brokerage arrangements that are not permissible, where they should have been alerted by the circumstances to possible fraud, may risk liability under general antifraud principles. Further, the registered broker-dealer is also responsible for adequate disclosure of such arrangements to its customers (*i.e.*, that a portion of compensation being paid by the customer is being passed on by the broker-dealer), as well as for assuring that the broker-dealer's books and records adequately reflect the directed brokerage arrangements.

286 *See generally* SEC Release No. 34-34902 (Oct. 27, 1994) (requiring certain disclosures to customers in

connection with payment for order flow arrangements).

287 *See* Letter from Harvey L. Pitt, Chairman, SEC, to Salvatore F. Sodano, Chairman, AMEX (Jan. 24, 2003).

288 § 15(k) and (m) of the Exchange Act; *see also*, § 913 of the Dodd-Frank Act.

289 § 15(k) of the Exchange Act; *see also* § 913 of the Dodd-Frank Act. Section 913 of the Dodd-Frank Act also required the SEC to conduct a study on the effectiveness of existing legal standards of care for brokers, dealers and investment advisers in connection with providing personalized investment advice to retail customers, and whether to impose a uniform federal fiduciary standard of care on broker-dealers and investment advisers. § 913 of the Dodd-Frank Act. The completed study (submitted to Congress, as required, on January 21, 2011) recommended the adoption of a uniform federal fiduciary standard for brokers and advisers providing personalized investment advice about securities to retail customers "no less stringent than the standard currently applied to investment advisers" under §§ 206(1) and 206(2) of the Advisers Act and suggested that broker-dealers and advisers be required "to act in the best interest of the customer" and to eliminate or disclose all conflicts of interest. STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, SEC (Jan. 21, 2011). In 2013, the SEC released a request for data and other information relating to the duties of brokers, dealers and investment advisers. *See* SEC Release No. 34-69013 (Mar. 1, 2013). In its request for data, the SEC noted that the SEC staff had recommended rulemaking in its 2011 study, but that the SEC had not yet determined whether to commence a rulemaking. *See* 78 Fed. Reg. 14,848, 14,850 (Mar. 7, 2013). ("The [SEC] recognizes that Section 913 of the Dodd-Frank Act does not mandate that we undertake any such rulemaking, and the [SEC] has not yet determined whether to commence a rulemaking. We expect that the data and other information provided to us in connection with this request will assist us in determining whether to engage in rulemaking, and if so, what the nature of that rulemaking ought to be.").

290 SEC Release No. 34-69013 (Mar. 1, 2013).

291 In testimony before the House Financial Services Committee on November 15, 2016, Chair Mary Jo White indicated she did not expect further action by the SEC during the remainder of her tenure. (On November 14, 2016, Chair White announced her plans to resign at the end of the Obama Administration.) *See* http://financialservices.house.gov/calendar/eventsingle.aspx? EventID=401173. Chair White has suggested it is unlikely the SEC will issue a fiduciary rule proposal prior to her departure. *See* Mark Schoeff Jr., *SEC Chairwoman Mary Jo White Says Agency Mulling Fiduciary Duty*, INVESTMENTNEWS (Sept. 12, 2016), http://www.investmentnews.com/article/20160912/FREE/160919991/sec-chairwoman-mary-jo-white-says-agency-mulling-fiduciary-duty.

292 Definition of the Term ‘‘Fiduciary’’; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (Apr. 8, 2016).

293 Definition of the Term ‘‘Fiduciary’’; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (Apr. 8, 2016).

294 In 2000, the SEC adopted Regulation FD, SEC Release No. 33-7881 (Aug. 15, 2000), which applies to communications with market professionals including broker-dealers and focuses on the problem of selective disclosure. Also in 2000, the SEC adopted Rule 10b5-1 under the Exchange Act, which clarifies that trading while in possession of inside information is presumed to be a violation of § 10(b) of the Exchange Act regardless of actual use of such information. The rule states the general principle that insider trading liability arises when a person trades while aware of material nonpublic information and provides two affirmative defenses to liability when it is clear that a trade was not made on the basis of the material nonpublic information. One defense is available if an entity can show that the individual making decisions to trade on behalf of the entity was not aware of the material nonpublic information and that the entity had implemented reasonable policies and procedures, such as information barriers and restricted lists, to prevent insider trading. The other defense is available in those situations in which a contract to trade is entered into before the person becomes aware of the material nonpublic information. SEC Release No. 33-7881 (Aug. 15, 2000). *See* § 4.10[6] regarding Regulation FD and § 11.05[2] regarding Rule 10b5-1 under

the Exchange Act and other insider trading rules.

295 *See*, *e.g.*, *Slade v. Shearson, Hammill & Co.*, Fed. Sec. L. Rep. (CCH) ¶¶94,329, 94,439 (S.D.N.Y.), *remanded* 517 F.2d 398 (2d Cir. 1974), for an illustration of the various conflicts of interest that may arise when a firm acts as investment banker, market-maker and broker for the securities of a single company.

296 When securities are placed on a "restricted list," a firm's activities with respect to such securities are curtailed. Generally, this may mean that the firm ceases trading for its own account in such securities, does not trade for discretionary customer accounts or solicit customer trades, does not issue research reports regarding the securities and orders its employees not to trade for their own accounts in the securities or to advise or cause others to do so. Securities may be restricted for reasons not related to concerns regarding insider trading, such as, for example, the restrictions imposed on distribution participants by Regulation M under the Exchange Act. *See* § 3.02[9].

297 A firm does not typically suspend its ordinary trading activity with respect to securities placed on a "watch list" and, in fact, such lists ordinarily would not be widely disseminated within the firm. Rather, the firm's compliance department will monitor and investigate unusual trading activity in securities that had been placed on the list. A firm also may maintain a "rumor list" made up of issuers involved in recently announced transactions, or which have been the subject of rumors of a transaction, with which the firm is not involved. After placing a security on the rumor list, the firm's compliance department generally would conduct a review of recent activity in the issuer's securities to uncover unusual activity prior to the rumor becoming generally known.

298 Among the procedures that may be adopted in connection with the establishment of information barriers are: the use of project code words, control over distribution of draft documents relating to prospective transactions including the numbering of all such documents, restrictions on access to computer systems and to office communications systems such as fax machines, locked offices and file storage areas and personnel education regarding prohibitions on insider trades and the related sanctions.

299 *See* SEC Release No. 34-17120 (Sept. 4, 1980); § 11.06[4]. The SEC's move to making procedures to prevent insider trading mandatory was a step toward reversing its previous failure to obtain an injunction against a broker-dealer that did not have such procedures in place. *See SEC v. Geon Industries, Inc*., 531 F.2d 39 (2d Cir. 1976); *see also SEC v. Lum's Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973).

300 Rule 14e-3(b)(2) under the Exchange Act.

301 Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988); *see* § 11.05[2] for further discussion on insider trading.

302 § 15(g) of the Exchange Act.

303 § 21A(b)(1) of the Exchange Act. Persons liable may be required to pay a penalty of three times the profit gained or loss avoided by the insider trading or $1 million, whichever is greater. § 21A(a)(3) of the Exchange Act.

In 2006, the SEC brought settled administrative proceedings against Morgan Stanley & Co. Inc. and Morgan Stanley DW Inc. (collectively, "Morgan Stanley") fining them $10 million for a failure to maintain and enforce adequate written policies and procedures to prevent the misuse of material nonpublic information. Morgan Stanley failed to conduct surveillance of a large number of employee accounts held at the firm, as well as trading in certain securities in those and other accounts. In addition, Morgan Stanley's written policies did not provide adequate guidance to personnel charged with conducting surveillance and it used inadequate controls with respect to surveillance of its "watch list." *In re Morgan Stanley & Co. Inc.*, SEC Release No. 34-54047 (June 27, 2006); *see also In re Merrill Lynch, Pierce, Fenner & Smith Inc.*, SEC Release No. 34-59555 (Mar. 11, 2009); *In re A. Carlos Martinez*, SEC Release No. 34-57755 (May 1, 2008); *SEC v. Chanin Capital LLC*, SEC Litigation Release No. 20551 (May 1, 2008).

304 § 15(g) of the Exchange Act.

305 SEC, Division of Market Regulation, BROKER-DEALER POLICIES AND PROCEDURES DESIGNED TO SEGMENT THE FLOW AND PREVENT THE MISUSE OF MATERIAL NONPUBLIC INFORMATION (Mar. 1990) ("1990 Information

Barrier Report"); *see also* SEC, Division of Market Regulation, BROKER-DEALER INTERNAL CONTROL PROCEDURES FOR HIGH YIELD SECURITIES (Oct. 1993) (separate review of broker-dealers' information barrier procedures relating to noninvestment grade securities).

306 Nonetheless, the 1990 Information Barrier Report indicated that the SEC would engage in rulemaking were its recommendations with respect to information barrier procedures not implemented by broker-dealers.

307 1990 Information Barrier Report.

308 NYSE Information Memo 91-22 (June 28, 1991); NASD Notice to Members 91-45 (July 1991).

309 The NYSE and the NASD endorsed the SEC's warning in the 1990 Information Barrier Report against the use of a "loose mixture of internal memoranda, excerpts from employee manuals and certifications." 1990 Information Barrier Report at 38; NYSE Information Memo 91-22 (June 28, 1991); NASD Notice to Members 91-45 (July 1991).

310 For example, the NASD Conduct Rules provide that an associated person of a FINRA member may not open a trading account with another member (the "executing member") without informing the executing member of his association with another FINRA member and providing his employer (the "employing FINRA member") with notice of the account. At the request of the employing FINRA member, the executing member must provide the employing FINRA member with a record of all trades in the account. NASD Rule 3050, FINRA MANUAL; NASD Notice to Members 91-27 (May 1991); *see also* Incorporated NYSE Rule 407, FINRA MANUAL.

311 For example, full-service firms that participate in securities markets and the credit markets often have access to nonpublic information (*e.g.*, "syndicate information") about companies to whom they have extended loans or whose loans they have acquired. Such firms should have policies and procedures in place to assure that such nonpublic information is not misused in their securities trading activities, a particularly acute concern for firms that hedge their credit exposures with securities transactions, or security-based swap agreements subject to the insider trading prohibitions of the Securities Act and the Exchange Act. Industry groups have provided recommendations regarding policies and procedures relating to material nonpublic information received by credit market participants. *See*, *e.g.*, Loan Syndication and Trading Association ("LSTA"), Statement of Principles for the Communication and Use of Confidential Information by Loan Market Participants (Dec. 2006); Joint Market Practices Forum ("JMPF"), Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants (Oct. 2003; European Supplement, May 2005); *see also* Joint Statement Regarding the Communication and Use of Material Nonpublic Information (Dec. 2006) (12 trade associations reaffirm their commitment to fair and competitive markets in which inappropriate use of material nonpublic information is not tolerated, referencing the LSTA and JMPF, and others', statements of principles). *See also* SEC Office of Compliance Inspections and Examinations, STAFF SUMMARY REPORT ON EXAMINATIONS OF INFORMATION BARRIERS: BROKER-DEALER PRACTICES UNDER SECTION 15(G) OF THE SECURITIES EXCHANGE ACT OF 1934 (Sept. 27, 2012).

312 *See* § 14.07[1].

313 A "short sale" is "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." Rule 200(a) of Regulation S HO under the Exchange Act.

314 *See* SEC Release No. 34-54891 (Dec. 7, 2006).

315 *See* SEC Release No. 34-55970 (June 28, 2007).

316 *See* SEC Release No. 34-61595 (Feb. 26, 2010); Rule 201 of Regulation S HO under the Exchange Act.

317 Rules 200–203 of Regulation S HO under the Exchange Act.

In addition, Rule 105 of Regulation M specifically addresses manipulative short selling in connection with a public offering by prohibiting persons who effected short sales during a specified period prior to the pricing of a registered offering from purchasing securities in the offering, subject to certain enumerated exceptions. *See* §§ 3.02[9][d] and 11.05[3][c]; *see also* SEC Release No. 34-56206 (Aug. 6, 2007) (adopting amendments to Rule 105 to eliminate the former "covering" component of the rule and to make certain other changes).

318 Abusive "naked" short selling generally refers to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard settlement cycle. *See* SEC Release No. 34-56212 (Aug. 7, 2007). In 2008, the SEC adopted a "naked" short selling antifraud rule under which it is unlawful for "any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due." SEC Release No. 34-58774 (Oct. 14, 2008); Rule 10b-21 under the Exchange Act.

319 Large and persistent failures by sellers of securities to deliver the securities they have sold on the scheduled settlement date (referred to as "fails to deliver") may have a negative effect on the market for the relevant securities by depriving shareholders of certain benefits of ownership, such as voting and lending, effectively converting without the consent of the buyer a contract for delivery within the standard settlement cycle into an undated futures-type contract, damaging the reputation of the relevant securities and potentially enabling manipulative conduct. *See* SEC Release No. 34-56212 (Aug. 7, 2007).

320 Although Regulation S HO imposes this requirement on broker-dealers, broker-dealers often contractually require customers to inform them whether a sell order is long or short.

321 Rule 200(g) of Regulation S HO under the Exchange Act; *see also* SEC Release No. 34-61595 (Feb. 26, 2010) (addressing when a broker-dealer may mark qualifying sell orders as "short exempt").

322 Rule 203(a)(1) of Regulation S HO under the Exchange Act. Rule 203(a)(2) provides for exceptions to this general requirement for certain good-faith mistakes and where the broker-dealer knows, or has been reasonably informed by the seller, that the seller owns the security and would deliver it prior to the scheduled settlement but the seller failed to do so. The SEC has noted that it may be unreasonable for a broker-dealer to accept the customer's assurances where it has been repeatedly required to use borrowed shares to make delivery on sales marked "long." *See* SEC Release No. 34-50103 (July 28, 2004).

323 Rule 203(b)(1) of Regulation S HO under the Exchange Act. Under Rule 203(b)(2) of Regulation S HO under the Exchange Act, this "locate" requirement generally does not apply to orders from other broker-dealers (provided the broker-dealer accepting the order has not agreed to be responsible for obtaining a "locate"), sales of securities the seller owns and intends to deliver as soon as all restrictions on delivery have been removed (although securities must be borrowed or the short position closed out if the securities are not received within 35 days after the trade date), or sales by a market-maker in connection with *bona fide* market-making activities in the security sold.

324 Rule 204 of Regulation S HO under the Exchange Act. Rule 204 provides several limited exceptions to this "close-out" requirement, including a three-settlement-day grace period for fail to deliver positions attributable to *bona fide* market-making activities by a registered options market maker and fail to deliver positions that the clearing agency participant reasonably allocates to another registered broker-dealer for which it clears (in which case the close-out and pre-borrow obligations are imposed on such other registered broker-dealer). In addition, there is an extended grace period of 35 settlement days where the fail to deliver position is in a security sold pursuant to Rule 144 under the Securities Act, in order to allow additional time for the mechanics of effecting the transfer of the security. *See* SEC Release No. 34-60388 (July 27, 2009).

325 Rule 204(b) of Regulation S HO under the Exchange Act. This "pre-borrowing" requirement applies to any broker-dealer for which the clearing agency participant clears and, unlike the locate requirement of Rule 203(b)(1), does not have an exception for short sales in connection with market-making activities.

326 "Customers," in the context of the financial responsibility rules, generally are those persons who deposit funds or securities with a broker-dealer in the course of the broker-dealer's securities business. For the various ways in which the term "customer" is defined in some of the relevant provisions, *see* Rule 15c3-3(a)(1) under the Exchange Act (customer protection rule), Rule 15c3-1(c)(6) under the Exchange Act (net capital rule) and § 16(2) of the Securities Investor Protection Act, Pub. L. No. 91-598, 84 Stat. 1636 (1970)

("SIPA").

327 These requirements and protections (including the net capital rule and SIPA) generally do not apply to FCMs that have notice-registered as broker-dealers for the limited purpose of trading security futures products. *See* § 15(b)(11)(B) of the Exchange Act. In addition, limited purpose broker-dealers who restrict their securities activities to dealings in OTC derivative products are subject to a customized regime that includes a variety of exemptions from, among other rules, rules under § 15(c)(3) of the Exchange Act. *See* Rule 15a-1 under the Exchange Act.

328 § 15(c)(3)(A) of the Exchange Act.

329 The rules under § 15(c)(3) are not the only measures the SEC has instituted to assure the solvency of broker-dealers. The extensive books and records requirements contained in Rules 17a-3 and 17a-4 under the Exchange Act arose out of the "paperwork crisis" of 1967–1970 in which broker-dealers' back offices were unable to keep accurate records of their trades. The inability of individual broker-dealers to track, and thus to fulfill, their trade obligations led to a series of broker-dealer failures. Similarly, Rule 17a-13 under the Exchange Act requires quarterly securities examinations, counts, verifications of securities inventories, comparisons between these inventories and the records that the broker-dealer keeps and the recording of any differences between the inventories and the records. Rules 17f-1 and 17f-2 under the Exchange Act, which deal with the problem of securities theft (including the question of just what securities are in inventory), also supplement the explicitly financial rules. *See generally*, SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, Part I, Chapter 3 (1963) (describing the regulatory framework for broker-dealers and highlighting areas in which investors need additional protection).

330 *See*, *e.g.*, Statement of Richard Breeden, Chairman, SEC, before Senate Comm. on Banking, Housing & Urban Affairs, Concerning the Bankruptcy of Drexel Burnham Lambert Group Inc. (Mar. 12, 1990).

331 *See generally* § 14.07[2][c] (discussing SIPA).

332 *See generally* SEC Release No. 34-9882 (Nov. 21, 1972), 37 Fed. Reg. 25,224, 25,226 (Nov. 29, 1972); SEC Release No. 34-70072 (July 30, 2013), 78 Fed. Reg. 51,824 (Aug. 21, 2013). For a more detailed discussion of the customer protection rule, *see* Michael P. Jamroz, *The Customer Protection Rule*, 57 BUS. LAW. 1069 (May 2002). Pursuant to § 15C of the Exchange Act, registered government securities broker-dealers and government-noticed financial institutions are subject to customer protection rules generally identical to those applicable to registered broker-dealers. *See* Treas. Reg. § 403.4 (regulations applicable to registered government securities broker-dealers); Treas. Reg. §§ 403.5 and 450.4 (regulations applicable to financial institutions that are government securities broker-dealers).

333 The rule designates (or provides that the SEC may upon application designate) certain locations, including overseas locations, other than in the actual physical possession of the broker-dealer, as acceptable control locations. Rule 15c3-3(c) under the Exchange Act; *see also* SEC Release No. 34-10429 (Oct. 12, 1973) (acceptable control locations for foreign securities).

334 "Excess margin securities" are those securities purchased by a customer with a loan from a broker-dealer that are more than the amount of securities that the broker-dealer is permitted to use to obtain funding for such loan. Generally speaking, securities with a market value in excess of 140% of a broker-dealer's loan to its customer are "excess margin securities." Rule 15c3-3(a)(5) under the Exchange Act.

335 Special rules apply to securities borrowed from customers and securities subject to "hold in custody" repurchase agreements. *See* Rule 15c3-3(b)(3) and (4) under the Exchange Act.

Rule 15c3-3(b)(3) specifies conditions under which a broker-dealer is not required to maintain possession or control of fully-paid or excess margin securities borrowed from any person under written agreements, including that the broker-dealer provides to the lender eligible collateral, marks to market the securities borrowed and collateral posted on a daily basis and provides additional collateral if the value of the collateral held by the lender is less than the value of the securities borrowed, and includes in the agreement a prominent notice that SIPA may not protect the lender. Prior to 2003, Rule 15c3-3(b)(3) required broker-dealers to collateralize securities loans with cash, US treasury securities or irrevocable letters of credit (although SEC interpretations and no-action letters had permitted some additional flexibility). In 2003, the

SEC amended Rule 15c3-3(b)(3) to permit it to expand, by order, the categories of collateral a broker-dealer may post when borrowing securities from a customer and issued an order under the amended rule permitting a wider range of collateral to be posted by broker-dealers. SEC Release No. 34-47480 (Mar. 11, 2003) (amending Rule 15c3-3(b)(3)); SEC Release No. 34-47683 (Apr. 16, 2003) (order expanding the types of permitted collateral).

Rule 15c3-3(b)(4) allows a broker-dealer that has custody of securities subject to a repurchase agreement not to maintain possession or control of the securities subject to the repurchase agreement during the trading day if the broker-dealer provides certain specified notices and warnings to its counterparty (including that the Securities Investor Protection Corporation has taken the position that SIPA does not protect the counterparty) and follows the procedural requirements of the rule.

336 *See* SEC Release No. 34-70072 (July 30, 2013), 78 Fed. Reg. 51,830 (Aug. 21, 2013); SEC Release No. 34-70701 (Oct. 17, 2013), 78 Fed. Reg. 62,930 (Oct. 22, 2013) (extending effective date of certain amendments).

337 "Fails to receive" are securities that a broker-dealer should have received on the settlement date for a transaction (which for most securities transactions in the United States is generally three business days after the trade date) but did not. *See generally* Rule 15c6-1 under the Exchange Act (providing for settlement of securities transactions no later than three business days with specific exceptions); SEC Release No. 34-35750 (May 22, 1995) (exemption from three business day settlement convention in connection with certain transactions involving foreign securities).

338 Rule 15c3-3(d)(2) under the Exchange Act. For government securities that are mortgage-backed securities, the broker-dealer is not required to take action until the securities are on its books as fails to receive for more than 60 days. Treas. Reg. § 403.4(h).

339 *See Securities Industry Association* (avail. July 16, 1988).

340 *See FINRA Interp. Handbook*, SEA Rule 15c3-3(a)(1) /04.

341 The Reserve Formula is set forth in Exhibit A to Rule 15c3-3a under the Exchange Act.

342 The Reserve Formula also takes securities fails to deliver and fails to receive into account and so serves as a mechanism to encourage a broker-dealer to maintain its securities delivery and inventory systems in good order.

343 "Qualified securities" are securities issued by the United States or in respect of which the principal and interest are guaranteed by the United States. By interpretation, broker-dealers are also permitted (subject to certain limits) to use qualifying certificates of deposit to satisfy their reserve account deposit obligations. *See FINRA Interp. Handbook* at 2023, SEA Rule 15c3-3(a)(6)/012.

