COMPLIANCE GUIDE to the Registration and Regulation of BROKERS AND DEALERS

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BROKERS AND DEALERS

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I. INTRODUCTION

The Securities Exchange Act of 1934 governs how the nation's securities markets and its brokers and dealers operate. We have prepared this Compliance Guide to summarize some of the significant provisions of this Act and its rules. You will find information about whether you need to register as a broker-dealer, how you can register, and what standards of conduct and financial responsibility rules broker-dealers must follow.

CAUTION - MAKE SURE YOU FOLLOW ALL LAWS AND RULES

Although this Compliance Guide highlights some of the significant provisions of the Act and our rules, it is not comprehensive. Brokers and dealers, and their associated persons, must comply with all regulatory requirements of the SEC and their self-regulatory organizations, and not just the requirements summarized here.

The SEC staff stands ready to answer your questions and help you comply with our rules. Please feel free to contact the Office of Interpretations and Guidance in the Office of Chief Counsel of the Division of Market Regulation or the Regional Office of the SEC in your area. (You will find our phone number at the end of this Compliance Guide.)

The SEC staff