344 The bank at which the reserve accounts are maintained must provide the broker-dealer with a written agreement, the minimum terms of which are specified in the customer protection rule, stating that the funds in the reserve account are being kept for the exclusive benefit of the broker-dealer's customers or the PAB account holders, as applicable. Rule 15c3-3(f). Broker-dealers must maintain these reserve accounts at unaffiliated banks and limit the deposit at any bank to 15% of the bank's equity capital as reported by the bank in its most recent Call Report. Rule 15c3-3(e)(5). *See also* SEC, Division of Trading and Markets, Frequently Asked Questions Concerning the Amendments to Certain Broker-Dealer Financial Responsibility Rules (Mar. 6, 2014) (noting that the definition of "affiliated" is that contained in Rule 15c3-3(a)(13)). The Call Reports for U.S. branches of foreign banks do not contain an equity capital line item, and therefore, in order to maintain a reserve account at such a branch, the broker-dealer needs to request exemptive relief from the SEC. *See* SEC Release No. 34-70072 (July 30, 2013), 78 Fed. Reg. 51,834–35 (Aug. 21, 2013); *Kris Dailey* (avail. Feb. 26, 2014) (providing no-action relief where a foreign bank has an exemptive request pending on or before March 3, 2014 and the broker-dealer uses the foreign bank's equity capital, as reported in the foreign bank's most recent financial statement, in lieu of a Call Report, to calculate the 15% bank equity capital threshold).

345 For a more detailed discussion of the net capital rule, *see* Michael P. Jamroz, *The Net Capital Rule*, 47 BUS. LAW. 863 (May 1992). At the time he wrote the article, Mr. Jamroz was one of the SEC staff members

primarily responsible for the rule's interpretation.

346 Broker-dealers that hold customer funds or securities are required to maintain at least $250,000 in net capital. Those that clear customer transactions but do not hold customer funds or securities are subject to a $100,000 minimum net capital requirement; all other broker-dealers are required to maintain either $5,000, $25,000 or $50,000 in net capital, depending on whether they receive securities and the type of securities business in which they are engaged. In addition, broker-dealers that act as market-makers are subject to additional capital requirements. *See* Rule 15c3-1(a)(2) under the Exchange Act; SEC Release No. 34-31511 (Nov. 24, 1992); *see also* SEC Release No. 34-31512 (Nov. 24, 1992) (increasing minimum net capital requirements imposed on broker-dealers to the levels described above). The stated dollar amounts of minimum capital that a broker-dealer is required to maintain can be misleading in that the net capital rule requires substantial deductions from a broker-dealer's net worth in determining its regulatory capital, as discussed at § 14.07[2][b][i].

Treasury's version of the net capital rule, applicable to registered government securities broker-dealers, the "liquid capital rule," was designed with special consideration of the financings customary in the government securities market. For example, as compared to the nonexempt securities market, there is a greater use in the government securities market of hedging devices and of repurchase and reverse repurchase agreements. A major GAO report on the regulation of government securities broker-dealers found that the differences between the two rules were of little practical effect. GAO/GGD 90-114, U.S. GOVERNMENT SECURITIES: MORE TRANSACTION INFORMATION AND INVESTOR PROTECTION MEASURES ARE NEEDED at 43 (Sept. 1990). In 1995, Treasury adopted several amendments to the "liquid capital rule" to parallel amendments to the net capital rule adopted or proposed by the SEC. *See* Amendments to Regulations for the Government Securities Act of 1986, Treas. Reg. § 402.2(b)(1).

347 In 2004, the SEC adopted amendments to the net capital rule that permit certain broker-dealers to apply to the SEC for a conditional exemption from the net capital rule to use a risk-based method for calculating deductions from net capital for market and derivatives-related credit risk. Broker-dealers obtaining such exemptions are subject to additional minimum capital requirements. *See* § 14.07[2][b][iii].

348 In 2013, the Division of Trading and Markets stated that it is considering recommending that the SEC propose an amendment to the net capital rule that would prohibit a broker-dealer that carries customer accounts from having a ratio of total assets to regulatory capital in excess of a certain level. SEC, Broker-Dealer Leverage Ratio, RIN: 3235-AL50 (Fall 2013), *available at* http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201310&RIN=3235-AL50 (last visited Oct. 11, 2016).

349 A newly registered broker-dealer must maintain net capital equal to at least one-eighth of its aggregate indebtedness for the first year of its business. Or, if the broker-dealer is also registered as an FCM under the CEA, the broker-dealer must not allow the funds required to be segregated pursuant to the CEA to be greater than 25 times its net capital. *See* Rule 15c3-1(a)(1) under the Exchange Act. SROs often impose more restrictive requirements in connection with the approval of membership of new broker-dealers.

350 *See* SEC Release No. 34-18417 (Jan. 13, 1982); *see also* Statement of Richard Breeden, then-Chairman, SEC, before Senate Comm. on Banking, Housing & Urban Affairs, Concerning the Bankruptcy of Drexel Burnham Lambert Group Inc. at 10 (Mar. 12, 1990). Although a broker-dealer may initially elect either method of calculation, it may not thereafter switch without the SEC's permission.

351 However, the assets and liabilities of a related entity of the broker-dealer generally are not taken into account in computing net capital. The primary exception to this rule is where a broker-dealer guarantees the liabilities of a related entity (which is generally a subsidiary that is also an SEC-registered broker-dealer). In that situation, the broker-dealer consolidates its own assets and liabilities with those of the related entity. If the consolidation decreases net capital, the lower net capital figure is used. If the consolidation increases the broker-dealer's net capital, the increase can be taken into account only if the broker-dealer provides its designated examining authority and the SEC with assurance that the net assets of the guaranteed entity can be quickly distributed to the broker-dealer in the event of the broker-dealer's

liquidation.

352 Generally, a satisfactory subordination agreement must provide as follows: the lender acknowledges that its loan is subordinate to the claims of all present and future creditors, including customers; the broker-dealer may use the cash freely as part of its business and is subject to the general risks of the business; the payment obligation of the broker-dealer is suspended if, after any such payment, the broker-dealer's aggregate indebtedness would exceed 12 times its net capital; and the loan is for a term of at least one year. The minimum one-year term does not apply to properly subordinated revolving loans. In addition, in connection with underwritings or other "extraordinary activities," a broker-dealer may, three times during any 12-month period, enter into subordination agreements that have a term of not more than 45 days. Except in the case of certain subordinated loans from its partners or shareholders (which must have a term of at least three years), not more than 70% of a broker-dealer's regulatory capital may consist of subordinated loans. *See* Rule 15c3-1(d) under the Exchange Act.

All subordination agreements must be approved by the broker-dealer's designated examining authority and may not be terminated or modified without that SRO's approval. FINRA makes available standardized subordinated loan agreements that are required to be used by its members in order to accelerate the approval process.

353 These various required deductions make it relatively expensive for a broker-dealer to engage in any substantial business other than buying and selling readily marketable securities, as the assets associated with other businesses generally have no value for net capital purposes. This is one reason many broker-dealers operate as part of a holding company structure, where other affiliates engage in businesses (*e.g.*, nonsecurities activities) that do not require broker-dealer registration or compliance with broker-dealer net capital requirements.

354 Rule 15c3-1(c)(2)(vii) under the Exchange Act. "Ready market" is defined at Rule 15c3-1(c)(11) under the Exchange Act; *see also* SEC Release No. 33-6862 (Apr. 23, 1990) (capital treatment of Rule 144A-eligible securities).

In 1996, a no-action letter was issued to the Securities Industry Association (the "SIA") (which in 2006 combined with The Bond Market Association to form the Securities Industry and Financial Markets Association ("SIFMA")) permitting broker-dealers to apply haircuts of less than 100% to proprietary positions in certain "restricted securities" (as defined in Rule 144(a)(3) under the Securities Act) that cannot be publicly offered or sold, such as certain nonconvertible debt securities, convertible debt, convertible preferred stock, preferred stock, commercial paper and securities freely convertible into publicly traded securities or securities with registration rights that provide for an exchange offer. *See Securities Industry Association* (avail. Mar. 30, 1996) (the "1996 SIA Letter"). Similarly, in 2000, the SEC provided the SIA with no-action relief permitting broker-dealers to apply haircuts of less than 100% to certain single-rated investment-grade asset-backed debt securities. *See Securities Industry Association* (avail. July 27, 2000).

The SEC also has to some degree liberalized its prior very conservative approach to the valuation of foreign securities for purposes of the net capital rule. The GAO in 1992 published a report criticizing the SEC for its then-existing policy in this regard. *See* GAO/GGD-92-41, SECURITIES MARKETS: CHALLENGES TO HARMONIZING INTERNATIONAL CAPITAL STANDARDS REMAIN at 8 (Mar. 1992). Shortly after this GAO report, the SEC issued a no-action letter to the SIA, in response to an SIA request that had been sent to the SEC almost two years earlier that expanded the types of foreign convertible and nonconvertible debt securities, preferred stock and sovereign-issued debt securities that broker-dealers are permitted to treat as having a "ready market." *See Securities Industry Association* (avail. June 12, 1992); *see also Sanwa-BGK Securities* (avail. Feb. 27, 1992) (capital treatment of certificates of deposit issued by banks organized in the Cayman Islands). Subsequently, the SEC staff issued a letter treating foreign equity securities listed on the Financial Times-Actuaries World Indices (now known as the FTSE World Index) as having a ready market. *See Securities Industry Association* (avail. Aug. 13, 1993). The 1996 SIA Letter expanded the category of foreign securities entitled to a capital charge of less than 100% to include (i) convertible and nonconvertible debt and preferred stock if the issuer has issued common stock included in the Financial Times-Actuaries World Indices and (ii) certain investment-grade commercial paper.

In 2012, the SEC staff issued a no-action letter to FINRA expanding the types of equity securities of a foreign issuer that can be considered as having a ready market. *See Grace B. Vogel* (avail. Nov. 28, 2012). In particular, the SEC staff said that an equity security of a foreign issuer can be considered as having a ready market under Rule 15c3-1(c)(11) if (1) it is listed for trading on a foreign exchange located in a country that is recognized on the FTSE World Index, where the security has been trading on that exchange for at least the previous 90 days; (2) daily quotations for bid and ask or last sale prices for the security provided by the foreign securities exchange on which the security is traded are continuously available to broker-dealers in the United States through an electronic quotations system; (3) the median daily trading volume (calculated over the preceding 20 business day period) of the security on the foreign securities exchange is at least 100,000 shares or $500,000; and (4) the aggregate unrestricted market capitalization in shares of such security exceeds $500 million over each of the preceding 10 business days. *See Grace B. Vogel* (avail. Nov. 28, 2012).

355 The net capital rule also provides for "concentration charges" if a broker-dealer's net capital before haircuts includes securities of a single class or series of an issuer that have a market value of more than 10% of such net capital.

356 Rule 15c3-1(c)(2)(vi)(A) and (C) under the Exchange Act.

357 For debt securities generally, the haircuts are intended to take into account market risk, credit risk, price volatility and the liquidity of the particular debt instruments. Reduced haircuts are permitted for certain debt securities positions that are hedged by other positions in debt securities, options or other market instruments within certain maturity parameters. In 1997, the SEC proposed to modify the haircuts applicable to most interest rate instruments, including government securities, investment-grade nonconvertible debt securities, pass-through mortgage-backed securities and interest rate swaps, but thus far no additional action has been taken with respect to this proposal. *See* SEC Release No. 34-39455 (Dec. 17, 1997), which was incorporated into SEC Release No. 34-39704 (Feb. 27, 1998). In order to be able to deduct a haircut for commercial paper, nonconvertible debt securities and preferred stock, a broker-dealer must be able to determine that such securities represent only a minimal amount of credit risk in accordance with policies and procedures that consider a variety of different risk factors. *See* Rule 15c3-1(c)(2)(vi)(E), (F), (H) and (I). Prior to 2014, a broker-dealer could rely instead on credit ratings issued by nationally recognized statistical rating organizations to make this credit determination. However, the SEC amended these provisions to require an internal credit determination, implementing Section 939A of the Dodd-Frank Act, which requires all federal agencies to eliminate references to ratings as standards of creditworthiness. *See* SEC Release No. 34-71194 (Jan. 8, 2014).

358 Rule 15c3-1(c)(2)(viii)–(ix) under the Exchange Act.

359 In 1997, the SEC issued a concept release seeking comment on how the net capital rule could be modified to incorporate the evolving risk management techniques being utilized in the securities markets, in particular, the extent to which securities firms should be permitted to use statistical models to calculate their net capital requirements. SEC Release No. 34-39456 (Dec. 17, 1997), which was incorporated into SEC Release No. 34-39704 (Feb. 27, 1998). Similarly, the SEC's adopting release regarding the establishment of a new broker-dealer registration category for so-called "OTC derivatives dealers" (a regime sometimes referred to as "BD Lite") states that such entities will, subject to SEC approval, be permitted to calculate their net capital using proprietary "value-at-risk" or other statistical models. SEC Release No. 34-40594 (Oct. 23, 1998); *see* § 14.09. In 2004, the SEC adopted amendments to the net capital rule that permit certain broker-dealers to apply to the SEC for a conditional exemption from the net capital rule to use a risk-based method for calculating deductions from net capital for market and derivatives-related credit risk. *See* § 14.07[2][b][iii].

360 *See*, *e.g.*, Rules 15c3-1(e) and 17a-11 under the Exchange Act. Rule 17a-11 under the Exchange Act requires that a broker-dealer notify the SEC and its designated examining authority if its net capital falls below specific levels. The SRO that is the broker-dealer's designated examining authority may, among other things, require the broker-dealer to restrict further development, contract its activities or transfer its public customer accounts. *See*, *e.g.*, FINRA Rule 4120, FINRA MANUAL.

361 Rule 15c3-1(e)(2) under the Exchange Act.

362 *See* SEC Release No. 34-28927 (Feb. 28, 1991); *see also* SEC Release No. 34-28347 (Aug. 15, 1990).

363 The SEC issued only one order under Rule 15c3-1(e)(3)—to limit withdrawals from REFCO Securities, LLC and REFCO Clearing, LLC, after their parent company announced that its financial statements could no longer be relied upon and had ceased all activities for a 15-day period. *See* SEC Release No. 34-52606 (Oct. 13, 2005).

364 Rule 15c3-1(e)(3)(i).

365 Rule 15c3-1(e)(4)(iv) under the Exchange Act.

366 *See* Rule 15c3-1(c)(2)(i)(G); SEC Release No. 34-70072 (July 30, 2013), 78 Fed. Reg. 51,830 (Aug. 21, 2013)

367 "Tentative net capital" means the net capital of the broker-dealer before deductions for market and credit risk, increased by the balance sheet value (including counterparty net exposure) resulting from transactions in derivative instruments that otherwise would be required to be deducted. Tentative net capital includes securities for which there is no ready market if the value of the securities is computed using mathematical models the SEC has approved for computing capital deductions for the securities. *See* Rule 15c3-1(c)(15) under the Exchange Act.

368 SEC Release No. 34-49830 (June 8, 2004); *see also* SEC Release No. 34-55559 (Mar. 29, 2007) (approving amendments to the NYSE's net capital and early warning rules (Rules 325 and 326) adopting relevant thresholds for broker-dealers calculating their net capital according to the alternative risk-based method).

369 Goldman Sachs, Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") and Morgan Stanley were the other three CSE investment bank holding companies. JP Morgan and Citigroup were the two CSE bank holding companies.

370 *See* Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008) (announcing the end of the CSE Program). The extent to which the 2004 net capital rule change and the CSE Program contributed to the 2007–2009 financial crisis has been the subject of much debate. *Compare* Stephen Labaton, "*Agency's '04 Rule Let Banks Pile Up New Debt*," N.Y. TIMES, Oct. 3, 2008, p. A1, *with* THE FINANCIAL INQUIRY CRISIS REPORT (Jan. 2011) at 153–54 (noting that CSE holding companies were actually more highly leveraged in the 1990s than they were after the 2004 rule change).

371 *See* Chairman Mary Schapiro, Testimony Concerning the Lehman Brothers Examiner's Report, Before the House Financial Services Comm., Apr. 20, 2010, at 11.

372 Rule 15c3-1(a). *See* SEC Release No. 34-70073 (July 30, 2013), 78 Fed. Reg. 51,824, 51,855 (Aug. 21, 2013).

373 For a general discussion of the liquidation procedures applicable to a failed broker-dealer, *see* Stephen P. Harbeck, *Stockbroker Bankruptcy: The Role of the District Court and the Bankruptcy Court under the Securities Investor Protection Act*, 56 AM. BANKR. L.J. 277 (1982). *See also* SIPA, TRUSTEE'S GUIDE (a manual distributed to trustees of broker-dealers being liquidated in accordance with SIPA); COLLIER ON BANKRUPTCY ¶¶741–52 (16th ed. 2009).

374 Customers of a registered government securities broker-dealer are not eligible for SIPC insurance. Customers of a government-noticed financial institution likewise do not receive SIPC insurance but are eligible to receive FDIC insurance. *See generally* GAO/GGD 90-114 U.S. GOVERNMENT SECURITIES: MORE TRANSACTION INFORMATION AND INVESTOR PROTECTION MEASURES ARE NEEDED at 61–63, (Sept. 1990) (discussing SIPC insurance and recommending that Congress expand SIPC coverage to all government securities brokers and dealers).

375 *See* § 3(a)(2) of SIPA. Certain broker-dealers with limited activities, including OTC derivatives dealers, are excluded from membership in SIPC. While any broker-dealer that has more than half its business outside the United States appears to be excluded from SIPC membership by the express language of the act (*see* § 3(a)(2)(A)(i) of SIPA), the SEC likely takes the position that virtually every broker-dealer with any U.S.

customers must become a SIPC member. Telephone conversation with Michael Don, Deputy General Counsel and Secretary of SIPC, Aug. 24, 1990. Rule 10b-10(a)(9) under the Exchange Act requires broker-dealers to disclose, in a written confirmation to the customer at or before completion of a transaction, that the broker-dealer is not a SIPC member, if such is the case.

376 § 4(c) of SIPA. SIPC is required to assess its member broker-dealers when the balance in the SIPC fund falls below $100 million and has discretion as to whether to impose assessments otherwise. From 1996 through early 2009, SIPC imposed an annual assessment of $150 on each member broker-dealer. *See* SIPC 2006 Annual Report at 8.9. Since April 2009 annual assessments have been based on one-quarter of 1% of the net operating revenues of SIPC members. *See* SIPC News Release, SIPC to Reinstitute Assessments of Member Firms' Operating Revenues (Mar. 2, 2009); *see also* SIPC, Assessment Rate, *available at* http://www.sipc.org/for-members/assessment-rate (last visited Oct. 11, 2016).

377 § 8 of SIPA. SIPA defines a "customer" as "any person (including any person with whom the [failed broker-dealer] deals as principal or agent [*i.e.*, another broker-dealer]) who has a claim on account of securities received, acquired, or held by the [failed broker-dealer] in the ordinary course of its business as a broker or dealer … [including any person who has deposited cash with the [failed broker-dealer] for the purpose of purchasing securities]… and any person who has a claim … arising out of sales or conversions of securities…." § 16(2) of SIPA. "Customer name securities" are those securities that are registered (or in the process of being registered) in the particular customer's name and are not transferable by the broker-dealer by delivery, power of attorney or otherwise. § 16(3) of SIPA; *See* COLLIER ON BANKRUPTCY ¶6741.03 (16th ed. 2009); *see also In re Bevill, Bressler & Shulman, Inc.*, 59 B.R. 353 (D.N.J. 1986). "Customer property" generally includes all property (other than customer name securities) received, acquired, or held by a failed broker-dealer that was, or should have been, set aside for customers. § 16(4) of SIPA.

378 § 9(a) and (d) of SIPA. The cash must have been on account for the purpose of purchasing securities or as a result of a sale of securities. *See* SEC Release No. 34-18262 (Nov. 17, 1981). Section 929H of Title IX of the Dodd-Frank Act raised the cash limit from $100,000 to $250,000.

379 *See* § 9(a)(5) of SIPA.

380 *See* § 9(a)(5) of SIPA.

381 *See*, *e.g.*, § 6 of the Exchange Act (registration of the national securities exchanges) and § 15A of the Exchange Act (registration of national securities associations, *i.e.*, FINRA). Most of the provisions giving the SEC extensive regulatory authority over the SROs and setting the standards that the SROs must follow in proceedings involving their own members were adopted in 1975 amendments to the Exchange Act. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 16, 89 Stat. 97, 147–48 (1975). In 2004, the SEC proposed new rules and rule amendments relating to the governance, administration, transparency and ownership of SROs, the periodic reporting of information by SROs regarding their regulatory programs, and the listing and trading by the SROs of their own or affiliated securities. *See* SEC Release No. 34-50699 (Nov. 18, 2004). The comment period with respect to these proposals was extended to March 8, 2005, *see* SEC Release No. 34-51019 (Jan. 11, 2005), but the proposed rule was withdrawn in 2011.

Pursuant to amendments codified in the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 (Appendix E), 114 Stat. 2763, 2763A-365 (2000) (hereinafter the "CFMA"), § 2(a)(1)(D) of the CEA and § 6(h) of the Exchange Act require that security futures products be traded on exchanges that are registered under both the CEA and the Exchange Act. Accordingly, futures exchanges may register as national securities exchanges for the limited purpose of trading security futures products, and *vice versa*. *See* § 6(g) of the Exchange Act. In addition, CFTC-registered futures associations (such as the National Futures Association) are considered to be registered national securities associations for the limited purpose of supervising FCMs that notice register as broker-dealers for purposes of security futures product trading. *See* § 15A(k) of the Exchange Act. Such notice-registrants are exempt from certain of the requirements otherwise applicable to national securities exchanges and national securities associations. §§ 6(g)(4), 15A(k)(3) and (4) of the Exchange Act. *See generally* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 4.

382 § 19(b) of Exchange Act; *see also* Rule 19b-4 under the Exchange Act.

383 § 19(c) of the Exchange Act. However, the SEC cannot require the SROs to adopt rules that go beyond the SEC's own proper purposes under the Exchange Act. *See Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

384 § 19(g) of Exchange Act. This obligation is subject to enforcement by the SEC. In 2013, for example, the Chicago Board Options Exchange settled a proceeding brought by the SEC alleging failure to enforce or even fully comprehend rules to prevent abusive short selling, pursuant to which the CBOE was fined $6 million. *See* SEC Charges CBOE for Regulatory Failures, SEC Press Release 2013-107 (June 11, 2013).

385 *See*, *e.g.*, §§ 6(d) and 15A(h) of the Exchange Act.

386 *See* § 19(d) and (e) of the Exchange Act and Rule 19d-3 thereunder.

387 FINRA in particular is required under the Exchange Act to adopt rules intended to prevent fraudulent and manipulative acts. *See* § 15A(b)(6) of the Exchange Act.

388 FINRA Rule 2010, FINRA MANUAL.

389 These exchanges are Bats BYX Exchange, Inc. (formerly BATS Y-Exchange, Inc.), Bats BZX Exchange, Inc. (formerly BATS Exchange, Inc.), Bats EDGA Exchange, Inc. (formerly EDGA Exchange, Inc.), Bats EDGX Exchange, Inc. (formerly EDGX Exchange, Inc.), BOX Options Exchange LLC, C2 Options Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, International Securities Exchange, LLC, ISE Gemini, ISE Mercury, Miami International Securities Exchange, NASDAQ BX, Inc. (formerly NASDAQ OMX BX, Inc.; Boston Stock Exchange), NASDAQ PHLX LLC (formerly NASDAQ OMX PHLX, LLC; Philadelphia Stock Exchange), National Stock Exchange, Inc., New York Stock Exchange, NYSE MKT LLC (formerly NYSE AMEX and the American Stock Exchange), the Investors Exchange LLC, the Nasdaq Stock Market LLC, As previously noted, FINRA is the only registered national securities association.

As noted in *supra* Note 381, futures exchanges and registered futures associations may notice register as limited-purpose national securities exchanges and national securities associations in connection with the trading of security futures products.

Following the SEC's adoption in 1998 of Regulation ATS, certain electronic trading systems have registered as for-profit national securities exchanges, such as NYSE Arca and the Nasdaq Stock Market. *See* §§ 14.10 and 3.01, Note 4; SEC Release No. 34-53128 (Jan. 13, 2006).

390 *See supra* Note 280 and accompanying text.

391 *See* § 14.07[1][a]. Guidance for FINRA Rule 2111 states in part:

> Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of FINRA's rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.

FINRA Rule 2111 (Suitability), Supplementary Material.01 (General Principles), FINRA MANUAL.

392 FINRA Rule 5110, FINRA MANUAL; *See* SEC Release No. 34-30587 (Apr. 15, 1992); FINRA Regulatory Notice 08-57 (Oct. 2008); *see also* FINRA Rule 5121, FINRA MANUAL, which contains special rules regarding offerings by a member of its own or its affiliates' securities.

393 FINRA Rule 5130, FINRA MANUAL. Rule 5130 is intended to ensure that FINRA members make a *bona fide*

public offering of new issues of equity securities at the public offering price. FINRA Rule 5130 replaced the NASD's prior interpretation, issued under Rule 2110 of the NASD Conduct Rules (now FINRA Rule 2010), prohibiting "free-riding" and "withholding" in connection with the underwriting of "hot issues." FINRA Rule 5130 is limited in its application to initial public offerings of equity securities, but applies to all such offerings regardless of whether they constitute "hot issues." *See* NASD Notice to Members 03-79 (Dec. 2003); FINRA Regulatory Notice 08-57 (Oct. 2008); *see also* § 3.06[2][a].

394 FINRA Rule 5131, FINRA MANUAL; *see also* § 3.06[2][b].

395 FINRA Rule 5141 FINRA MANUAL; *see* § 3.06[3]. FINRA Rule 5141 replaced the set of rules and interpretations commonly known as the Papilsky Rules, and like its predecessor, in some circumstances at least, permits tiered pricing for volume purchases where the pricing structure is disclosed in the offering prospectus.

396 FINRA Rules 2341, 5141, FINRA MANUAL.

397 FINRA Rule 2111, FINRA MANUAL. FINRA Rule 2111(b) incorporated earlier NASD interpretive guidance as to the manner in which a broker-dealer may satisfy its suitability obligation with respect to institutional customers. *See* FINRA Rule 2111, FINRA MANUAL; FINRA Regulatory Notice 13-31 (Sept. 2013) . In addition, to address concerns over the increasing use of the Internet by broker-dealers to provide information to prospective investors, FINRA issued a policy statement regarding the application of the suitability rule to online communications. The policy statement does not alter member obligations under the suitability rule, but provides "guidelines to assist members in evaluating whether a particular communication could be viewed as a 'recommendation.'" *See* NASD Notice to Members 01-23 (Apr. 2001). FINRA has also provided guidance regarding the applicability of NASD Rule 2310 (now FINRA Rule 2111) to recommendations of structured products. *See* NASD Notice to Members 05-59 (Sept. 2005). In addition, the Department of Labor's 2016 rulemaking expanded fiduciary duties for financial institutions engaged in advising employee benefit plans under ERISA. *See* 81 Fed. Reg. 68, 20946 (Apr. 8, 2016); § 14.07[1][a].

398 FINRA Rule 5310, FINRA MANUAL. FINRA amended NASD Rule 2320 (now FINRA Rule 5310) to expressly provide that the duty of best execution applies to any transaction for or with a customer or a customer of another broker-dealer, resolving an ambiguity about the application of the rule where a broker-dealer receives a customer order from another broker-dealer for the purpose of order handling or execution. (The duty of best execution does not apply, however, when another broker-dealer is simply executing a customer order against the broker-dealer's quote.) SEC Release No. 34-54339 (Aug. 21, 2006). In 2015, FINRA issued guidance regarding the duty of best execution in which it noted that developments in order routing technology makes order-by-order review of execution quality possible for equity securities and standardized options and then identified large-sized orders and internally executed orders as two situations in which order-by-order (as opposed to regular and rigorous) review may be required. FINRA Regulatory Notice 15-46 (Nov. 2015).

399 FINRA Rule 2121, FINRA MANUAL.

400 FINRA Rule 2122, FINRA MANUAL.

401 SEC Release No. 34-43590 (Nov. 17, 2000). Pursuant to Rule 11Ac1-5 under the Exchange Act (redesignated as Rule 605 of Regulation NMS), market centers that trade national market system securities are required to make publicly available monthly electronic reports that include uniform statistical measures of execution quality. Under Rule 11Ac1-6 (redesignated as Rule 606 of Regulation NMS), broker-dealers that route customer orders in equity and option securities are required to make publicly available quarterly reports that identify venues to which customer orders are routed for execution. Broker-dealers are also required to disclose to customers, upon request, the venue to which their individual orders were routed. The SEC staff has addressed frequently asked questions about Rule 11Ac1-5 in SEC, Division of Corporation Finance, Staff Legal Bulletin No. 12A (Sept. 6, 2001), Fed. Sec. L. Rep. (CCH) ¶60,012, and about Rule 11Ac1-6 in SEC, Division of Corporation Finance, Staff Legal Bulletin No. 13A, Fed. Sec. L. Rep. (CCH) ¶60,013 (Oct. 16, 2001).

402 FINRA Rule 2121, Supplementary Material.01 (Mark-Up Policy) and.02 (Additional Mark-Up Policy For

Transactions in Debt Securities, Except Municipal Securities), FINRA MANUAL. *See generally* NASD Notice to Members 92-16 (Apr. 1992); NASD Notice to Members 07-28 (June 2007). Supplementary Material.02(b)(9) provides for an exception to Rule 2121 (and the interpretations thereunder) for transactions with qualified institutional buyers ("QIBs") purchasing or selling noninvestment grade debt securities when the broker-dealer has determined that the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in deciding to enter into the transaction.

403 FINRA Rule 4210, FINRA MANUAL.

404 FINRA Rules 2210 and 2220, FINRA MANUAL.

405 FINRA Rule 2300 series and Rule 2216, FINRA MANUAL.

406 FINRA Rule 5320, FINRA MANUAL.

407 FINRA Rule 5280, FINRA MANUAL.

408 FINRA Rule 5210, FINRA MANUAL; *see also* FINRA Notice 14-28 (June 2014).

409 *See* FINRA Rules 6000 through 14,000 series, FINRA MANUAL

410 *See* § 14.07[2][b].

411 FINRA provides that a member whose aggregate indebtedness is more than ten times net capital must notify FINRA and may not grow its business further if such condition continues to exist for more than 15 consecutive business days. Additionally, if a FINRA member's aggregate indebtedness rises above 12 times its net capital, the member must actively reduce its liabilities. *See*, *e.g.*, FINRA Rules 4120(a)(1)(B), 4120(c)(1)(B), FINRA MANUAL. FINRA rules similarly have more stringent requirements for member firms that adopt the alternative method for calculating net capital.

412 *See* FINRA Rule 4210, FINRA MANUAL; *see also* § 14.07[6].

413 *See infra* Note 602.

414 *See* FINRA Rule 3270, FINRA MANUAL. It was relatively unusual for the NYSE to disapprove of a person's proposed outside activities.

415 *See* § 14.07[3][b] below.

416 For this purpose, a "control person" is a person who has the power to direct the management or policies of a company through ownership of securities, by contract, or otherwise. Control is presumed to exist if, before the transaction, the person has the right to vote or the power to sell or direct the sale of 25% or more of a class of voting securities or in the case of a partnership or limited liability company has the right to receive upon dissolution, or has contributed, 25% or more of the capital. A "privately-held company" is one that does not have any class of securities registered, or required to be registered, with the SEC under § 12 of the Exchange Act or with respect to which the company files, or is required to file, periodic information, documents, or reports under § 15(d) of the Exchange Act. FINRA CAB Rule 016(c)(1)(F), FINRA MANUAL.

417 FINRA CAB Rule 016(c), FINRA MANUAL.

See supra § 14.03[h] for discussion of the no-action letters referenced in item (G).

Because a CAB's activities must be limited to this list, a broker cannot register as a CAB if it carries or acts as an introducing broker with respect to customer accounts, holds or handles customer funds or securities, accepts orders from customers to purchase or sell securities either as principal or as agent for the customer (except as permitted by items (F) and (G) of this list), has investment discretion on behalf of any customer, engages in proprietary trading of securities or market-making activities, or participates in or maintains an online platform in connection with offerings of unregistered securities pursuant to Regulation Crowdfunding or Securities Act Regulation A, or effects securities transactions that would require the broker or dealer to report the transaction under the FINRA's trade reporting rules.

418 FINRA CAB Rule 201, FINRA MANUAL.

419 FINRA Rule 2210(d)(1)(F), with limited exceptions, prohibits member communications that "predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast." The parallel provision of FINRA CAB Rule 221 only prohibits member communications

that "imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast."

420 FINRA CAB Rules 300, 313, FINRA MANUAL.

421 FINRA CAB Rule 238, FINRA MANUAL.

422 *See also* § 14.08[1].

423 NASD Membership and Registration Rules, Rules 1020 and 1030, FINRA MANUAL. In addition, FINRA has issued interpretations, modeled after Rule 206(4)-3 under the Advisers Act, that regulate the involvement of registered broker-dealers with foreign "finders" of business. *See* NASD Membership and Registration Rules, Rule 1060(b), FINRA MANUAL; Incorporated NYSE Rule Interpretations, Rule 345(a)(i)/Interpretation 03, FINRA MANUAL.

424 For purposes of FINRA's rules, "associated person of a member" generally includes any registered natural person (or applicant for registration), sole proprietors, partners, officers, directors and branch managers of the member firm, any natural person occupying a similar status or performing similar functions, any natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member (whether or not such person is registered or exempt from registration). FINRA By-Laws, Art. I, Paragraph (rr), FINRA MANUAL. Note that this is not the same as the definition of "associated person of a broker or dealer" under the Exchange Act, *see* § 3(a)(18) of the Exchange Act, nor is it the same as the definition of "associated person" in NASD Rule 1011, which is applicable solely for purposes of the Rule 1010 Series (Membership Proceedings).

425 NASD Membership and Registration Rules, Rule Series 1020 and 1030 and Rule 1050, FINRA MANUAL (registration of principals, representatives and research analysts). Rule 1030 permits associated persons who act as representatives in certain limited areas to take a more focused examination than the Series 7 and receive a limited representative registration.

426 FINRA Rule 1230(b)(6), FINRA MANUAL.

427 NASD Rule 1021(e), FINRA MANUAL.

428 NASD Rule 1022(b), FINRA MANUAL.

429 NASD Rule 1022(d), FINRA MANUAL.

430 NASD Rule 1022(f), FINRA MANUAL.

431 NASD Rule 1013(a)(2), FINRA MANUAL. Certain associated persons of government-noticed financial institutions must file Form G-FIN-4 with the appropriate regulatory agency.

432 "Statutory disqualification" is defined in § 3(a)(39) of the Exchange Act.

433 FINRA has developed a centralized computer tracking system of all registered representatives and broker-dealers against whom actions have been taken or complaints have been made; access to such system is available to all SROs, broker-dealers, investors and the SEC. *See* § 14.08[1]. In addition, FINRA permits retail investors to review information on the professional background, business practices, and conduct of FINRA member firms and their associated persons through its BrokerCheck service. Member firms are required to include a "readily apparent reference and hyperlink"on their websites to BrokerCheck. FINRA Rule 2210, FINRA Manual; FINRA Regulatory Notice 15-50 (Dec. 2015).

434 FINRA allows a qualified registered representative in good standing with the Securities Association of the United Kingdom to become qualified as a general securities representative in the United States by passing a modified general securities representative examination (the Series 17 examination). NASD Notice to Members 90-69 (Oct. 1990). A modified version of the general securities representative examination has also been developed by the NYSE for qualified representatives in good standing with Canadian and Japanese securities regulators. *See* SEC Release Nos. 34-37112 (Apr. 12, 1996) (Japan), 34-36825 (Feb. 9, 1996) (Canada), 34-36708 (Jan. 11, 1996) (Japan).

In 2005, the NASD, the NYSE, and the Securities & Investment Institute (the United Kingdom's principal financial services qualifications provider) announced their agreement to create the Global Capital Markets Qualification (GCMQ) examination, a common qualifications test for capital market professionals that would allow such professionals to operate more easily in both the United States and in the United Kingdom. *See* Press Release, NASD, NASD, NYSE Regulation and U.K.'s Securities & Investment Institute Agree to Create New, International Securities Qualification Exam (July 26, 2005). Although the original press release predicted a late 2006 launch, thus far there have been no subsequent announcements or further developments after the consolidation of the NASD and NYSE into FINRA.

435 *See* Incorporated NYSE Rule 345A FINRA MANUAL; FINRA Rule 1250, FINRA MANUAL; SEC Release No. 34-35341 (Feb. 8, 1995) (order approving proposed rule changes of SROs relating to a continuing education requirement for registered persons); *see also* SEC Release No. 34-50456 (Sept. 27, 2004) (order approving amendments to rule changes of SROs eliminating all currently effective exemptions from the Regulatory Element of the Continuing Education Program).

436 *See* SEC Release No. 34-35341 (Feb. 8, 1995); SEC Release No. 34-50456 (Sept. 27, 2004); FINRA Regulatory Notice 11-33 (July 2011).

437 *See* SEC Release No. 34-35341 (Feb. 8, 1995); SEC Release No. 34-50456 (Sept. 27, 2004); FINRA Regulatory Notice 11-33 (July 2011).

438 FINRA By-Laws, Art V, Sec. 3(a); NASD Notice to Members 04-09 (Feb. 2004); *see also* FINRA Regulatory Notice 10-39 (Sept. 2010) (reminding members of their obligation to provide timely, complete and accurate information on Form U5).

439 A proposal by FINRA to provide its members with qualified immunity in arbitration proceedings for statements made in good faith in certain disclosure on Forms U4 and U5 ended when FINRA withdrew the proposed rule in 2005. *See* SEC Release No. 34-39892 (Apr. 21, 1998) (giving notice of the proposed rule); NASD, Withdrawal of Proposed Rule Change (Oct. 4, 2005).

440 *Rosenberg v. MetLife, Inc.*, 866 N.E.2d 439 (N.Y. 2007). *But see Moreland v. Perkins, Smart & Boyd*, 240 P.3d 601, 637 (Kan. Ct. App. 2010) (disagreement with *Rosenberg* and holding that statements on a Form U5 are subject only to a qualified privilege).

441 Bank Secrecy Act of 1970, Pub. L. No. 91-508, 84 Stat. 1118 (1970).

442 USA PATRIOT Act, Pub. L. No. 107-56, 115 Stat. 272 (2001). The full name of the PATRIOT Act is the "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001."

443 In 2010, the BSA regulations administered by FinCEN were transferred from 31 C.F.R. Part 103 to 31 C.F.R. Chapter X. *See* 75 Fed. Reg. 65,806 (Oct. 26, 2010).

444 *See* GAO-02-11-1, ANTI-MONEY LAUNDERING: EFFORTS IN THE SECURITIES INDUSTRY (Oct. 2001).

445 *See* 31 U.S.C. § 5318(h); § 352 of the PATRIOT Act. In April 2016, FinCEN proposed a rule that would include funding portals that are involved in the offering or selling of crowdfunding securities pursuant to § 4(a)(6) of the Securities Act in the definitions of ‘‘broker or dealer in securities" and ‘‘broker-dealer'' under the regulations implementing the BSA in order to subject such funding portals to the AML program and other AML requirements currently applicable to SEC-registered broker-dealers. *See* Amendments to the Definition of Broker or Dealer in Securities, 81 Fed. Reg. 19,086 (Apr. 4, 2016).

446 *See* 31 C.F.R. § 1023.210(b)(1); *see also* 67 Fed. Reg. 21,110, 21,111 (Apr. 29, 2002).

447 *See* FINRA Rule 3310, FINRA MANUAL; *see also* NASD Notice to Members 02-78 (Nov. 2002); NASD Notice to Members 02-21 (Apr. 2002); NYSE Information Memo 02-16 (Apr. 12, 2002); 74 Fed. Reg. 47,630 (Sept. 16, 2009) (adopting NASD Rule 3011 as FINRA Rule 3310 (without substantive changes). *See generally* FINRA, AML FAQs, *available at* http://www.finra.org/industry/faq-anti-money-laundering-faq (last visited Sept. 9, 2016); SEC, AML Source Tool, *available at* http://www.sec.gov/about/offices/ocie/amlsourcetool.htm (June 20, 2012) (last visited Sept. 9, 2016); SIFMA Anti-Money Laundering and Financial Crimes Committee, 2008 Guidance for Deterring Money Laundering and Terrorist Activity (Feb. 2008).

448 Firms that elect to be treated as "capital acquisition brokers" will be subject to a rule requiring them to implement a written AML program, similar to FINRA Rule 3310, but which will permit such firms to conduct

the required independent testing every two years rather than every year as required by FINRA Rule 3310. *See* FINRA Regulatory Notice 16-37 (Oct. 2016).

449 *See* 31 U.S.C. § 5318(g), PATRIOT Act § 356 (requiring adoption of final regulations applying BSA suspicious activity reporting requirements to broker-dealers); 31 C.F.R. § 1023.320; *see also* NASD Notice to Members 02-47 (Aug. 2002).

450 31 C.F.R. § 1023.320(a)(2). In promulgating its SAR Rule for broker-dealers, FinCEN clarified how introducing and clearing brokers may coordinate the filing of a single SAR for a reportable transaction. *See* 67 Fed. Reg. 44,048, 44,051–52 (July 1, 2002). *See also* FinCEN, Guidance to Financial Institutions in Filing SARs Regarding the Proceeds of Foreign Corruption (Apr. 17, 2008).

451 31 U.S.C. § 5318(g)(2); 31 C.F.R. § 1023.320(e); 75 Fed. Reg. 75,593, 75,595 (Dec. 3, 2010).

452 In 2006, FinCEN and the federal banking agencies issued guidance clarifying that financial institutions (including broker-dealers) may share SARs with their head offices or controlling companies (subject to certain requirements) but may not share SARs "horizontally" with other affiliates. *See* FinCEN, Interagency Guidance on Sharing Suspicious Activity Reports with Head Offices and Controlling Companies (Jan. 20, 2006). In 2010, FinCEN adopted rules clarifying that the SAR confidentiality requirement extends to the SAR and "any information that would reveal the existence of a SAR," which would include all material prepared in connection with detecting and reporting suspicious activity whether or not a SAR was ultimately filed, but does not include "the underlying facts, transactions, and documents upon which a SAR is based." 75 Fed. Reg. 75,593, 75,595 (Dec. 3, 2010). The rules further provide that SARs or any information that would reveal the existence of a SAR may not be disclosed to any person, other than as specifically authorized, which for broker-dealers, would, so long as no person involved in the transaction is notified, permit sharing with (1) FinCEN, (2) any federal, state or local law enforcement agency, (3) any federal regulatory authority that examines the broker-dealer for BSA compliance, (4) any SRO that examines the broker-dealer for SAR rule compliance at the request of the SEC, (5) other financial institutions in connection with preparing a joint SAR, (6) in connection with certain employment references or termination notices or (7) within the broker-dealer's corporate organizational structure for purposes consistent with Title II of the BSA. 31 C.F.R. § 1023.320(e); *see also* 75 Fed. Reg. 75,593, 75,595 (Dec. 3, 2010). Additional guidance released by FinCEN in 2010 clarified that certain financial institutions (including broker-dealers) may share SARs that it has itself filed "horizontally" with certain affiliates that are also subject to a SAR regulation, subject to written confidentiality agreements with the affiliates agreeing to protect the confidentiality of SARs. *See* FinCEN, Guidance on Sharing Suspicious Activity Reports by Securities Broker-dealers, Mutual Funds, Futures Commission Merchants, and Introducing Brokers in Commodities with Certain U.S. Affiliates (Nov. 23, 2010).

453 31 U.S.C. § 5318(g)(3); 31 C.F.R. § 1023.320(f).

454 *Lopez v. First Union Nat'l Bank*, 129 F.3d 1186, 1192–93 (11th Cir. 1997).

455 *See Stoutt v. Banco Popular*, 320 F.3d 26 (1st Cir. 2003); *Lee v. Bankers Trust Co.*, 166 F.3d 540, 544–45 (2d Cir. 1999).

456 *See* 31 C.F.R. § 1023.220; 68 Fed. Reg. 25,133 (May 9, 2003); *see also* Joint Press Release, Department of Treasury, FinCEN and federal financial regulators, Treasury and Federal Financial Regulators Issue Final PATRIOT Act Regulations on Customer Identification (Apr. 30, 2003); FinCEN and other federal financial regulators, Interagency Interpretive Guidance on Customer Identification Program Requirements under Section 326 of the USA PATRIOT Act (Apr. 28, 2005); SEC, Guidance from the Staffs of the Department of the Treasury and the SEC: Questions and Answers Regarding the Broker-Dealer Customer Identification Program Rule (Oct. 1, 2003), *available at* http://www.sec.gov/divisions/marketreg/qa-bdidprogram.htm (last visited Sept. 9, 2016).

457 In its first enforcement action under the PATRIOT Act, in May 2006, the SEC sanctioned broker-dealer Crowell, Weedon & Co. for failing to document properly its actual customer identity verification procedures in its CIP. *See In the Matter of Crowell, Weedon & Co.*, SEC Release No. 34-53847 (May 22, 2006); *see also* FinCEN, FIN-2008-G002, Customer Identification Program Rule No-Action Position Respecting

Broker-Dealers Operating Under Fully Disclosed Clearing Agreements According to Certain Functional Allocations (Mar. 4, 2008) (FinCEN stating that it will take no action against a clearing firm not complying with the CIP rule with respect to a customer introduced pursuant to a clearing agreement with an introducing broker that allocates the functions of opening and approving customer accounts and directly receiving and accepting orders from the introduced customer exclusively to the introducing firm).

458 *See* 31 C.F.R. § 1023.100(d).

459 *See* 31 C.F.R. § 1023.220(a).

460 31 C.F.R. § 1023.220(a)(6); *see also Securities Industry and Financial Markets Association* (avail. Jan. 9, 2015) extending, until the earlier of (i) January 9, 2017 or (ii) the date upon which an AML program rule for investment advisers becomes effective, a no-action position first taken in *Securities Industry Association* (avail. Feb. 12, 2004) (SEC staff no-action position indicating that a broker-dealer may rely on a registered investment adviser to perform elements of the broker-dealer's CIP with respect to shared customers).

In 2010, FINRA recognized that there are limited "legitimate business arrangements" pursuant to which the identities of the beneficial owners of multiple sub-accounts to a master account may not be disclosed to the broker-dealer and, therefore, the broker-dealer may rely on information provided by others as to whether to treat a master/sub-account as having a single beneficial owner. For example, when a registered broker-dealer procures clearing services pursuant to an omnibus clearing arrangement on a basis in which the sub-account owners' identities are not disclosed to the clearing broker, the clearing broker may rely on information provided by the registered broker-dealer, absent actual or inquiry notice. FINRA Regulatory Notice 10-18 (Apr. 2010). *See also* Guidance from the Staffs of the Department of the Treasury and the SEC, Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule (Oct. 1, 2003), *available at* http://www.sec.gov/divisions/marketreg/qa-bdidprogram.htm (last visited Sept. 9, 2016).

461 *See* 31 C.F.R. § 1023.220(a)(6); *see also Securities Industry and Financial Markets Association* (avail. Jan. 9, 2015).

462 *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,397 (May 11, 2016); 31 C.F.R. § 1010.230. *See also* FinCEN, FIN-2016-G003, Frequently Asked Question Regarding Customer Due Diligence Requirements for Financial Institutions (July, 19, 2016). The Final CDD Rule applies to a set of financial institutions that is generally consistent with the scope of financial institutions currently subject to BSA CIP requirements (*i.e.*, banks, broker-dealers, mutual funds, futures commission merchants and introducing brokers in commodities). The Final CDD Rule amends the rules implementing the AML program requirement for all such financial institutions to expressly codify the existing "four pillars" of BSA AML programs (internal controls, independent testing, BSA compliance officer and training) and to add a new fifth pillar requiring appropriate risk-based procedures for conducting ongoing customer due diligence. *See*, *e.g.*, 31 C.F.R. 1023.210.

463 *See* Final CDD Rule, 81 Fed. Reg. 29,397, 29,409 (May 11, 2016); 31 C.F.R. § 1010.230.

464 Final CDD Rule, 81 Fed. Reg. 29,397, 29,398 (May 11, 2016).

465 *See* Final CDD Rule, 81 Fed. Reg. 29,397, 29,412 (May 11, 2016); 31 C.F.R. 1010.230(e).

466 *See* Final CDD Rule, 81 Fed. Reg. 29,397, 29,415-16 (May 11, 2016).

467 *See* Guidance from the Staffs of the Department of the Treasury and the SEC, Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule (Oct. 1, 2003). Other financial institutions subject to the Final CDD Rule would also be able to rely on existing guidance that applies for CIP purposes. *See also, e.g.*, Guidance from the Staffs of the Department of the Treasury and the SEC, Questions and Answers Regarding the Mutual Fund Customer Identification Rule (Aug. 11, 2003); FinCEN, FIN-2006-G004, Frequently Asked Question regarding Customer Identification Programs for Futures Commission Merchants and Introducing Brokers (Feb. 14, 2006); FinCEN, FIN-2006-G009, Application of the Regulations Requiring Special Due Diligence Programs for Certain Foreign Accounts to the Securities and Futures Industries (May 10, 2006).

468 *See* 31 C.F.R. § 1020.220(a)(6).

469 31 C.F.R. § 1010.520. In 2008, the Agreement on Mutual Legal Assistance between the United States and the European Union was ratified, giving EU member states access to the FinCEN 314(a) program. *See* 75 Fed. Reg. 6560 (Feb. 10, 2010); *see also* FinCEN, FinCEN's 314(a) Fact Sheet (Oct. 25, 2016) (describing the success of the FinCEN program). In 2010, the Information Sharing Rule was amended to include state, local and foreign (to the extent necessary to satisfy reciprocal treaty obligations) law enforcement agencies. 75 Fed. Reg. 6560 (Feb. 10, 2010).

470 *See* FinCEN Press Releases dated Apr. 2, 2003 (responding to industry comments regarding the information sharing process, and Dec. 17, 2004 (describing law enforcement-related results of the information sharing process under § 314(a)); *see also* GAO 10-622T, BETTER COMMUNICATIONS COULD ENHANCE THE SUPPORT FINCEN PROVIDES TO LAW ENFORCEMENT (Apr. 2010).

471 Financial institutions wanting to share such information with one another may satisfy the notice requirement by filing a standard 314b registration form with FinCEN, enabling the submission of such information through use of electronic mail. *See* FinCEN, Financial Institution Notification Form, *available at* http://www.fincen.gov/statutes_regs/patriot/section314b.html (last visited Sept. 9, 2016).

472 *See* 31 C.F.R. § 1010.540; § 314(b) of the PATRIOT Act.

473 31 U.S.C. § 5318(i); § 312 of the PATRIOT Act.

474 31 U.S.C. § 5318(i). Section 312 of the PATRIOT Act defines the term "private banking account" as an account (or combination of accounts) that (i) requires a minimum aggregate deposit of funds or other assets of not less than $1 million, (ii) is established on behalf of one or more individuals who have a direct or beneficial ownership in the account and (iii) is assigned to, or is administered or managed, in whole or in part, by an officer, employee or agent of a financial institution acting as a liaison between the financial institution and the direct or beneficial owner of the account. *See* 31 U.S.C. § 5318(i)(4)(B).

475 *See also* 31 C.F.R. § 1010.610.

476 A "correspondent banking account" is commonly understood to mean a deposit account established by one bank for another bank to receive deposits and make payments.

477 31 C.F.R. § 1010.605(c)(1)(i); *see also* 31 U.S.C. § 5318A(e)(1)(B) (similarly defining "correspondent account" for banks).

478 31 C.F.R. § 1010.605(c)(2)(ii).

479 *See* 71 Fed. Reg. 496 (Jan. 4, 2006); 71 Fed. Reg. 16,040 (Mar. 30, 2006).

480 31 C.F.R. §§ 1010.610(a) and 620(a); *see also* FinCEN Guidance, FIN-2006-G009, Application of the Regulations Requiring Special Due Diligence Programs for Certain Foreign Accounts to the Securities and Futures Industries (May 10, 2006).

481 72 Fed. Reg. 44,768 (Aug. 9, 2007); 31 C.F.R. § 1010.610(b); *see also* FinCEN, FIN-2010-G001, Interagency Guidance on Obtaining and Retaining Beneficial Ownership Information (Mar. 5, 2010).

482 31 U.S.C. § 5318(j), *amended by* § 313(a) of the PATRIOT Act.

483 31 C.F.R § 1010.630. The prohibition on dealings with foreign shell banks also applies to U.S. banks and U.S. branches and agencies of foreign banks, but does not apply to other categories of BSA-regulated financial institutions.

The term "regulated affiliate" includes any foreign shell bank that (i) is an affiliate of a depository institution, credit union or foreign bank that maintains a physical presence in the United States or a foreign jurisdiction and (ii) is subject to supervision by a banking authority in the jurisdiction regulating such affiliated depository institution, credit union or foreign bank. *See* 31 C.F.R. § 1010.605(n).

484 31 C.F.R. § 1010.630(a)(2).

485 31 C.F.R. § 1010.630(b).

486 This does not prevent a research analyst from attending a pitch meeting in connection with an initial public offering of an "emerging growth company" ("EGC") that is also attended by investment banking personnel, provided that the research analyst does not engage in otherwise prohibited conduct during such meetings,

including efforts to solicit investment banking business. FINRA Rule 2241.01(b), FINRA MANUAL. FINRA members subject to the 2003 Global Research Settlement (described in §14.07[5][b] below) remain prohibited from participating in EGC pitch meetings.

487 In addition, compensation of any research analyst primarily responsible for the preparation of a research report must be reviewed and approved at least annually by a committee that reports to a member's board and that does not have any representation by the member's investment banking department. FINRA Rule 2241(b)(2)(F), FINRA MANUAL.

488 These prohibitions are not required with respect to "emerging growth companies," and may have exceptions for significant news or events occurring during these periods. FINRA Rule 2241(b)(2)(I), FINRA MANUAL.

489 FINRA Rule 2241(c), FINRA MANUAL.

In public appearances, a research analyst must similarly disclose if the analyst (or any member of the analyst's household) has a financial interest in the subject company's securities, if the member or its affiliates beneficially owns 1% or more of any class of the subject company's common equity, if the analyst knows or has reason to know the member or its affiliates received any compensation from the company or the subject company was a client of the member in the preceding twelve months, any other material conflict of interest of the research analyst or member that the research analyst knows or has reason to know. FINRA Rule 2241(d), FINRA MANUAL.

These disclosures in research reports or public appearances are not required to the extent they would reveal material non-public information regarding specific potential future investment banking transactions. FINRA Rule 2241(c)(5), (d)(2), FINRA MANUAL.

490 FINRA Rule 2241(c)(6), (7), FINRA MANUAL.

491 A FINRA member is not considered to have distributed an independent third-party research report that is made available on request, through a member-maintained website, or to a customer in connection with a solicited order in which a registered representative informed the customer of the availability of independent research and the customer requests such independent research.

492 An "independent third-party research report" is a research report produced by a person with no affiliation or business or contractual relationship with the FINRA member or its affiliates that is reasonably likely to inform the content of its research reports and makes content determinations without any input from the distributing member or its affiliates. FINRA Rule 2241(a)(3), FINRA MANUAL.

493 In March 2004, the NASD and NYSE issued a joint memorandum that provided interpretive guidance regarding the research analyst and research reports rules (the "2004 Joint Memorandum"). *See* NASD Notice to Members 04-18 (Mar. 2004) and NYSE Information Memo 04-10 (Mar. 9, 2004). Among other things, the 2004 Joint Memorandum stated that if a broker-dealer distributes a "globally branded" research report that was prepared by an affiliate but that uses a single marketing identity encompassing the broker-dealer, then all of the analyst conflict rules would apply to that report. In addition, under certain circumstances, foreign-based analysts employed by a foreign affiliate of the member may be viewed by the NASD and NYSE as "associated persons" of the member requiring, among other things, licensing and member-firm supervision. *See* NASD Notice to Members 04-18 (Mar. 2004) and NYSE Information Memo 04-10 (Mar. 9, 2004). These statements regarding globally branded research and foreign-based analysts engendered considerable controversy within the industry. In 2008, FINRA responded by creating an exemption from the research analyst qualification requirements for certain foreign-based analysts who contribute only to globally branded or foreign affiliate research reports. *See* NASD Rule 1050, FINRA MANUAL; Incorporated NYSE Rule Interpretation 344/02, FINRA MANUAL; SEC Release No. 34-57278 (Feb. 6, 2008).

494 FINRA Rule 2241(f), FINRA MANUAL.

495 *See* NASD Notice to Members 04-25 (Mar. 2004). A research analyst employed by a foreign broker-dealer affiliate of the FINRA member is not required to register as a research analyst and pass the examination unless the research analyst is also an associated person of the FINRA member. *See* NASD Notice to

Members 04-25 (Mar. 2004).

496 *See* NASD Notice to Members 04-81 (Nov. 2004).

497 *See* SEC Release No. 34-47384 (Feb. 20, 2003). Regulation AC applies to both U.S. and foreign broker-dealers (subject to the limited exception noted below) and certain of their affiliates in respect of research reports prepared by research analysts that have been distributed to U.S. persons. Regulation AC, however, does not apply to those affiliates with respect to which the broker-dealer has established and enforced information barriers and other appropriate policies and procedures reasonably designed to prevent the broker-dealer from influencing the affiliate or the content of research reports prepared by the affiliate or its personnel (this provision is intended to prevent the broker-dealer from doing indirectly through an affiliate what it could not do directly without complying with the certification requirements of the regulation). In addition, Regulation AC includes certain exemptions related to (i) the distribution by a broker-dealer or other covered person of third-party research, (ii) offshore appearances by research analysts employed outside the United States by a non-U.S. entity, (iii) activities of the news media, (iv) activities of investment advisers not required to register under the Advisers Act, and (v) research reports on foreign securities prepared by a foreign broker-dealer that is not affiliated with an SEC-registered broker-dealer and that provides such research reports to major U.S. institutional investors in accordance with Rule 15a-6(a)(2) under the Exchange Act. *See also* SEC, Division of Trading and Markets, Responses to Frequently Asked Questions Concerning Regulation Analyst Certification (rev. Apr. 26, 2005), in which the SEC staff clarifies a number of issues regarding Regulation AC, including the general application of Regulation AC to foreign broker-dealers and the circumstances under which foreign broker-dealers that are not associated with SEC-registered broker-dealers may disseminate research reports to U.S. investors without becoming subject to the requirements of Regulation AC.

498 Rule 501 of Regulation AC.

499 Rule 502(a) of Regulation AC.

500 Rule 502(b) of Regulation AC.

501 The ten settling firms were: Bear, Stearns & Co. Inc.; Credit Suisse First Boston LLC; Goldman, Sachs & Co.; Lehman Brothers Inc.; J.P. Morgan Securities Inc.; Merrill Lynch; Morgan Stanley & Co. Inc.; Citigroup Global Markets Inc. (formerly, Salomon Smith Barney Inc.); UBS Warburg LLC; and U.S. Bancorp Piper Jaffray Inc. *See* SEC Litigation Release No. 18438 (Oct. 31, 2003).

Two other firms involved in related enforcement actions, *Deutsche Bank Securities Inc.*, SEC Litigation Release No. 18854, and *Thomas Weisel Partners LLC*, SEC Litigation Release No. 18855, reached a settlement with the Regulators on August 26, 2004 and agreed to pay a total of $87.5 million and $12.5 million, respectively. The terms of these two settlement agreements were substantially the same as the settlements entered into with the other ten firms and, for purposes of the remainder of this discussion, the terms "Global Research Settlement" and "settling firms" include these two additional firms. In March 2007, Banc of America Securities LLC reached a similar settlement with the Regulators and became subject to many of the same requirements as the other firms with respect to the separation of research and investment banking operations. *See* SEC Release No. 34-55466 (Mar. 14, 2007).

502 The settling firms and the Regulators agreed to amend certain provisions of the forward-looking aspects of the Global Research Settlement, which amendments were entered by the district court on September 24, 2004. On November 2, 2004, the staff of the SEC's Division of Market Regulation (since renamed the Division of Trading and Markets) issued an interpretive letter to Cleary, Gottlieb, Steen & Hamilton, acting on behalf of the settling firms, which addressed a number of questions regarding the forward-looking aspects of the Global Research Settlement. *See* Letter, dated Nov. 2, 2004, to Dana G. Fleischman of Cleary, Gottlieb, Steen & Hamilton re: Global Research Settlement. Further information with respect to the Global Research Settlement may be found on the SEC website, at www.sec.gov/spotlight/globalsettlement.htm.

503 For example, the NASD and NYSE revised their rules to incorporate certain of the Global Research Settlement's requirements, including the prohibition on research analysts' participation in certain company-

sponsored or investment banking-sponsored roadshows. *See* SEC Release No. 34-51593 (Apr. 21, 2005). Further, in recognition of the IPO Allocation Initiative and following through with certain suggestions made in the IPO Task Force Report, FINRA adopted Rule 5131, which addresses quid pro quo allocations, spinning and flipping. *See* FINRA Rule 5131, FINRA MANUAL. For further information with regard to the IPO Task Force Report, *see* § 3.06[2][b].

In addition, the SEC has published an interpretation of Regulation M highlighting certain prohibited attempts to induce aftermarket purchases during the restricted period. SEC Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations, SEC Release No. 34-51500 (Apr. 7, 2005); *see also* § 3.02[9].

504 For example, the Treasurer of the State of California, one of the nation's largest bond issuers and a major investor *via* its pension funds, announced that new conflict of interest and disclosure standards (the "Investment Protection Standards") would be imposed on investment banks that do business with the state, which standards largely mirror the terms of the Global Research Settlement. *See* News Release, California State Treasurer Phil Angelides, Treasurer Angelides Announces Tough New Requirements for Investment Banks That Do Business With State of California (May 8, 2003). The California Public Employees Retirement System and the California State Teachers Retirement System (the nation's largest and third largest public pension funds, respectively) also voted to impose the Investment Protection Standards on those investment banks that do business with them. *See* Gilbert Chan, *Pension Fund Calls for Reforms*, THE SACRAMENTO BEE, Aug. 19, 2003; News Release, California State Treasurer Phil Angelides, Treasurer Angelides Wins CalSTRS Approval of Key Shareholder Protection Initiatives (July 9, 2003).

505 *See*, *e.g.*, CFA Institute Best Practice Guidelines Governing Analyst/Corporate Issuer Relations (Nov. 12, 2004), a joint product of the CFA Institute (formerly known as the Association for Investment Management and Research) and the National Investor Relations Institute, which addresses such issues as analyst independence as it applies to analysts' relationships with corporate issuers, access to corporate executives, retaliation by issuers against analysts, pre-publication review of analyst research reports by the issuer and issuer-paid research.

506 Because of the global nature of the operations of the settling firms, the settling firms (and their affiliates) may also be subject to requirements regarding research analyst conflicts of interest and related matters in other jurisdictions (both outside the United States and within the United States under state or local law). For example, the Financial Conduct Authority of the United Kingdom (the "FCA") takes a principles-based approach, which requires regulated firms to develop and publish policies to ensure that their research analysts do not compromise their objectivity. *See* Business Standards, Conduct of Business Sourcebook, COBS 12, FCA HANDBOOK (Jan. 2013); *see also* Hong Kong Securities and Futures Commission, CODE OF CONDUCT FOR PERSONS LICENSED BY OR REGISTERED WITH THE SECURITIES AND FUTURES COMMISSION, paragraph 16 (Mar. 2014); International Organization of Securities Commissions, IOSCO STATEMENT OF PRINCIPLES FOR ADDRESSING SELL-SIDE SECURITIES ANALYST CONFLICTS OF INTEREST (Sept. 2003).

507 *See*, *e.g.*, SEC, Jumpstart Our Business Startups Act, Frequently Asked Questions About Research Analysts and Underwriters (Aug. 22, 2012), *available at* https://www.sec.gov/divisions/marketreg/tmjobsactresearchanalystsfaq.htm (last visited Dec. 19, 2016).

508 *See*, *e.g.*, Susanne Craig & Kara Scannell, *SEC Tried to Ease Curbs*, WALL STREET J. (Mar. 17, 2010).

509 § 7(c)(1) of the Exchange Act. Section 7(d) of the Exchange Act empowers the Board to impose restrictions on securities-related lending by lenders other than broker-dealers and certain of their associated persons and § 7(f) authorizes restrictions on borrowers. Section 7(c)(2) of the Exchange Act makes it unlawful for a broker-dealer or member of a national securities exchange to extend or maintain credit or collect margin in connection with any security futures product except in compliance with regulations promulgated by the Board or by the SEC and CFTC jointly pursuant to authority delegated by the Board. The Board has delegated margin-setting authority in connection with security futures products to the SEC and CFTC jointly. *See* Letter of the Board, dated March 6, 2001, to James E. Newsome, then-Acting Chairman of the CFTC, and Laura S. Unger, then-Acting Chairman of the SEC. Margin requirements in connection with

security futures products are required to be consistent with the margin requirements for comparable exchange-traded options and in particular, initial and maintenance margin levels may not be lower than the lowest level of margin, exclusive of premium, required for comparable exchange-traded options. § 7(c)(2)(B) of the Exchange Act. In 2002, the SEC and the CFTC adopted rules to establish margin requirements for security futures. *See* SEC Release No. 34-46292 (Aug. 1, 2002).

510 A customer who purchases securities "on margin" pays only a portion of the purchase price and receives an extension of credit for the remainder. The margin regulations, among other things, specify the minimum amount of cash or margin the purchaser must put up as collateral in connection with a transaction involving borrowing on securities.

511 The credit practices of broker-dealers received increased attention with the expansion of prime brokerage services and the proliferation of hedge funds. *See*, *e.g.*, *Hedge Funds and Systemic Risk: Perspectives of The President's Working Group on Financial Markets: Hearing before the House Financial Services Comm.*, 110th Cong. (July 11, 2007) (testimony regarding SEC initiatives by Erik R. Sirri, Director, SEC Division of Market Regulation); Annette L. Nazareth, SEC Commissioner, Remarks Before the PLI Hedge Fund Conference (June 6, 2007); Ben S. Bernanke, Chairman, Federal Reserve Board, Hedge Funds and Systemic Risk, Remarks at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference (May 16, 2006).

512 *See* H. Rep. No. 1383, 73d Cong., 2d Sess. (1934); 78 CONG. REC. 7703 (Apr. 30, 1934).

513 12 C.F.R. Part 220. Regulation T also applies to certain associated persons of broker-dealers, including their subsidiaries (broker-dealers and other persons covered by Regulation T are known as "creditors"). Regulation U (12 C.F.R. Part 221) governs securities-related lending by banks and certain other lenders not subject to Regulation T. Regulation X (12 C.F.R. Part 224) governs U.S. persons, and certain foreign persons controlled by U.S. persons, who borrow outside the United States to finance a purchase of securities of U.S. issuers and, in some cases, who borrow in the United States to finance a purchase of any securities.

514 *See* § 14.07[6][a][ii].

515 *See* 12 C.F.R. § 220.3(g). Prior to the 1996 amendments to Regulation T, a broker-dealer generally could not (except in certain limited circumstances) arrange for an extension of credit by a third party to a customer on terms better than Regulation T would allow the broker-dealer to extend directly. *See* 61 Fed. Reg. 20,386 (May 6, 1996). Note, however, that there continues to be an "arranging prohibition" in Regulation U. *See* 12 C.F.R. § 221.3(a)(3). For a discussion of restrictions on lending in connection with a distribution by broker-dealer participants, *see* § 14.07[6][c].

516 For purposes of Regulation T, a "customer" of a "creditor," *see supra* Note 513, is defined as (i) any person or persons, other than an "exempted borrower," to or for whom the creditor extends, arranges, or maintains any credit or who would be considered a customer of the creditor according to the ordinary usage of the trade, (ii) any partner of the creditor who would be considered a customer absent the partnership relationship, and (iii) any joint venture in which the creditor participates which would be considered a customer if the creditor were not a participant. 12 C.F.R. § 220.2.

517 12 C.F.R. § 220.4.

518 In contrast, FINRA imposes "maintenance" margin requirements on its members. *See* § 14.07[6][b].

521 12 C.F.R. § 220.12.

522 12 C.F.R. § 220.3(i).

523 A "'payment period" is defined in Regulation T (12 C.F.R. § 220.2) as the standard securities settlement cycle in the United States plus two business days. Effective June 7, 1995, the standard settlement cycle was reduced from five business days to three, at which time a "payment period" was correspondingly reduced from seven business days to five. *See* SEC Release No. 34-33023 (Oct. 6, 1993); *see also* SEC Release No. 34-34952 (Nov. 9, 1994).

524 12 C.F.R. § 220.4(c)(3)(i).

525 12 C.F.R. § 220.4(d).

526 12 C.F.R. § 220.8 (cash account); 12 C.F.R. § 220.7 (broker-dealer credit account) 12 C.F.R. § 220.6 (good faith account).

The "broker-dealer credit account" may be used for certain transactions with other broker-dealers. For example, the account may be used for purchase and sale transactions between two self-clearing broker-dealers acting for their own behalf if the seller will promptly deliver the securities against payment of the purchase price. *See* Fed. Res. Reg. Serv. ¶5-615.78 (staff opinion, Jan. 28, 1998). The account may also be used to effect and finance transactions for another SEC-registered broker-dealer that gives written instructions that all transactions in the account will be for such broker-dealer's customers.

In addition to these three special purpose accounts, Regulation T provides for a "special memorandum account" that is linked to the customer's margin account. 12 C.F.R. § 220.5. It is used to hold customer funds not required by Regulation T to be maintained in the margin account (such as margin excess, interest or dividend payments, and funds deposited to satisfy a maintenance margin call under SRO rules or the broker-dealer's "house" requirements) and has the effect of preserving a customer's ability to use or withdraw such funds. No securities are purchased in a special memorandum account; instead, the purchase is recorded in the margin account and funds can be transferred from the special memorandum account to the margin account to satisfy the Regulation T margin requirement.

527 12 C.F.R. § 220.8(a)(1).

528 12 C.F.R. § 220.8(b)(2).

529 12 C.F.R. § 220.8(b)(1)(ii).

530 12 C.F.R. § 220.10(a); *see also infra* § 14.07[6][a][iii].

531 The types of securities defined as "margin securities" are specified at 12 C.F.R. § 220.2.

532 *See* 63 Fed. Reg. 2806 (Jan. 16, 1998).

533 *See* 63 Fed. Reg. 2806, 2815 (Jan. 16, 1998); 12 C.F.R. § 220.2. This provision became obsolete on August 1, 2006, when the Nasdaq Stock Market began operating as a national securities exchange.

534 12 C.F.R. § 220.2. Securities deemed to have a "ready market" for purposes of the SEC's net capital rule include equity securities of foreign issuers that are listed on the FTSE World Index and certain other equity securities listed for trading on a foreign exchange located in a country recognized on the FTSE World Index. *See FINRA Interp. Handbook* Rule 15c3-1(c)(11)(i) Interpretation/02; *Grace B. Vogel* (avail. Nov. 28, 2012); *William Wollman* (Feb. 9, 2016). Technically, "foreign margin stock" also includes equity securities that appear on a List of Foreign Margin Stock published by the Federal Reserve Board, but that list has not been published since 2004. FRB Press Release (Mar. 3, 2004).

535 *See* 12 C.F.R. § 220.1(b)(3)(ii); *see also* 12 C.F.R. § 220.10(c) (expressly permitting exempted borrowers to lend securities without regard to Regulation T and broker-dealers to borrow securities from an exempted borrower without regard to Regulation T).

536 *See* 12 C.F.R. § 220.2.

537 Under the safe harbor provided in 12 C.F.R. § 220.2, exempted borrowers include any registered broker-dealer that:

- Maintains at least 1000 active accounts on an annual basis for persons other than brokers, dealers, and persons associated with a broker or dealer;
- Earns at least $10 million in gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer; or
- Earns at least 10 percent of its gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer.

538 *See* 12 C.F.R. §§ 221.1(b)(3) and 221.2.

539 SRO margin requirements may still apply to certain loans by a member to an exempted borrower and

capital charges or "haircuts" may need to be taken to the extent those loans are not adequately margined. *Cf. FINRA Interp. Handbook* Rule 15c3-1(c)(2)(iv)(B) Interpretation/093 (requiring broker-dealers, including exempted borrowers, engaged in "nonpurpose" securities borrowing transactions solely for the purpose of financing positions of another broker-dealer to maintain equity at least equal to the haircut deduction required under the SEC's Net Capital Rule or take a charge against its own capital for any deficiency).

540 FINRA Rule 4210(g), FINRA MANUAL; CBOE Rule 12.4.

541 *See* SEC Release No. 34-54918 (Dec. 12, 2006) (NYSE); SEC Release No. 34-54919 (Dec. 12, 2006) (CBOE); SEC Release No. 34-55471 (Mar. 14, 2007) (NASD).

542 Currently, the only model that has been approved by the SEC is The Options Clearing Corporation's Theoretical Intermarket Margining System ("TIMS").

543 Before implementing portfolio margining for any customer, a firm must receive approval from its designated examining authority and establish a comprehensive risk analysis methodology. The firm must maintain a separate securities account for portfolio margining, and only certain equity securities and futures are eligible for portfolio margin treatment. *See generally* FINRA Rule 4210(g), FINRA MANUAL. Significant regulatory uncertainty remains as to how accounts that hold both securities and futures will be handled. *See* Cleary Gottlieb Steen & Hamilton LLP, *SEC Approves Amendments to NYSE and CBOE Margin Rules that Substantially Expand Portfolio Margining*, at 23-25 (Jan. 3, 2007) (on file with the Business Development Department of Cleary Gottlieb Steen & Hamilton LLP). However, in a 2012 no-action letter, the SEC staff stated that it would not recommend enforcement action if a broker-dealer, when calculating its net capital using a theoretical option pricing, groups a U.S.-listed security futures contract on individual stocks with equity options on, and positions in, the same underlying instrument. *See FINRA* (avail. May 4, 2012).

544 The Board has authority to prescribe maintenance margin requirements but generally has not done so.

The SRO margin rules also supplement Regulation T in a variety of other ways, such as providing detailed margin requirements for options, *see* FINRA Rule 4210(f)(2), FINRA MANUAL, and specific requirements for day trading, *see* FINRA Rule 4210(f)(8)(B), FINRA MANUAL and § 14.10[4].

545 *See* FINRA Rule 4210(e)(2)(A), FINRA MANUAL.

546 The Exchange Act does not define the circumstances under which a broker-dealer will be deemed to have participated in a "distribution" for purposes of § 11(d)(1). Several SEC no-action letters have found that certain traditional private placements under § 4(2) (now § 4(a)(2)) of the Securities Act were not subject to § 11(d)(1). *See*, *e.g.*, *Synergia Resources XX* (avail. Mar. 20, 1986); *Brandywine Associates II* (avail. Nov. 12, 1973). Although the SEC has not expressed a view on whether §11(d)(1) applies to Rule 144A offerings generally, the SEC staff has issued no-action letters to that effect in particular circumstances. *See*, *e.g.*, *Ontala Forest Products Inc.* (avail. Dec. 14, 1994) (§ 11(d) of the Exchange Act does not apply to a Rule 144A offering to a limited number of qualified institutional buyers); Suncor Inc. (avail. Feb. 25, 1992).

547 A secondary offering of securities can in some circumstances constitute a new issue for purposes of § 11(d) of the Exchange Act. *See*, *e.g.*, *Oakwood Homes* (avail. Oct. 11, 1978).

548 The SEC has taken the position that for purposes of § 11(d)(1), shares of registered investment companies and unit investment trusts, including most mutual funds and exchange-traded funds ("ETFs"), are distributed in a continuous manner. Broker-dealers selling such securities are therefore deemed to be participating in a "distribution" of a new issue, and thus require an exemption from § 11(d)(1) to provide financing on such securities. Rule 11d1-2 under the Exchange Act provides an exemption for credit on securities issued by a registered open-end investment company or unit investment trust that have been owned by the borrower for more than 30 days or purchased pursuant to a plan for the automatic reinvestment of the dividends on such security. The SEC has also provided exemptive relief allowing broker-dealers involved in the issuance of ETF shares to extend credit on those shares without violating § 11(d)(1), subject to certain conditions. These conditions include a broad prohibition on compensation to the broker-dealer from the ETF or other persons associated with the ETF to promote or sell ETF shares, a requirement that the relevant ETF shares be issued by a "qualifying ETF," and the passage of a 30-day start-up period for the ETF. *See Derivative Products Committee of the Securities Industry Association*

(avail. Nov. 21, 2005) (This no-action letter addresses additional topics that may be of concern to broker-dealers trading or financing ETF shares, such as describing significant restrictions on the ability of broker-dealers to receive compensation (including "12b-1 fees") from the ETF or any related parties to promote or sell such ETF shares.). In 2012, the SEC staff clarified that the broker-dealer would be eligible for the relief even if it receives payment in-kind, such as the donation of experts from an ETF research team to speak at a webcast, from ETF sponsors, advisers or service providers to fund educational and training programs for clients and investment professionals. *See Elliott R. Curzon* (avail. Aug. 23, 2012).

549 *See* H. Rep. No. 1383, 73d Cong., 2d Sess. 22 (1934) (§ 11(d) of the Exchange Act strikes at "one of the greatest potential evils inherent in the combination of the broker and dealer function in the same person, by assuring that he will not induce his customers to buy on credit securities which he has undertaken to distribute to the public").

550 *See supra* Note 547. The SEC, however, has exempted certain "direct participation programs" (*see* Rule 3a12-9 under the Exchange Act), and granted no-action or exemptive relief in a number of cases to permit broker-dealers to effect installment sales, or other sales of partly-paid securities, to U.S. persons in connection with global offerings. *See*, *e.g.*, *Cleary Gottlieb Steen & Hamilton LLP* (avail. Sept. 12, 2006) (up to 40% of global offering sold within the United States to qualified institutional buyers under Rule 144A); *Telecom Corp. of New Zealand* (avail. Feb. 25, 1998) (up to 20% of global offering publicly offered in the United States).

U.S. Regulation of the International Securities and Derivatives Markets, § 14.08, INTERNAL PROCEDURES

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

p. 14-135

To assure compliance with applicable rules and regulations, registered broker-dealers are required to follow detailed procedures with respect to a number of their internal practices, including hiring, supervisory procedures and recordkeeping. [551]

[1] Hiring

A broker-dealer's compliance responsibilities for its employees [552] and other associated persons begin in the hiring process. A broker-dealer is required to obtain from an employment applicant the information specified in FINRA's Form U-4. [553] The broker-dealer must affirmatively verify the information that an applicant provides. [554] All of the required information must be kept current after the applicant becomes an employee. Failure to register personnel with FINRA is a violation of Rule 15b7-1 under the Exchange Act. [555]

As a result of increasing concern regarding sales practice abuses by broker-dealer employees who are able to obtain new employment despite past misconduct, the staff of the SEC, in coordination with the NASD and NYSE, made a number of recommendations to improve employee monitoring and reporting procedures. [556] In addition to recommending that broker-dealers improve their compliance procedures and monitoring and recording of data on employees generating regulatory actions, complaints and arbitration damages, the SEC staff

p. 14-135

p. 14-136

has also recommended that broker-dealers increase the frequency and scope of their reports to SROs regarding such employees. [557]

To assist in the hiring and supervising processes, FINRA maintains a centralized, industry-wide computer tracking system of all employees and broker-dealers against whom actions have been taken or complaints have been made; access to such system is available to all SROs, broker-dealers, investors and the SEC. [558] In connection with the expanded monitoring and access to records of such employees and broker-dealers, the staff of the SEC recommended that broker-dealers more rigorously screen employees with histories of misconduct by, among other things, involving the legal and compliance departments in hiring, providing written justification when an applicant is hired against the advice of such departments and encouraging SROs to sanction broker-dealers who hire recidivist problem employees. [559] The SEC also announced that a registered representative against whom it imposed an unqualified bar (*i.e.*, one that does not allow for reapplication after a specified time period) permanently excluding such representative from participation in the securities industry will be, absent extraordinary circumstances, unable to successfully petition for reentry. [560]

[2] Supervision

A broker-dealer is liable for any violation of the securities laws committed by any of its associated persons unless the broker-dealer can establish a defense that: (i) the broker-dealer "established procedures and a system for applying such procedures" that could reasonably be expected to "prevent and detect" a violation, (ii) the procedures were properly performed, and (iii) the supervisor had no reason to suspect any violation. [561]

p. 14-136

p. 14-137

In 1992, the SEC for the first time fined and suspended persons that had been executive officials, including the former chief executive officer of a broker-dealer, for their failure to provide adequate supervision of employees, which failure was, in the SEC's view, compounded by the officials' failure to report prior securities law violations to government authorities. [562] The Supervisory Release announcing the fines and suspensions was intended by the SEC to serve as a significant statement of its policies regarding supervision, and to put officers of broker-dealers generally on notice of the SEC's views. [563] The Supervisory Release states that the federal securities laws "require a vigorous response even to indications of wrongdoing." It continues by stating that even if supervisory knowledge "is limited to ‘red flags' or ‘suggestions' of irregularity," a supervisor cannot discharge his responsibilities by relying on employees' unverified statements denying wrongdoing; instead, a supervisor must independently "follow-up and review" the irregularity. Further, where more than one supervisor is involved in considering the actions to be taken in response to possible misconduct, there must be a "clear assignment" of follow-up responsibilities to particular individuals, with the chief executive officer of the broker-dealer bearing "ultimate responsibility." [564]

The Supervisory Release also states that a broker-dealer's in-house lawyers or compliance personnel who do not have actual supervisory authority over an individual engaged in wrongdoing may be found to be "supervisors" where the lawyer or compliance officer has the "requisite degree of responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue." Where the lawyer or compliance officer takes "appropriate steps but management fails to act," the lawyer or compliance officer "should consider" disclosure of the matter to the broker-dealer's board of directors, resignation or disclosure to regulatory authorities. [565]

Like the SEC, FINRA does not prescribe any particular system of supervision or specific procedures that must be implemented. This is left to the individual broker-dealer and is expected to vary with the size of and activities

p. 14-137

p. 14-138

engaged in by the broker-dealer. FINRA does, however, provide certain minimum standards for a system of internal supervision. [566] Each broker-dealer is required to (i) "establish and maintain a system [of written procedures] to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA and Municipal Securities Rulemaking Board ("MSRB") rules," [567] (ii) have in place mandatory cycles of independent inspections for its supervisory branch offices, nonsupervisory branch offices and unregistered locations, [568] (iii) designate and specifically identify to FINRA one or more principals charged with establishing, maintaining and enforcing a system of "supervisory control policies and procedures" that test, verify and, where necessary, create additional or amended supervisory procedures of the member broker-dealer, [569] (iv) designate and specifically identify to FINRA a principal to serve as chief compliance officer [570] and (v) have its chief executive officer execute an annual compliance and supervision certification with respect to the member broker-dealer's written compliance policies and supervisory procedures. [571]

[3] Recordkeeping and Financial Reporting

[a] Reports Concerning the Broker-Dealer

The Exchange Act's extensive books and records requirement [572] serves to assist the SEC and SROs in enforcing the Exchange Act's substantive regulatory requirements. [573] For example, the books and records requirement is an important

p. 14-138

p. 14-139

adjunct to the financial responsibility rules. [574] In addition, the records that a broker-dealer keeps of its own trades allow the SEC and the SROs to audit the broker-dealer's compliance with the trading, anti-manipulative and antifraud restrictions of the securities laws. [575] Moreover, the records that a broker-dealer keeps of employment applications allow the SEC to verify that the broker-dealer is in compliance with the rules related to associated persons.

Rules 17a-3 and 17a-4 are the most significant Exchange Act provisions regarding broker-dealer recordkeeping. [576] The records required by Rule 17a-3 include, in addition to ordinary balance sheets, a "blotter" [577] of all purchases and sales of securities, blotters for securities and cash received and disbursed, customer ledgers, records of every confirmation sent with respect to a securities transaction, records of every purchase and sale for the account of the broker-dealer and records of every brokerage order or other instruction given or received for the purchase or sale of securities, whether or not executed. Rule 17a-4 provides that a registered broker-dealer must, among other things, maintain its checkbooks, bank statements, bills, originals of all communications received and copies of all communications sent (including inter-office memoranda and communications) relating to its business and all written business agreements, as well as a description of the broker-dealer's procedures concerning its handling of fully paid and excess margin securities. The SEC has stated that the records required to be maintained under Rule 17a-4 are not limited to physical documents, and that internal (or "intra-office") electronic communications relating to a broker-dealer's "business as such" are covered by the rule. [578] The location in which and

p. 14-139

---

p. 14-140

the length of time for which a broker-dealer must keep records are also set out in Rule 17a-4. [579]

The financial statements and reports that must be prepared by a broker-dealer are described in Rule 17a-5, which was substantially amended in 2013. [580] Prior to 2013, the rule required, among other things, the preparation of an annual audited financial statement that included the following: (i) statement of financial condition, (ii) statement of income (loss), (iii) statement of cash flows, (iv) statement of changes in stockholders' equity, and (v) statement of changes in liabilities subordinated to claims of general creditors. [581]

Pursuant to the 2013 amendments, with respect to fiscal years ending on or after June 1, 2014, a broker-dealer must file certain annual reports within 60 calendar days of the end of its fiscal year. [582] Pursuant to the amended rule, all registered broker-dealers are required to file with the SEC an annual financial report containing the same types of information included in the financial statements required prior to the 2013 amendments (as described in the paragraph above). [583] Further, a PCAOB-registered independent public accountant must prepare a report based on an examination of the broker-dealer's financial report in

p. 14-140

---

p. 14-141

accordance with PCAOB standards. [584] In addition, a broker-dealer is required to file either a "compliance report" (if it holds customer funds or securities) or an "exemption report" (if it does not hold customer funds or securities) and a PCAOB-registered independent accountant must prepare a report based on an examination of certain statements in the broker-dealer's compliance report or exemption report. [585] All reports must be filed with the SEC and, if the broker-dealer is a member of SIPC, with SIPC. [586] The broker-dealer must also file a supplemental report on the status of its membership in SIPC (including a report of an independent public accountant that covers the SIPC annual general assessment reconciliation or exclusion from membership forms). [587]

The compliance report must contain (1) a statement as to whether the broker-dealer has established and maintained internal controls providing it with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis, (2) a statement as to whether the internal controls were effective during the most recent fiscal year, [588] (3) a statement as to whether the controls were effective as of the end of the most recent fiscal year, (4) a statement as to whether the broker-dealer is in compliance with Rule 15c3-1 and Rule 15c3-3(e) as of the end of the most recent fiscal year, and (5) a statement as to whether the information the broker-dealer used to state whether it was in compliance with Rule 15c3-1 and Rule 15c3-3(e) was derived from the books and records of the broker-dealer. [589]

The exemption report must include, to the best knowledge and belief of the broker-dealer, (1) a statement that identifies the provision in Rule 15c3-3(k) under which the broker-dealer claimed an exemption from Rule 15c3-3, (2) a statement that the broker-dealer met the identified exemption provisions in Rule 15c3-3(k) throughout the most recent fiscal year without exception or that it met them as described in the report, and (3) if applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provision in Rule 15c3-3(k) and that describes the nature of each exception. [590]

p. 14-141

p. 14-142

If the independent accountant determines during the course of preparing its reports that the broker-dealer is not in compliance with the financial responsibility rules or if it determines any material weakness exists in a broker-dealer's internal control over compliance with the financial responsibility rules, the accountant must immediately notify the broker-dealer, and if the notification concerns compliance with the financial protection rules, the broker-dealer must file a notification with the SEC and its designated examining authority. [591]

In addition, pursuant to the 2013 amendments, a broker-dealer is required to file a "Form Custody" with its designated examining authority within 17 business days after the end of each calendar quarter and within 17 business days after the end of the broker-dealer's fiscal year where that date was other than the end of a calendar year. [592] The Form contains nine categories of questions about the broker-dealer's custodial activities. [593]

Broker-dealers are also generally required to file with the SEC or with their designated examining authority certain financial statements (commonly known as "FOCUS Reports") at the end of each month and additional reports quarterly. [594] Within 105 days of the end of its fiscal year, a broker-dealer must provide each of its customers with an audited statement of financial condition and related notes. [595] A broker-dealer also has to provide each customer with an unaudited mid-year statement of financial condition. [596] If, in connection with its most recent annual reports, the report of the accountant covering the broker-dealer's compliance report identified a material weakness, the broker-dealer must include with its statement of financial condition a statement that one or more material weaknesses have been identified and that a copy of the accountant's report is available for the customer's inspection at the SEC's Washington, D.C. office and the regional office for the region where the broker-dealer has its principal place of business. [597]

[b] Reporting Rules Concerning Affiliates

p. 14-142

p. 14-143

Until 1992, the SEC's regulation of broker-dealers had been only of the registered entity and, through the NASD and other SROs, of its officers and employees. [598] SEC regulation of affiliated persons other than employees was generally limited to ensuring that the registered broker-dealer was not associated with or controlled by persons or entities deemed unfit for involvement in the securities business, such as persons who had been convicted of securities law violations.

In 1990, Congress adopted § 17(h) of the Exchange Act providing for maintenance of records and filing with the SEC of information to be specified by the SEC regarding affiliates of registered broker-dealers. [599] The records to be kept by the registered entity and the information to be filed relate to the activities of the affiliates and the resulting risks to, and potential impact on, the financial and operational condition of the registered broker-dealer. In mid-1992, the SEC adopted "Final Temporary" rules under § 17(h) that require registered broker-dealers to make and preserve records and to file quarterly reports with the SEC concerning certain of their affiliated entities. [600]

Rules 17h-1T and 17h-2T require a registered broker-dealer to maintain and file with the SEC reports concerning each of its "material associated persons" ("MAPs"), [601] a term that includes any associated person (other than a natural person) of a broker-dealer whose "business activities are reasonably likely to have material impact on the financial and operational conditions of the broker-dealer." [602]

The required information concerning MAPs falls into two broad categories: (i) organizational and risk management policies and information and (ii) financial information. The first category of required information includes an organizational chart of the holding company structure (showing all MAPs, as well as other associated persons), records regarding material legal or arbitration proceedings and copies of written policies governing such matters as credit controls, sources of funding and trading risks. Required financial information includes, for each MAP, its aggregate securities and commodities positions, positions in certain financial instruments involving off-balance sheet risk, its short-term borrowing positions (which is an area of particular SEC concern) and its real estate activities. In addition, consolidating and consolidated balance sheets and income and cash flow statements are required for the broker-dealer and the broker-dealer's ultimate holding company parent. Entities using a set of accounting principles other than U.S. GAAP are required to disclose and explain the type of accounting principles employed, but do not need to reconcile their financials to U.S. GAAP. With respect to MAPs that are subject to regulation by a foreign financial regulatory authority, the broker-dealer is required to maintain and to file with the SEC only the reports that the MAP files with its foreign regulator. [603] With respect to certain MAPs that are themselves regulated by U.S. banking or insurance authorities or by the CFTC, broker-dealers are required to file with the SEC only certain of the reports that the MAP files with its U.S. regulator and are not required to generate any additional reports to satisfy the requirements of Rule 17h-1T or 17h-2T. [604] Information reported to the SEC pursuant to Rules 17h-1T and 17h-2T is not publicly available, but is available to Congress and to U.S. and foreign regulators.

p. 14-144

p. 14-145

While the focus of § 17(h) of the Exchange Act and the rules thereunder has been the potential impact on registered broker-dealers of their affiliates' activities, the GAO has issued a report recommending that the SEC also use its authority under § 17(h) to gather any information necessary to determine whether regulation by the SEC of the unregulated affiliates of broker-dealers is warranted. [605] The GAO report notes, by way of example, that U.S. banking regulation applies not only to entities that are banks but to all of the companies in a bank holding company group. The SEC, in a letter responding to the GAO, said it did not believe that the SEC should expand its regulatory reach beyond broker-dealers, as this would impose unnecessary costs on broker-dealers and entangle the SEC in the regulation of nonsecurities activities. Nonetheless, the SEC stated that it would use the information that it gathers concerning broker-dealer affiliates to determine whether any such regulation might be useful. [606]

In 1999, Congress adopted § 17(i) of the Exchange Act to create a regulatory framework under which a holding company of a broker-dealer may voluntarily be supervised by the SEC as a "supervised investment bank holding company" ("SIBHC"). [607] In 2004, the SEC adopted rules implementing § 17(i). [608] Under these rules, an "investment bank holding company" that met certain requirements could have elected to become a SIBHC by filing a notice of intention with the SEC. [609] A SIBHC must comply with a number of requirements including requirements related to its group-wide internal risk management control system, recordkeeping and periodic reporting. The reporting requirements include a requirement to report consolidated computations of allowable capital and risk allowances consistent with the standards published by the Basel Committee on Banking Supervision. Because certain of the SIBHC requirements would duplicate requirements under the risk assessment rules, the SEC provided

p. 14-145

p. 14-146

an exemption from Rules 17h-1T and 17h-2T for a broker-dealer that is affiliated with a SIBHC. [610]

In 2010, the Dodd-Frank Act deleted § 17(i) of the Exchange Act, terminating the SIBHC program and replacing it with a new regulatory framework for voluntary supervision of securities holding companies (*i.e.*, nonbank companies owning one or more registered broker-dealers) by the Board. This supervisory framework is intended to satisfy requirements that securities holding companies be subject to comprehensive consolidated supervision in the United States. [611] Consequently, the SEC rescinded its rules implementing § 17(i) of the Exchange Act and providing exemptions from Rules 17h-1T and 17h-2T. [612] Upon registering with the Board, the supervised securities holding companies ("SSHCs") would become subject to all of the examination, supervision and enforcement regulations applicable to registered bank holding companies, other than the restrictions on nonbanking activities set forth in § 4 of the Bank Holding Company Act.

In June 2012, the Board issued a final rule implementing the new SSHC regime and, in particular, outlining the requirements that an SSHC must satisfy to make an effective registration. [613] The rule requires a company electing to be a "securities holding company" [614] to submit a form containing organizational information, financial reports and income statements, a description of the methods used to monitor and control its operations, a description of the bank regulatory systems existing in the home country of any of its foreign bank subsidiaries and a description of any other regulatory capital framework to which

p. 14-146

p. 14-147

the company is subject. [615] Upon effective registration, an SSHC is supervised and regulated as if it were a bank holding company (*e.g.*, submitting the same reports and subject to the same examination procedures, supervisory guidance and capital standards), except that the nonbanking restrictions contained in § 4 of the Bank Holding Company Act will not apply to SSHCs. [616]

[c] Large Trader Reporting Rules and Electronic Submission of Trading Data

In 2000, the SEC adopted Rule 17a-25 under the Exchange Act, which is intended to codify the SEC's electronic submission requirements with respect to trading data and enhance the SEC's ability to monitor the securities activities of large traders. [617] Rule 17a-25 requires registered broker-dealers to submit electronically to the SEC, upon request, certain information with respect to customer and proprietary securities trading. Among other things, the rule requires that broker-dealers electronically provide information regarding prime brokerage identifiers, average price account identifiers and identifiers used by depository institutions in order to enable the SEC to identify double reporting and create uniformity in reporting.

In 2011, the SEC, in acknowledging the "increasingly prominent role in the securities markets" of large traders, declared Rule 17a-25 ineffective and inadequate at monitoring large trader activity, specifically faulting the current system for its time delays and inability to identify and track large traders, [618] and adopted Rule 13h-1 under the Exchange Act. Among other things, Rule 13h-1 requires a U.S.-registered broker-dealer to maintain specified account and transaction records for persons (including foreign entities) who have identified themselves as "large traders" or persons whom the broker-dealer has "reason to know" are large traders based upon the aggregate transactions that the trader has effected through the broker-dealer. [619] Rule 13h-1 is intended to enable the SEC to collect market information necessary to reconstruct the activities of large traders during

p. 14-147

p. 14-148

periods of market stress, such as the rapid declines in the U.S. securities markets during October of 1987 and 1989 and to support the SEC's investigative and enforcement activities. [620]

The rule requires U.S.-registered broker-dealers to record and report electronically to the SEC all transactions effected directly or indirectly by or through accounts of large traders if the trading activity for a particular day equals or exceeds the "reporting activity level" of 100 shares. [621] In addition, broker-dealers must monitor each person whom the broker-dealer "knows or has reason to know" is a large trader where such person has not identified itself as such to the SEC in compliance with the large trader requirements of Rule 13h-1. Such a determination may be based solely by taking into account the transactions of such person in NMS securities effected by or through such broker-dealer. A broker-dealer may rely on its conclusion that it does not know or have reason to know that person is a large trader so long as the broker-dealer (i) has no reason to expect that any of its customers' transactions approach the identifying activity level or does not have actual knowledge that a person is a large trader and (ii) has implemented policies and procedures "reasonably designed to identify customers whose transactions at the broker-dealer equal or exceed the identifying activity level." Absent these circumstances, the broker-dealer is obligated to notify such person that it may be a large trader and its potential reporting obligations under the rule. [622]

Footnotes

551 *See*, *e.g.*, § 14.07[1][b] regarding the special procedures broker-dealers are required to establish to prevent insider trading. SEC-registered broker-dealers must also have detailed anti-money laundering compliance procedures. *See* § 14.07[4].

552 Although, for convenience, the term "employee" is sometimes used in this section, the Exchange Act and FINRA rules generally use the term "associated persons." Persons who are not employees in the labor law sense of that term (such as independent contractors) may be deemed "employees" or "associated persons" of a broker-dealer. *See*, *e.g.*, NASD Membership and Registration Rules, Rules 1021 and 1031, FINRA MANUAL.

553 *See* § 14.07[3][b]. In addition, Rule 17f-2 under the Exchange Act contains a requirement, subject to certain exceptions, that employees of a broker-dealer be fingerprinted and their fingerprints submitted to the U.S. Attorney General.

554 *See*, *e.g.*, SEC Release No. 34-6872 (Aug. 8, 1962) (casual interviews and a perfunctory telephone call to a former employer are not evidence of "reasonable care" in hiring); *see also* Remarks of Mary L. Schapiro, then-Commissioner of the SEC, Investor Protection: The Role of the SEC, the SROs, and the Industry in Preventing Sales Practice Abuses (Oct. 9, 1992) (broker-dealer hiring procedures "should be designed to uncover and disqualify from employment" individuals having a bad disciplinary history).

555 *See* SEC Release No. 34-32261 (May 4, 1993).

556 *See* SEC, Division of Market Regulation and Division of Enforcement, REPORT ON THE STATUS OF THE RECOMMENDATIONS FROM THE LARGE FIRM PROJECT REPORT (1994) (hereinafter "Large Firm Project Recommendations").

557 *See* Large Firm Project Recommendations. FINRA Rule 4530 requires each FINRA member to report to FINRA the occurrence of certain specified events (such as criminal or administrative proceedings, or customer complaints) that suggest that the member or an associated person may have engaged in a violation of the securities laws. FINRA Rule 4530, FINRA MANUAL. FINRA Rule 4530 also requires each member firm to file quarterly summary statistics concerning written customer complaints it has received relating to the firm or its associated persons. The rule is closely patterned after former NASD Rule 3070 and NYSE Rule 351.

558 *See* Appendix B to Large Firm Project Recommendations.

559 *See* Appendix B to Large Firm Project Recommendations.

560 *See* Appendix B to Large Firm Project Recommendations.

561 *See* § 15(b)(4)(E) of the Exchange Act; *see also* § 14.07[1][b]; *See*, *e.g.*, *Hollinger v. Titan Capital Corporation*, 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 975 (1991) (to establish defense to controlling person liability, broker-dealer must prove it maintained and enforced proper system of supervision and internal control); *Paul F. Newton v. Texas Commerce*, 630 F.2d 1111 (5th Cir. 1980) (evidence of supervision was insufficient to establish that broker-dealer diligently enforced a proper system of supervision and control).

Broker-dealers are responsible not only for establishing procedures for the supervision of their employees, but may under certain circumstances also be held responsible for establishing procedures to ensure that they are not facilitating illegal actions by their clients. *In re Goldman Sachs Execution & Clearing, L.P.*, SEC Release No. 34-55465 (Mar. 14, 2007) ("Had Goldman Clearing instituted and maintained procedures reasonably designed to detect any significant disparity between its customers' pattern of trading and the manner in which they marked their orders to sell, it could have discovered that its trading and clearance records revealed the pattern of unlawful trades effected by its customers….Accordingly, Goldman Clearing did not have a reasonable basis to believe its customers' representations that they were 'long' the securities they were selling and, therefore, violated the Commission's short sale rules and was a cause of its customers' violations of the rules….").

562 *See Section 21(a) Report of Investigation: In re Gutfreund*, SEC Release No. 34-31554 (Dec. 3, 1992)

(hereinafter "Supervisory Release").

563 *See* Remarks of then-Chairman of the SEC Richard Breeden to the SIA (Dec. 3, 1992).

564 *See* Supervisory Release.

565 *See* Supervisory Release.

566 FINRA Rule 3110, FINRA MANUAL. For example, a FINRA member must designate a senior representative responsible for ensuring that any delegated authority and responsibility is properly exercised. *Cf*. *In re Shearson, Hammil*, 42 S.E.C. 811, 843 (1965) (excessive reliance upon subordinates constitutes improper abdication of supervisory responsibility). FINRA also requires that only duly qualified persons be in charge of member firm offices or departments. *See*, *e.g.*, SEC Release No. 34-18429 (Jan. 19, 1982) (disciplining broker-dealer for not having a registered options principal in branch office).

567 FINRA Rule 3110, FINRA MANUAL.

568 FINRA Rule 3110(c), FINRA MANUAL.

569 FINRA Rule 3120, FINRA MANUAL.

570 FINRA Rule 3130(a), FINRA MANUAL.

571 FINRA Rule 3130(b), FINRA MANUAL.

572 Certain of these requirements may not apply to FCMs that have notice-registered as broker-dealers for the limited purpose of trading security futures products. *See* §§ 15(b)(11)(B) and 17(b)(4) of the Exchange Act; U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.07[2].

573 The SEC may prescribe the books and records that a broker-dealer is required to keep. *See* § 17(a) of the Exchange Act. The recordkeeping, record preservation and financial reporting requirements of registered government securities broker-dealers are generally identical to those imposed upon registered broker-dealers. *See* Treas. Reg. § 404.2. Financial institutions registered as government securities broker-dealers by notice to an appropriate regulatory agency are, subject to certain conditions, generally exempted from the Exchange Act's recordkeeping requirements. Notwithstanding this general exemption, such government-noticed financial institutions must keep customer and securities positions ledgers and must make a record of periodic securities count differences. *See* Treas. Reg. § 404.4(a)(1).

574 *See*, *e.g.*, Rule 17a-3 of the Exchange Act (requiring the maintenance of a transaction blotter); Rule 17a-13 (requiring quarterly securities counts and verification of accuracy of records as against physical counts); *see also* SEC Litigation Release No. 34-13533 (Feb. 25, 1993) (disciplining U.S. broker-dealer subsidiary of a foreign broker-dealer for failure to keep adequate financial records, which failure permitted the U.S. broker-dealer to conceal its capital deficiency).

575 *See*, *e.g.*, SEC Release No. 34-25125 (Nov. 16, 1987) (suspending a broker-dealer for failure to comply with, among other things, Rule 17a-3 of the Exchange Act, which made it impossible for the SEC to reconstruct the broker-dealer's activities).

576 *See generally* American Institute of Certified Public Accountants, Brokers and Dealers in Securities: Audit and Accounting Guide (2015) (description of the records required by Rules 17a-3 and 17a-4 under the Exchange Act); SEC Release No. 34-11935 (Dec. 17, 1975).

577 The term "blotter" is used in the securities industry as the term "journal" is more commonly used in accounting for other industries.

578 *See* SEC Release Nos. 34-51200 (Feb. 14, 2005) and 34-46937 (Dec. 3, 2002) (imposing penalties against various broker-dealers for failure to preserve electronic mail communications including inter-office memoranda and communications). The SEC has stated that for purposes of Rule 17a-4 under the Exchange Act, "broker-dealers must retain only those e-mail and Internet communications (including inter-office communications) which relate to the broker-dealer's ‘business as such.’" SEC Release No. 34-38245 (Feb. 5, 1997). The reference to "inter-office memoranda and communications" in Rule 17a-4(b)(4) is deemed also to refer to "intra-office" memoranda and communications.

In 2006, the SEC brought a settled civil action against Morgan Stanley & Co. Inc. for repeated failures to produce e-mails during the IPO and research analyst investigations conducted by the SEC from December 11, 2000 through at least July 2005. The SEC complaint alleged that (i) Morgan Stanley did not diligently search for back-up tapes containing responsive e-mails until 2005, (ii) failed to produce responsive e-mails because the company over-wrote back-up tapes, and (iii) made numerous misstatements regarding the status and completeness of its productions, the unavailability of certain documents, and its efforts to preserve requested e-mails. Morgan Stanley consented to a permanent injunction and a $15 million civil penalty, and agreed to adopt and implement policies, procedures and training on the preservation and production of e-mail communications. *See SEC v. Morgan Stanley & Co.*, SEC Litigation Release No. 19693 (May 10, 2006).

579 The SEC has adopted several amendments to Rules 17a-3 and 17a-4 designed to require retention of certain records of value to state regulators. Under the amendments, which became effective in 2003, broker-dealers are required, among other things, to make certain records available in local offices or to produce the records promptly at the request of a securities regulatory authority. *See* SEC Release No. 34-44992 (Sept. 26, 2001); *see also* SEC Release No. 34-47910 (May 22, 2003) (clarifying certain issues relating to broker-dealer books and records rules, some of which have been raised as a result of the amendments that were adopted on September 26, 2001).

580 *See generally* SEC Release No. 34-11935 (Dec. 17, 1975); SEC Release No. 34-70073 (July 31, 2013).

581 The annual audited financial statements, prepared in accordance with U.S. GAAP applicable to broker-dealers, had to be filed with the SEC within 60 days after the end of a fiscal year. Copies of such statements generally had to be provided to SROs of which the broker-dealer was a member and to state regulatory agencies in states in which the broker-dealer was registered.

582 *See generally* SEC Release No. 34-70073 (July 31, 2013).

583 Rule 17a-5(d)(2) under the Exchange Act.

584 Rule 17a-5(e) under the Exchange Act.

585 Rule 17a-5(d)(3) and (4) under the Exchange Act.

586 Rule 17a-5(d)(6) under the Exchange Act. In addition, copies must be made for any SRO of which the broker-dealer is a member, unless the SRO waives this requirement. Rule 17a-5(d)(6) under the Exchange Act.

587 Rule 17a-5(e)(4) under the Exchange Act.

588 A broker-dealer will be unable to conclude that the controls were effective if there were one or more material weaknesses (*i.e.*, deficiencies such that there is a reasonable possibility that non-compliance with (1) Rule 15c3-1 or Rule 15c3-3(e) will not be prevented or detected on a timely basis, or (2) Rule 17a-13 or any account statement rule will not be prevented or detected on a timely basis).

589 Rule 17a-5(d)(3) under the Exchange Act.

590 Rule 17a-5(d)(4) under the Exchange Act.

591 Rule 17a-5(h) under the Exchange Act.

592 Rule 17a-5(a)(4) under the Exchange Act.

593 17 C.F.R. 249.639.

594 Rule 17a-5(a) under the Exchange Act.

595 Rule 17a-5(c)(2) under the Exchange Act.

596 The SEC has adopted amendments to Rule 17a-5 that provide a conditional exemption to the requirement that a broker-dealer send its full balance sheet and certain other financial information to each of its customers twice a year. Under the amendments, a broker-dealer may send its customers only certain information regarding its net capital so long as it also provides customers with a toll-free number to call for a free copy of its full balance sheet and makes its full balance sheet available to customers over the Internet. The amendments codify relief the SEC has provided under a voluntary pilot program that began in 1999.

SEC Release No. 34-48272 (Aug. 1, 2003).

597 Rule 17a-5(c)(2)(iv) under the Exchange Act.

598 *See* § 14.07[3][b].

599 Market Reform Act of 1990, Pub. L. No. 101-432; 104 Stat. 963 (1990).

600 *See* Rules 17h-1T and 17h-2T under the Exchange Act; *see also* SEC Release No. 34-30929 (July 16, 1992); SEC Release No. 34-29635 (Aug. 30, 1991) (solicitation of public comment). The rules provide limited exemptions for broker-dealers that are permitted to maintain net capital of less than $250,000 or that do not carry customer accounts and that are permitted to have capital of less than $20 million. *See* Rules 17h-1T(d) and 17h-2T(b). Like the SEC's net capital rule amendments instituted in 1991 that prevent sudden withdrawals of capital from a broker-dealer, *see* § 14.07[2][b][ii], these disclosure requirements, which originally were considered by Congress and the SEC as a reaction to the impact of the financial difficulty of the parent holding corporation on its registered broker-dealer subsidiary Drexel and the rapid collapse of Drexel immediately following the bankruptcy of its parent, also now in part reflect a more generalized concern regarding the financial condition of a broker-dealer's affiliates and the material impact that activities of those affiliates could have on the broker-dealer. *See* SEC Release No. 34-29635 (Aug. 30, 1991). For a discussion of other regulatory developments as a result of Drexel's failure, *see* § 14.07[2][b][ii].

601 A broker-dealer that receives SEC approval to calculate market and derivatives-related credit risk deductions in accordance with Appendix E of the SEC's net capital rule, Rule 15c3-1(e) under the Exchange Act, and that is affiliated with an ultimate holding company that has a principal regulator is exempt from Rules 17h-1T and 17h-2T. Rules 17h-1T(d)(4) and 17h-2T(b)(4) under the Exchange Act. For a discussion of the requirements applicable to broker-dealers authorized to use risk-based capital deductions, *see* § 14.07[2][b][iii].

602 *See* SEC Release No. 34-30929 (July 16, 1992), 57 Fed. Reg. 32,159, 32,161 (July 21, 1992). Factors to be considered in determining whether a particular associated person is a "MAP" include: (i) the legal relationship between it and the broker-dealer, (ii) its and the broker-dealer's financing requirements and the degree, if any, to which they are financially interdependent, (iii) the degree, if any, to which the broker-dealer relies on the associated person for operational support or services, (iv) the riskiness of its activities, and (v) the extent to which the associated person has the authority or the ability to cause a withdrawal of capital from the broker-dealer. *See* Rule 17h-1T(a)(2) under the Exchange Act.

603 *See* Rules 17h-1T(c) and 17h-2T(d). The SEC staff has informally indicated that it does not wish to be deluged with reports filed with foreign regulators and that broker-dealers should file only reports in the nature of FOCUS Reports (*see* § 14.08[3][a]) that will allow the SEC to determine the financial condition of the foreign entity. Any such reports must be translated into English.

604 *See* Rules 17h-1T(b) and 17h-2T(c); *see also Institute of International Bankers* (avail. Sept. 25, 1992) (providing that certain reports filed by foreign banking groups with U.S. banking regulators need not be filed with the SEC, although the SEC will have access through the banking regulator to the report).

605 *See* GAO/GGD-92-70, SECURITIES FIRMS: ASSESSING THE NEED TO REGULATE ADDITIONAL FINANCIAL ACTIVITIES at 5-6 (Apr. 21, 1992).

606 *See* Letter, from William H. Heyman, Director of the Division of Market Regulation, SEC, to Mr. Richard L. Fogel, Assistant Comptroller General, GAO (Feb. 26, 1992).

607 *See* § 231 of the GLB Act.

608 *See* SEC Release No. 34-49831 (June 8, 2004).

609 Section 17(i)(5)(A) of the Exchange Act defined "investment bank holding company" to mean any person other than a natural person that owns or controls one or more brokers or dealers and the associated persons of the investment bank holding company. Section 17(i)(1)(A) of the Exchange Act provided that an investment bank holding company could only have elected to become supervised as a SIBHC if it were *not* an affiliate of an insured bank (with certain exceptions) or a savings association; a foreign bank, foreign company, foreign bank branch agency, or a state-chartered commercial lending company; or a foreign bank

that controls an Edge Act Corporation. Given the limitations on the types of entities with which an investment bank holding company could have been affiliated, the SIBHC regime was expected to have little practical utility.

610 *See* Former Rules 17h-1(d)(5) and 17h-2(d)(5) under the Exchange Act.

611 § 618 of the Dodd-Frank Act; *see also* SEC, Rescission of Supervised Investment Bank Holding Company Rules, 78 Fed. Reg. 42,863 (July 18, 2013).

612 *See* SEC, Release No. 34-69979 (July 12, 2013).

613 Federal Reserve System, Supervised Securities Holding Company Registration, 77 Fed. Reg. 32,881 (June 4, 2012).

614 "Securities holding company" is defined in the rule as:

> (i) [a]ny company that directly or indirectly owns or controls, is controlled by, or is under common control with, one or more brokers or dealers registered with the [SEC]; and (ii) [i]s required by a foreign regulator or provision of foreign law to be subject to comprehensive consolidated supervision.…A securities holding company does not include a company that is—(i) A nonbank financial company supervised by the Board pursuant to title I of the [Dodd-Frank Act]; (ii) An insured bank (other than an institution described in subparagraphs (D), (F), or (H) of section 2(c)(2) of the [Bank Holding Company Act]) or a savings association; (iii) [a]n affiliate of an insured bank (other than an institution described in subparagraphs (D), (F), or (H) of section 2(c)(2) of the [Bank Holding Company Act]) or an affiliate of a savings association; (iv) [a] foreign bank, foreign company, or company that is described in section 8(a) of the [International Banking Act]; (v) [a] foreign bank that controls, directly or indirectly, a corporation chartered under section 25A of the Federal Reserve Act; or (vi) [c]urrently subject to comprehensive consolidated supervision by a foreign regulator.

12 C.F.R. § 241.2(a).

615 77 Fed. Reg. 32,881, 32,882 (June 4, 2012).

616 *See* 12 C.F.R. § 241.3(b)(3).

617 SEC Release No. 34-44494 (June 29, 2001).

618 *See* SEC Release No. 34-64976 (July 27, 2011), 76 Fed. Reg. 46,960, 46,963 (Aug. 3, 2011).

619 *See* SEC Release No. 34-64976 (July 27, 2011). As defined in Rule 13h-1 under the Exchange Act, a "large trader" is any person (including any foreign person other than a foreign central bank) who directly or indirectly exercises investment discretion over and effects transactions for or on behalf of its own accounts or accounts that it controls in NMS securities by or through a registered broker-dealer in an amount of at least 2,000,000 shares or $20 million during any calendar day, or at least 20,000,000 shares or $200 million during any calendar month. (The transactions of affiliated entities in some instances would be required to be aggregated to determine whether these limits had been reached.) In addition, persons engaged in program trading to any extent would be deemed large traders.

The Treasury has adopted large position rules that establish recordkeeping and reporting requirements for foreign and domestic entities that control large positions (*i.e.*, above $2 billion) in certain Treasury securities. 61 Fed. Reg. 48,338 (Sept. 12, 1996), codified at Treas. Reg. § 420. In 2002, the Treasury adopted amendments to its large position rules to increase reporting about these positions. *See* 67 Fed. Reg. 77,411 (Dec. 18, 2002).

620 SEC Release No. 34-64976 (July 27, 2011).

621 The "reporting activity level" is defined as "(i) [e]ach transaction in NMS securities, effected in a single account during a calendar day, that is equal to or greater than 100 shares; (ii) any other transaction in NMS securities, effected in a single account during a calendar day, that a registered broker-dealer may deem appropriate; or (iii) such other amount that may be established by order of the [SEC] from time to time." Rule 13h-1(a)(8) under the Exchange Act.

622 *See* SEC Release No. 34-64976 (July 27, 2011), 76 Fed. Reg. 46,960, 46,981 (Aug. 3, 2011) ("The Rule does not require broker-dealers to definitively determine who is, in fact, a large trader.").

U.S. Regulation of the International Securities and Derivatives Markets, § 14.09, OTC DERIVATIVES DEALERS AND TRANSACTIONS IN SECURITY FUTURES PRODUCTS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.09 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

[1] OTC Derivatives Dealers

Prior to the Dodd-Frank Act, the SEC had adopted a series of rules in 1998 that established a limited purpose broker-dealer registration category for entities (referred to as "OTC derivatives dealers") that engage in over-the-counter

p. 14-149

derivative instruments that are securities, but that do not engage in the broad range of securities activities typically associated with full purpose broker-dealers. [623] Due to the Dodd-Frank Act's creation of a comprehensive regulatory scheme for swaps and security-based swaps, the SEC may repeal or significantly modify this category. However, as of the date of publication, the SEC has not done so.

In adopting the series of rules that established the limited purpose broker-dealer registration category for OTC derivatives dealers, the SEC noted that the "traditional" broker-dealer regulatory structure under the Exchange Act has not permitted U.S. securities firms to operate a consolidated OTC derivatives business in the United States, involving both securities and nonsecurities instruments, on terms that are competitive with those offered by U.S. banks and foreign derivatives dealers. [624] Instead, current regulatory inefficiencies have, in many instances, caused U.S. securities firms to separate their securities derivatives activities (which they often conduct from abroad) from their nonsecurities derivatives activities (which they often place in unregistered U.S. affiliates), hindering their ability to manage risk and compete effectively in the global OTC derivatives markets.

The rules are intended to create a more practical and flexible commercial and regulatory framework under which U.S. securities firms may establish separately capitalized entities within the United States that engage in dealer activities in both securities and nonsecurities derivative instruments subject to specially tailored capital, margin and other requirements.

Registration as an OTC derivatives dealer is available to firms that are affiliated with a full purpose broker-dealer and that limit their securities derivatives activities to:

- engaging in dealer activities in "eligible OTC derivative instruments" that are securities;
- issuing and reacquiring securities that are issued by the dealer, including warrants on securities, hybrid securities and structured notes;
- engaging in "cash management securities activities";
- engaging in "ancillary portfolio management securities activities"; and
- engaging in such other securities activities as the SEC may designate by order. [625]

p. 14-149

---

p. 14-150

Registration as an OTC derivatives dealer is effected under § 15(b) of the Exchange Act by the filing of Form BD with the SEC.

An OTC derivatives dealer generally must effect its securities transactions through an affiliated full-purpose broker-dealer that is subject to applicable SRO sales practice requirements, except in the case of transactions with certain types of professional counterparties. [626] In addition, subject to certain enumerated exceptions, the rules require contacts with customers on behalf of the OTC derivatives dealer to be conducted by registered representatives of its affiliated full purpose broker-dealer.

OTC derivatives dealers are able to calculate their regulatory capital under Appendix F to Rule 15c3-1 under the Exchange Act rather than using the securities haircut provisions otherwise applicable to full purpose broker-dealers. [627] Extensions of credit by an OTC derivatives dealer are exempt from Regulation T (governing extensions of credit by broker-dealers), provided that the OTC derivatives dealer complies with the requirements of Regulation U (governing extensions of credit by banks and other nonbroker-dealers). In addition, OTC derivatives dealers are exempt from the provisions of SIPA, are not required to become members of an SRO and are exempted from a number of other regulatory requirements applicable to full-purpose broker-dealers. [628]

[2] Broker-Dealer Transactions in Security Futures Products

Transactions in security futures products are subject to a unique dual regulatory structure under the Exchange Act and the CEA. As part of this regime, intermediaries that engage in brokerage or dealing activities with respect to these

p. 14-150

p. 14-151

products are generally required to register both as a broker-dealer under the Exchange Act and as an FCM or introducing broker under the CEA. [629]

Footnotes

623 SEC Release No. 34-40594 (Oct. 23, 1998), *as amended by* SEC Release No. 34-40594A (Nov. 5, 1998) (containing minor corrections). The OTC derivatives dealers regulatory regime is commonly referred to as "BD Lite."

624 *See* SEC Release No. 34-40594 (Oct. 23, 1998).

625 *See* SEC Release No. 34-40594 (Oct. 23, 1998).

626 Because of this requirement, FINRA member broker-dealers that execute OTC options transactions for OTC derivatives dealers must comply with the option position limit and exercise requirements of FINRA Rule 2360 (the "position limit rules") with respect to such transactions. In its release adopting the OTC derivatives dealer regime, the SEC indicated that the NASD should consider an exemption from the position limit rules for those types of transactions. *See* SEC Release No. 34-40594 (Oct. 23, 1998). On October 12, 2004, the NASD (responding to a request from five broker-dealer affiliates of OTC derivatives dealers) submitted a proposed amendment to NASD Rule 2860 to provide a delta hedging exemption from the position limit rules for OTC derivatives dealers affiliated with NASD member broker-dealers if certain conditions are satisfied. The proposal was approved by the SEC on November 29, 2004, *see* SEC Release No. 34-50748 (Nov. 29, 2004), and subsequently adopted as part of the consolidated FINRA rulebook as FINRA Rule 2360, effective February 17, 2009. FINRA Regulatory Notice 08-78 (Dec. 2008).

627 Appendix F permits OTC derivatives dealers to calculate market risk capital charges using proprietary value-at-risk models with respect to certain asset categories and to take certain specified credit risk capital charges. Appendix F is generally consistent with the Basel Capital Accord and the capital rules of U.S. banking regulators. *Cf.* § 14.07[2][b] for a discussion of how net capital is calculated for full purpose broker-dealers.

628 To date, only a few firms have elected to register as OTC derivatives dealers. *See* SEC Release No. 34-47570 (Mar. 26, 2003), 68 Fed. Reg. 15,488, 15,489 n.7 (Mar. 31, 2003).

629 For a discussion of this dual regulatory structure, *see* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.07[3].

U.S. Regulation of the International Securities and Derivatives Markets, § 14.10, ELECTRONIC TRADING SYSTEMS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.10 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

In 1998, the SEC significantly revised the framework for the regulation of electronic trading systems. In particular, the SEC adopted new rules and rule amendments permitting certain "alternative trading systems" either to register as a national securities exchange or to register as a broker-dealer and comply with the requirements of Regulation ATS. [630] The SEC also adopted new recordkeeping requirements for "internal broker-dealer systems."

[1] Alternative Trading Systems

In the ATS Release, the SEC expanded its interpretation of an "exchange" under the Exchange Act to include a broad range of electronic trading systems, [631] while permitting certain "alternative trading systems" to continue to be regulated as broker-dealers, subject to compliance with a number of additional requirements imposed by Regulation ATS based on their activities and trading volume. [632]

Under Regulation ATS, an "alternative trading system" is defined to mean any organization, association, person, group of persons, or system that

p. 14-152

(i) constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing the functions commonly performed by a stock exchange (within the meaning of Rule 3b-16 under the Exchange Act) and (ii) does not (a) set rules governing the conduct of subscribers (other than the conduct of subscribers' trading on the system) or (b) discipline subscribers (other than by exclusion from trading). [633]

An alternative trading system subject to Regulation ATS must:

- register with the SEC as a broker-dealer;
- file with the SEC a notice of initial operation on Form ATS and quarterly transaction reports on Form ATS-R, as well as reports of any material changes to the operation of its system;
- maintain certain records, including detailed information about all orders and transactions;
- establish adequate safeguards and procedures to protect its subscribers' confidential trading information;
- cooperate with SEC and SRO examinations, inspections and investigations, including any examination, inspection or investigation of its subscribers; and
- refrain from using the words "exchange," "stock market" or similar terms in its name.

In addition to these basic requirements, Regulation ATS imposes certain additional requirements on alternative trading systems with significant trading volume. An alternative trading system that displays subscriber orders and has 5% or more of the average daily trading volume in certain equity securities during four of the six preceding calendar months must arrange with a registered securities exchange or FINRA to disseminate its best priced orders in those securities through the public quote stream and provide broker-dealers who have access to such exchange or FINRA with the ability to effect transactions with respect to those orders. [634] An alternative trading system that displays subscriber orders and has 5% or more of the average daily trading volume in certain equity securities or categories of debt securities during four of the six preceding calendar months must establish written standards for granting access to trading, not unreasonably prohibit or limit access by applying such standards in an unfair or discriminatory

p. 14-152

p. 14-153

manner, and make records and reports regarding grants and denials of access. [635] An alternative trading system with 20% or more of the average daily trading volume of certain equity securities or categories of debt securities must also satisfy certain system capacity, integrity and security requirements of Regulation ATS. [636]

Trading systems (i) whose activities are limited to routing orders to a registered securities exchange, market operated by FINRA or a broker-dealer for execution, or (ii) that automate the order routing and execution mechanisms of a single dealer or market maker, are expressly excluded from the revised interpretation of the term "exchange" and are not subject to Regulation ATS. [637]

In 2010, the SEC adopted Rule 15c3-5, under which broker-dealers that are able to trade securities on an exchange or ATS as members or subscribers, as well as broker-dealer operators of an ATS that provide access to the ATS to a nonbroker-dealer, generally are required to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed both to systemically limit the financial exposure of the broker-dealer that could arise as a result of market access and to ensure compliance with all regulatory requirements applicable in connection with market access. [638] Specifically, the required controls and procedures

- must prevent the entry of orders unless there has been compliance with all regulatory requirements applicable prior to order entry;
- must prevent the entry of orders that (a) exceed appropriate pre-set credit or capital thresholds, (b) appear to be erroneous, or (c) the broker-dealer or customer is restricted from trading;
- must restrict market access technology and systems to authorized persons;
- must assure appropriate surveillance personnel receive immediate post-trade execution reports; and

p. 14-153

p. 14-154

- must be under the direct and exclusive control of the broker-dealer with market access (unless the requirements of certain limited exceptions applicable when the customer is a broker-dealer are satisfied).

In addition, broker-dealers with market access must establish, document, and maintain a system for regularly reviewing the effectiveness of the required controls and procedures; the system must include, among other things, an annual review of the broker-dealer's business activity in connection with market access and an annual certification by the broker-dealer's CEO that the required review has been conducted and the required controls and procedures comply with Rule 15c3-5. A limited exception to Rule 15c3-5 applies to broker-dealers that provide outbound routing services to an exchange or ATS to prevent "trade-throughs" pursuant to Regulation NMS Rule 611, discussed below.

[2] Online Brokerage and Electronic Communications

The growth of electronic trading systems has led to regulatory concern regarding the actions of broker-dealers who participate in and conduct business over such systems and on the Internet. While all rules of the SEC and the SROs apply to such online broker-dealers, regulators have expressed concerns regarding how the rules can be enforced and monitored given the lack of paper records, the speed of transactions and the transitory nature of many online businesses. In light of the use of the Internet to facilitate communications with customers, the SEC has provided guidance with respect to specific online issues including the provision of electronic confirmations of trades and the delivery of prospectuses and other materials over the Internet and through electronic mail. [639]

In 1999, the SEC issued a report [640] with respect to the subject of technology and its impact on retail brokerage. The report consists of an overview of the issues raised by online brokerage for investors and the SEC and explores how online brokerage impacts the SEC's traditional regulatory scheme. It details the findings from three roundtables conducted with participants from full-service and discount, online and offline brokerage industry representatives, securities practitioners, academics, regulators, market participants and investors. The report recommends that the SEC examine information from broker-dealers

p. 14-154

---

p. 14-155

regarding how they conduct research and how they then customize information for customers in reference to suitability of investments. The report further recommends that the SEC take steps to require that broker-dealers ensure more adequate systems capacity, including contingency plans, keep records of significant systems outages, testing and evaluation and provide plain English disclosure of the risks of systems delays or outages in new account documentation. Also, the report makes recommendations regarding best execution, dissemination of real-time market data, investor education, online discussion forums, privacy and compensation for entities that are not registered as broker-dealers. [641]

In addition, as part of its continuing focus on electronic trading systems, the SEC's Office of Compliance Inspections and Examinations published a summary of its findings and recommendations resulting from its examination of broker-dealers who offer online trading. [642] The report provides examples of sound practices, as well as areas where some online broker-dealers could, through self-evaluation in line with the report, enhance their practices. In the report, the SEC staff recommends that broker-dealers offering online trading consider:

- the information provided to customers online about how orders are executed, how margin works and the possibility of system delays;
- the objectivity of their advertising;
- procedures for ensuring that customers receive best execution;
- procedures for ensuring adequate operational capability to handle customer trading volume;
- security measures to protect customer privacy and funds; and
- procedures to supervise employees' use of Internet communications. [643]

In 2014, the SEC began to emphasize cybersecurity, conducting examinations of broker-dealers and investment advisers. [644] In 2015, the SEC published the results of examinations of 57 registered broker-dealers and 49 registered investment advisers, and determined that examining these firms will be a central function of the SEC's cybersecurity initiative moving forward. [645]

[3] Internal Broker-Dealer Systems

p. 14-155

---

p. 14-156

In 1998, the SEC adopted recordkeeping requirements for "internal broker-dealer systems" that are sponsored by a registered broker-dealer. [646] Under the rules, an "internal broker-dealer system" is defined to mean any facility (other than a national securities exchange, an exempt exchange or an alternative trading system) that provides a mechanism, automated in full or in part, for collecting, receiving, disseminating or displaying system orders and facilitating agreement to the basic terms of a purchase or sale of a security between a customer and the sponsor, or between two customers of the sponsor, through use of the internal broker-dealer system or through the broker-dealer sponsor of the system. [647] Sponsors of such systems must maintain a record of the system's customers, daily summaries of trading in the system and time-sequenced records of each transaction effected through the system. Unlike former Rule 17a-23, these rules do not require "internal broker-dealer systems" to file reports with the SEC. [648]

[4] Day Trading

Day trading is a strategy employed by retail investors who are not registered as broker-dealers or as registered representatives who trade stock at a firm (a "day trading firm") that allows the investor real time access to the major stock exchanges. Day trading is characterized by multiple intra-day trades executed to take advantage of small price movements in stocks. Stocks are generally held for seconds or hours and generally positions are closed out overnight for small profits or losses. In 2000, the SEC released a study that reported the findings of a year-long investigation by the SEC's Office of Compliance Inspections and Examinations (in cooperation with the NASD and NYSE) of 47 registered broker-dealers providing day trading facilities to the general public (the "day trading study"). [649] The purpose of the examination was to review each firm's compliance with federal securities laws and SRO rules. In addition, examiners reviewed how day trading activities fit within the existing securities regulatory structure and identified regulatory issues that might require further consideration. The examination revealed that many firms need to take steps to improve

p. 14-156

p. 14-157

compliance with net capital, short selling and supervision rules. The day trading study focused in particular on the lack of information provided to customers concerning the risks of day trading. FINRA, in part in response to the day trading study, requires that prior to opening a day trading account a broker-dealer furnish to the customer a risk disclosure statement and approve the customer for day trading only after analyzing the customer's investment objectives; trading experience and knowledge; financial situation; marital, tax and employment status; and age to ensure that a day trading strategy is appropriate for the customer. [650] FINRA also has special day trading margin requirements designed to protect broker-dealers against their intra-day exposures to day traders. [651]

[5] National Market System

Section 11A(a) of the Exchange Act, enacted in 1975, directs the SEC to facilitate the development of a national market system for securities in accordance with Congressional findings and objectives set forth therein and with due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets. [652] The Congressional findings and objectives include that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure:

1. economically efficient execution of securities transactions;
2. fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;

p. 14-157

p. 14-158

3. the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
4. the practicability of brokers executing investors' orders in the best market; and
5. an opportunity, consistent with the provisions of clauses (i) and (iv), for investors' orders to be executed without the participation of a dealer.

The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders. [653]

Over the decades since the enactment of § 11A, the SEC has taken numerous steps to carry out Congress's instruction to facilitate the development of the national market system, including: requiring the SROs to adopt plans for the collection, consolidation and dissemination of last sale reports and quotations in certain securities and approving such plans; approving a plan linking the markets trading exchange-listed securities and SRO rules generally requiring participants in that plan to avoid execution of trades at a price worse than the best price displayed on another participant market ("trade-throughs"); requiring certain specialists and OTC market-makers to publicly display customer limit orders that better the dealer's displayed price or size; and requiring any specialist or OTC market-maker responsible for more than 1% of the volume of trading in a listed security to display their best-priced quotations and customer limit orders for that security. [654]

In 2005, the SEC published Regulation NMS, the most significant overhaul of its rules regarding the national market system since the enactment of § 11A. [655] Regulation NMS generally applies to stocks traded on a national exchange. FINRA has since adopted rules that apply Regulation NMS-style rules to the market for OTC Equity Securities as well. [656] In addition to modernizing its earlier national market system rules and consolidating them into a single regulation, Regulation NMS addresses three substantive topics:

p. 14-158

p. 14-159

Order Protection. Rule 611 of Regulation NMS (the "Order Protection Rule") requires "trading centers" to establish, maintain, and enforce written policies and procedures reasonably designed to prevent trade-throughs on such trading center of "protected quotations" for NMS stocks [657] displayed by other trading centers. [658] For this purpose, "trading centers" include national securities exchanges, SRO trading facilities, ATSs, exchange and over-the-counter market makers and any other broker-dealer that executes orders internally by trading as principal or crossing orders as agent. [659] The "protected quotations" covered by Rule 611 include the best bids and offers of a national securities exchange and FINRA's alternative display facility ("ADF"), provided that it is an automated quotation of an automated trading center and disseminated pursuant to an effective national market system plan. [660] To qualify quotations as "automated quotations" of an "automated trading center," the trading center displaying the quotation must (among other things) immediately and automatically execute certain orders against its displayed quotations and immediately and automatically update its displayed quotations. [661] The Order Protection Rule includes exceptions for intermarket sweep orders, quotations displayed by markets that fail to meet the response requirements for automated quotations, and "flickering" quotations with multiple prices displayed in a single second.

Intermarket Access. Rule 610 of Regulation NMS requires SRO trading centers to allow access to their quotations in NMS stocks on a nondiscriminatory basis and limits the fees that may be charged for access to quotations. Rule 610 also requires SROs to establish rules to prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross [662] the protected

p. 14-159

p. 14-160

quotations of other trading centers rather than executing against the protected quotation. [663] In addition, FINRA limits the fees that a member can impose for access to a published quotation in any OTC Equity Security and requires its members to implement policies and procedures that avoid the display of locking or crossing quotations in any OTC Equity Security. [664]

Sub-Penny Pricing. Rule 612 of Regulation NMS prohibits market participants from displaying, ranking, or accepting quotations in NMS stocks that are priced in an increment of less than $0.01 (or $0.0001 if the price of the quotation is less than $1.00). [665] This rule is intended to enhance the protection of customer limit orders by preventing sub-penny pricing from being used to "step-ahead" of such orders by an economically insignificant amount. FINRA applies the same rule to the displaying, ranking, or accepting of quotations in any OTC Equity Security. [666]

In 2010, the SEC began a broad review of the current structure of the national market system and published a concept release, seeking public feedback on, among others, the following issues: (i) how well the current market structure performs its functions, (ii) the strategies and tools used by firms in the current market structure, (iii) whether high volume trading poses a risk to the current market structure, (iv) the effects of undisplayed liquidity, and (v) any other notable aspects of the current market structure. The SEC intended to use the public comments received to determine whether further regulatory action is needed to improve the current equity market structure. [667]

In 2015, the SEC created an Equity Market Structure Advisory Committee to focus on the structure and operations of the U.S. equity markets. This committee is expected to discuss issues relating to the review of Regulation NMS, the role of exchanges in the current market structure and the presence and effect of conflicts in the routing and execution or equity orders. This committee has recommended a pilot program to adjust the cap that Rule 610 sets on fees that trading venues can charge to access published quotations, but as of the date of publication, the SEC has not taken any action on this recommendation. [668]

In 2016, FINRA and a group of national securities exchanges began a two-year pilot program to test the effect of widening the minimum quotation and

p. 14-160

p. 14-161

trading increment ("tick size") for stocks of some smaller companies from a penny to five cents. [669]

Footnotes

630 SEC Release No. 34-40760 (Dec. 8, 1998) (the "ATS Release"). The rules and rule amendments generally took effect on April 21, 1999, except as otherwise noted.

Prior to the adoption of Regulation ATS and related rules under the Exchange Act, electronic trading systems sponsored by registered broker-dealers operated pursuant to no-action relief granted by the SEC. *See*, *e.g.*, *Instinet Corp*. (avail. Sept. 8, 1986) (granting no-action relief from the exchange registration requirement of § 5 of the Exchange Act).

631 Pursuant to Rule 3b-16 under the Exchange Act, an organization, association or group of persons is considered to constitute, maintain or provide "a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing the functions commonly performed by a stock exchange" if it (i) brings together the orders for securities of multiple buyers and sellers, and (ii) uses established, nondiscretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade. *See* Rule 3b-16(a) under the Exchange Act.

632 An alternative trading system that limits its securities activities to government securities or commercial paper and certain related instruments (*e.g.*, repurchase and reverse repurchase agreements involving government securities or commercial paper, or unlisted options on government securities) is not required to comply with the requirements of Regulation ATS, provided that it is registered as a broker-dealer under § 15 of the Exchange Act or as a government securities broker-dealer under § 15C of the Exchange Act. *See* Rule 301(a)(4) of Regulation ATS.

Alternative trading systems that permit the trading of security futures products are required under the CEA to become limited-purpose contract markets pursuant to the CEA's notice registration provisions. CEA § 5f.

633 Rule 300(a) of Regulation ATS.

634 Rule 301(b)(3) of Regulation ATS. In 2009, the SEC proposed several amendments to Regulation ATS, one of which would have lowered the average trading volume threshold from 5% to 0.25%. The amendments would also have extended display requirements to all orders displayed to more than one person, regardless of that person's membership in the ATS. *See* SEC Release No. 34-60997 (Nov. 23, 2009). The SEC's proposal was withdrawn in 2013.

635 Rule 301(b)(5) of Regulation ATS; FINRA Rule 4552, FINRA MANUAL.

636 Rule 301(b)(6) of Regulation ATS. As of November 4, 2016, 82 entities have a current Form ATS on file with the SEC. *See* SEC, Frequently Requested FOIA Document: Alternative Trading System ("ATS") List (Nov. 4, 2016), *available at* https://www.sec.gov/foia/docs/atslist.htm (last visited Nov. 11, 2016).

637 *See* Rule 3b-16(b)(1) under the Exchange Act.

638 *See* SEC Release No. 34-63241 (Nov. 3, 2010); *see also* Press Release, SEC, SEC Adopts New Rule Preventing Unfiltered Market Access (Nov. 3, 2010).

639 *See*, *e.g.*, SEC Release No. 34-42728 (Apr. 28, 2000) (providing guidance on the use of electronic media by issuers of all types, including the use of electronic media to deliver documents, issuers' liability for website content and basic legal principles that issuers and market intermediaries should consider in conducting online offerings); SEC, ON-LINE BROKERAGE: KEEPING APACE OF CYBERSPACE (Nov. 1999); SEC Release No. 34-37182 (May 29, 1996); SEC Release No. 34-36345 (Oct. 6, 1995); *Lamp Technologies* (avail. May 29, 1998); *Thomson Financial Inc.* (avail. July 10, 2002).

640 SEC, ON- LINE BROKERAGE: KEEPING APACE of CYBERSPACE (Nov. 1999).

641 *See* SEC, ON- LINE BROKERAGE: KEEPING APACE of CYBERSPACE (Nov. 1999).

642 SEC, Office of Compliance Inspections and Examinations, EXAMINATIONS of BROKER- DEALERS OFFERING ONLINE TRADING: SUMMARY of FINDINGS and RECOMMENDATIONS (Jan. 25, 2001).

643 *See* SEC, Office of Compliance Inspections and Examinations, EXAMINATIONS of BROKER- DEALERS OFFERING ONLINE TRADING: SUMMARY of FINDINGS and RECOMMENDATIONS (Jan. 25, 2001).

644 SEC, Office of Compliance Inspections and Examinations, OCIE Cybersecurity Initiative (Apr. 15, 2014).

645 SEC, Office of Compliance Inspections and Examinations, OCIE's 2015 Cybersecurity Examination Initiative (Sept. 15, 2015).

646 Rule 17a-3(a)(16) under the Exchange Act; the ATS Release.

647 *See* Rule 17a-3(a)(16) under the Exchange Act.

648 Rule 17a-23 under the Exchange Act was repealed as of the effective date of Rule 17a-3(a)(16) under the Exchange Act.

649 SEC, Office of Compliance Inspections and Examinations, REPORT OF EXAMINATIONS OF DAY-TRADING BROKER-DEALERS (Feb. 25, 2000, revised Oct. 23, 2003). In the day trading study, a "day trader" is described as "an individual who conducts intra-day trading in a focused and consistent manner, with the primary goal of earning a living through the profits derived from this trading strategy."

650 FINRA Rule 2130, FINRA MANUAL.

Certain firms have also been the subject of enforcement actions involving day trading activities that resulted in violations of Regulation T. *See*, *e.g.*, News Release, FINRA, FINRA Fines Scottrade $200,000 for Pattern Day Trading Violations (Apr. 1, 2010); Press Release, NASD, NASD Fines Scottrade, Inc. $250,000 for Improperly Extending Credit to Cash Account Customers (Jan. 21, 2005). Similar actions were brought by the NASD against Ameritrade, Datek and iClearing in March 2004. *See* Press Release, NASD, NASD Fines Ameritrade, Datek and iClearing $10 Million For Improperly Extending Credit and Allowing Trades That Avoided NASD Day Trading Margin Rules (Mar. 11, 2004).

651 *See* FINRA Rule 4210(f)(8)(B), FINRA MANUAL. Because the Regulation T initial margin requirements and standard SRO maintenance margin requirements are calculated only at the end of each day, a day trader that has no positions in its account at the end of the day would have no initial or maintenance margin requirements (except to the extent of any trading losses during the day). The day trader's broker-dealer, however, is exposed to any losses the day trader may incur during the trading day, as well as the possibility that the day trader would be unable to close out its positions before the end of the trading day. Among other things, the special day trading margin requirements require day traders to provide margin based on the largest positions held during the trading day and limit the size of the intra-day positions of "pattern day traders."

652 § 11A(a)(1) of the Exchange Act.

653 § 11A(a)(1) of the Exchange Act.

654 For some of the history of SEC regulation of the national market system, *see* SEC Release No. 34-49325 (Feb. 26, 2004), Regulation NMS, Proposed Rule, 69 Fed. Reg. 11,126, 11,130–33 (Mar. 9, 2004).

655 *See* SEC Release No. 34-51808 (June 9, 2005), Regulation NMS, Final Rule, 70 Fed. Reg. 37,496 (June 29, 2005).

656 *See* FINRA Rules 6410-90, FINRA MANUAL; *see also* FINRA Regulatory Notice 10-42 (Sept. 2010).

657 "NMS stocks" are all securities, other than options, for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan. They include all equity securities traded on national securities exchanges. Rule 600(46) and (47) of Regulation NMS under the Exchange Act.

658 Rule 611 of Regulation NMS under the Exchange Act.

659 Rule 600(b)(78) of Regulation NMS under the Exchange Act.

660 Rule 600(b)(57) and (58) of Regulation NMS under the Exchange Act.

661 Rule 600(b)(3) and (4) of Regulation NMS under the Exchange Act.

One significant effect of Regulation NMS was initiatives by the NYSE to modernize its method of operations so that it is an "automated trading center" and some of its quotations are "automated quotations." In 2006, the SEC approved the NYSE's Hybrid Market proposal to integrate the NYSE's traditional floor-based auction market with enhanced automated trading functionality. The approved rule changes: (i) expanded the NYSE's automatic execution facility, Direct+, so that it may accept more order types and allow executions to occur against liquidity that is priced outside the NYSE's best bid or offer, (ii) automated participation by NYSE floor members so that they can electronically provide liquidity available for automatic executions, and (iii) allowed specialists to create proprietary algorithms so that they can quote and trade electronically. *See* SEC Release No. 34-53539 (Mar. 22, 2006).

662 Quotations are "locked" when the bid and offer are equal and "crossed" when the bid is higher than the offer.

663 Rule 610 of Regulation NMS under the Exchange Act.

664 FINRA Rules 6450 and 6437, FINRA MANUAL.

665 Rule 612 of Regulation NMS under the Exchange Act.

666 FINRA Rule 6434, FINRA MANUAL.

667 SEC Release No. 34-61358 (Jan. 14, 2010).

668 For one perspective on how the SEC should proceed in this regard, *see* COMMITTEE ON CAPITAL MARKETS REGULATION, THE U.S. EQUITY MARKETS: A PLAN FOR REGULATORY REFORM (July 2016), http://www.capmktsreg.org/wp-content/uploads/2016/10/08_08_FINAL_DRAFT_EMS_REPORT-1.pdf.

669 Press Release, SEC Approves Pilot to Access Tick Size Impact for Smaller Companies (May 6, 2015).

U.S. Regulation of the International Securities and Derivatives Markets, § 14.11, ENFORCEMENT

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.11 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

The SEC and SROs are charged with responsibility for overseeing and enforcing, through their respective inspection and sanction powers, broker-dealer compliance with U.S. securities laws, the rules and regulations thereunder and the rules of the SROs.

[1] Inspection

The Exchange Act gives the SEC broad powers to inspect broker-dealers. Section 17(b) of the Exchange Act provides that all records kept by a registered broker-dealer are subject "at any time … [to] reasonable periodic, special, or other examinations" by the SEC. [670] Under § 21(a) of the Exchange Act, the SEC has a power of "original inquiry" to make investigations as it deems necessary to determine whether any person is violating the U.S. securities laws, the rules and regulations thereunder or the rules of the SROs. [671] The SEC may also conduct investigations on the request of a foreign securities authority, even though no violation of U.S. law has been committed or is suspected. [672]

SROs, including FINRA, maintain the right to inspect all books, records and accounts of their members, as well as to require any member to submit

p. 14-162

written reports concerning its business practices. [673] A member that does not permit an investigation or refuses a request for information is subject to sanction by the relevant SRO.

Foreign branch offices (including perhaps any offices where "dual employees" of a U.S. broker-dealer and a foreign broker-dealer work) [674] are subject to examination and to the requirement that they make their records available for inspection by U.S. regulators as would be any U.S. office. In a disciplinary action instituted against the Swiss branch of a registered broker-dealer that had failed to provide its records for inspection on a timely basis, the SEC rejected out of hand the broker-dealer's defense that Swiss secrecy laws had prevented it from making customer records promptly available to the SEC. [675]

[2] Sanctions

[a] By SROs

FINRA and the other SROs have the authority to discipline members and their associated persons with a censure, fine, suspension or expulsion from membership or "any other fitting sanction." [676] Any disciplinary action taken by an SRO is subject to review by the SEC. [677]

[b] By the SEC

The SEC has the authority to sanction broker-dealers for any violation of the U.S. securities laws or the rules and regulations thereunder. Under § 15(b)(4) of the Exchange Act, the SEC is required to "censure, place limitations on the activities, functions or operations of, suspend for [not more than]… twelve months or revoke the registration of [a broker-dealer]" if it finds that the broker-dealer has committed one of a number of enumerated offenses and the disciplinary action is in the "public interest." No disciplinary action may be taken without "notice and opportunity for hearing." [678] Suspension may be too harsh for many

p. 14-162

p. 14-163

infractions, while a censure has been described by the SEC as a "slap on the wrist." [679]

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("SERPSA") [680] significantly expanded the range of penalties that the SEC could impose upon broker-dealers. Pursuant to SERPSA, the SEC may now seek money penalties of up to $100,000 against a natural person or up to $500,000 against any entity for violations of the U.S. securities laws. [681] Further, SERPSA authorizes the SEC to order respondents to "cease and desist" any violation of U.S. securities laws or "to take steps to effect compliance" with such laws. [682] Notice and opportunity for hearing are generally required in connection with SEC proceedings; however, in certain emergency situations, the SEC may issue temporary orders to regulated persons, such as broker-dealers, without a hearing. [683]

[c] Private Rights of Action

The civil actions for fraud that may be brought, for example, under § 10(b) of the Exchange Act and Rule 10b-5 thereunder may be brought against broker-dealers as well as other persons. The Private Securities Litigation Reform Act of 1995, [684] among other provisions, raises the pleading standards for fraud actions under the securities laws and prohibits broker-dealers from accepting referral fees from attorneys in connection with class actions for securities law violations.

p. 14-163

p. 14-164

Broker-dealers may also be liable for fraud under other provisions of federal and state law. [685]

In addition, under § 29(b) of the Exchange Act, any contract made in violation of the Exchange Act is void. Accordingly, § 29(b) might be used, for example, as a defense by a customer of an unregistered broker-dealer that did not wish to perform an agreed-upon transaction or in an action to seek rescission. [686] Further, it is possible that this provision of the Exchange Act could also serve as the basis for a rescission action where a customer did business with a broker-dealer's employee who was not properly registered with FINRA or other SRO, even though the broker-dealer was itself properly registered and the transaction was not otherwise improper. [687]

Footnotes

670 The CFMA imposes certain limitations on the SEC's examination authority over FCMs that are notice-registered as broker-dealers, such as requiring the SEC to coordinate with the CFTC and, where possible, to use reports of examination by the CFTC. *See* §§ 17(b)(1)(B) and 17(b)(2)-(4) of the Exchange Act.

671 *See*, *e.g.*, *United States v. Morton Salt*, 338 U.S. 632 (1950). To conduct an inspection, the SEC is required to demonstrate only that any investigation is for a lawfully authorized purpose and that any documents it is seeking are reasonably relevant to its inquiry; the SEC is not required to establish "probable" or "reasonable" cause. *See*, *e.g.*, *SEC v. Howatt*, 525 F.2d 226, 229 (1st Cir. 1975); *SEC v. Brigadoon Scotch Distributing*, 480 F.2d 1047, 1054 (2d Cir. 1973), *cert. denied*, 415 U.S. 915 (1974); *SEC v. Blackfoot Bituminous*, 622 F.2d 512, 514 (10th Cir.), *cert. denied*, 449 U.S. 955 (1980); *SEC v. Kaplan*, 397 F. Supp. 564 (E.D.N.Y. 1975).

Section 15C(d) of the Exchange Act provides that the appropriate regulatory agency for a government securities broker-dealer has authority to inspect its records. Although § 21(a) of the Exchange Act gives the SEC power to inspect "any person" who has violated the act, § 15C(g)(2) of the Exchange Act provides that the SEC generally may inspect only the government securities broker-dealers for which it is the appropriate regulatory agency.

672 § 21(a)(2) of the Exchange Act; *see also* § 14.03[3][i].

673 *See*, *e.g.*, FINRA Rule 8210, FINRA MANUAL; NYSE Rule 476(a)(11), NYSE GUIDE (CCH) ¶2476 (failure to

comply with a request by the NYSE for information or testimony is cause for disciplinary action). Such information and reports may be shared with other domestic or foreign SROs with whom FINRA or the NYSE has entered into an agreement for the exchange of information or mutual assistance.

674 *See* § 14.04[2].

675 *See* SEC Release No. 34-29243 (May 29, 1991).

676 *See*, *e.g.*, FINRA Rule 8310, FINRA MANUAL; NYSE Rule 476, NYSE GUIDE (CCH) ¶2476.

677 *See* § 19(d) and (e) of the Exchange Act and Rule 19d-3 thereunder.

678 *See* § 15(b)(4) of the Exchange Act.

679 *See generally* written testimony of Richard Breeden, then-Chairman of the SEC, before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, United States Senate (1990).

680 Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

681 *See* §§ 21(d)(3) and 21B of the Exchange Act. If the gross pecuniary gain to the defendant exceeds the maximum penalties listed in the text, the SEC can seek a penalty in court up to the amount of such gain under § 21(d)(3) of the Exchange Act. The relevant provisions provide for lower maximum penalties for first and second time offenders, unless the violation involved fraud or reckless disregard and resulted in substantial loss or created a risk of substantial loss to other persons. Note that violations of insider trading prohibitions are subject to the provisions of Exchange Act § 21A. *See* §§ 11.05[2][c] and 14.07[1][b].

682 § 21C(a) of the Exchange Act; *see also* § 21(d) of the Exchange Act (authorizing the SEC to seek injunctions in federal court). In connection with any cease and desist proceeding, the SEC may require an accounting and disgorgement. § 21C(e) of the Exchange Act. The SEC's second use of its § 21C injunctive power was in connection with a disciplinary action taken against the foreign branch of a U.S. broker-dealer that failed to make its records available for inspection on a timely basis. *See* SEC Release No. 34-29243 (May 29, 1991).

683 § 21C(c) of the Exchange Act.

684 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995); *see* § 11.03[c].

685 *See generally* Chapter 11.

686 *See*, *e.g.*, *Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*, 678 F.2d 552, 558 (5th Cir. 1982), *aff'd on other grounds*, 752 F.2d 178 (5th Cir. 1985) (later appeal); *Eastside Church of Christ v. National Plan, Inc.*, 391 F.2d 357 (5th Cir.), *cert. denied*, 393 U.S. 913 (1968) (allowing investors to rescind transactions with unregistered broker-dealer); *see also* Samuel H. Gruenbaum and Marc I. Steinberg, *Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened*, 48 GEO. WASH. L. REV. 1 (1979).

687 Violation of the rules of FINRA or other SROs generally does not give rise to a private right of action. *See*, *e.g.*, *Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980) (holding that there is no private right of action under the NYSE's "know your customer" rule or the NASD's suitability rule); *Emmons v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 532 F. Supp. 480 (S.D. Ohio 1982) (explaining that under the Supreme Court's test established in *Cort v. Ash*, 422 U.S. 66 (1975), there is no implied private right of action under NYSE or NASD rules); *Klitzman v. Bache Halsey Stuart Shields, Inc.*, 499 F. Supp. 255 (S.D.N.Y. 1980) (holding that there is no private right of action under NASD rules).

U.S. Regulation of the International Securities and Derivatives Markets, § 14.12, STATE REGISTRATION OF BROKER-DEALERS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 14.12 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Click to open document in a browser

A great complication for broker-dealers doing an international, or even a national, securities business in the United States is that they must contend both with the federal securities law registration and compliance requirements and with those contained in the securities laws of the various states ("blue sky" laws). [688] The state blue sky laws may be not only different from the federal laws but also different from each other; in addition, the various states' interpretation of the same written language may be inconsistent. It is thus essential for a broker-dealer to be aware of local securities law in each state in which it transacts business.

The North American Securities Administrators Association ("NASAA") is a coordinating agency of state securities administrators that attempts to minimize duplication and irregularity between the various jurisdictions. One result of

p. 14-165

this coordination is that a broker-dealer may register with the securities authority in every state by filing Form BD.

Most states have adopted the same version of the Uniform Securities Act, although they may differ in their respective implementations or interpretations of the act. [689] Section 201(a) of the Uniform Securities Act provides that "a person may not transact business in [a] state as a broker-dealer or sales representative unless licensed or exempt from licensing under …" the securities law of that state. A broker-dealer is defined by the Uniform Securities Act as "any person engaged in the business of effecting transactions in securities for the account of others or for his own account." [690] Excluded from this definition are, among others,

> a person who has no place of business in [the] state if (a) his only clients in [the] state are other investment advisers, broker-dealers, banks, savings institutions, trust companies, insurance companies, investment companies as defined in the Investment Company Act of 1940, pensions or profit-sharing trust[s], or other financial institutions or institutional buyers, whether acting for themselves or as trustees, or (b) during any period of twelve consecutive months he does not direct more than fifteen offers to sell or buy into [the] state in any manner to persons other than those specified in clause (a), whether or not he or any of the persons to whom the communications are directed is then present in [the] state. [691]

The Rule 15a-6 exemption from registration for foreign broker-dealers under the Exchange Act does not affect state registration requirements as such, although the above exclusions from the Uniform Securities Act definition of a broker-dealer to a certain extent overlap the Rule 15a-6 exemption from Exchange Act registration. [692] In particular, the Uniform Securities Act exclusion covers a foreign broker-dealer's transactions with registered broker-dealers,

p. 14-165

---

p. 14-166

banks and certain institutional investors. [693] However, the institutional investors whom an unregistered broker-dealer may contact in a particular state may not overlap precisely with the Rule 15a-6 definition of "U.S. institutional investors." Further, the Uniform Securities Act, unlike Rule 15a-6, does not provide a general exclusion for purchases and sales that are "unsolicited." [694] It is also important to note that certain states (including, *e.g.*, California) do not have an applicable exemption from registration for an out-of-state broker-dealer effecting securities transactions with only institutional investors unless the broker-dealer is registered under the Exchange Act.

The NSMIA largely preempts state securities broker-dealer qualification requirements that differ from or are duplicative of federal requirements. [695] On its face, the NSMIA would appear to eliminate state regulation of federally exempted foreign broker-dealers except for the bare requirements that such broker-dealers register and pay registration fees. Nonetheless, individual states continue to require certain documentation in addition to the Form BD, including, among other things, affidavits with respect to any previous sales activities in the state.

Accordingly, foreign broker-dealers need to consider carefully the potential applicability of state, as well as federal, registration requirements to their U.S. securities activities. This is particularly the case as state securities regulatory authorities may be quite aggressive in seeking fines or other disciplinary actions against a foreign broker-dealer. For example, the Commonwealth of Massachusetts not only imposed a substantial fine against, but also permitted Massachusetts investors to rescind individual transactions with, Midland Walwyn, a Canadian broker-dealer that was improperly doing business with former Canadians who had moved to Massachusetts. [696]

Footnotes

688 Section 28(a) of the Exchange Act preserves state law insofar as such law does not "conflict" with the provisions of the Exchange Act. *See generally* Joseph C. Long, BLUE SKY LAW (Chap. 8: Broker-Dealers, Agents & Investment Advisers) (2016).

689 Most state regulation derives from the Uniform Securities Act (1956), adopted by 37 jurisdictions, and its successor, the Revised Uniform Securities Act (published in 1985). After both of these acts were preempted in part by NSMIA, the Uniform Securities Act (2002) was drafted and approved by the National Conference of Commissioners on Uniform State Laws as a "new" Uniform Securities Act. The Uniform Securities Act (2002) has been adopted by Georgia, Hawaii, Idaho, Indiana, Idaho, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Hampshire, New Mexico, Oklahoma, South Carolina, South Dakota, Vermont, Wisconsin, Wyoming and the U.S. Virgin Islands.

690 § 401(c) of the Uniform Securities Act.

691 § 401(c)(4) of the Uniform Securities Act.

692 *See* § 14.03[3].

693 Similar to the exclusion from the definition of "broker-dealer" under the Uniform Securities Act (1956), § 401(b) of the Uniform Securities Act (2002) provides an exemption from registration for a broker-dealer without a place of business in the relevant state if its only transactions effected in the state are with "institutional investors" (a term defined in the Uniform Securities Act to include other registered broker-dealers, banks and certain types of other institutions).

694 *See* § 14.03[3][b][i].

695 In addition, § 28(a) of the Exchange Act (as amended by the CFMA) preempts the application of state laws with respect to the offer, sale or distribution of securities (other than generally applicable antifraud provisions) to transactions in security futures products.

696 *See In re Midland Walwyn Capital Corp.*, Commonwealth of Massachusetts, Docket No. E-92-148, 1993 Mass. Sec . LEXIS 2 (Dec. 3, 1993). In part in response to this case, NASAA has added § 201(a) to the Uniform Securities Act, providing for limited registration of Canadian broker-dealers. NASAA REPORTS (CCH) ¶1211. A similar limited registration regime has been adopted by Canadian securities regulatory authorities.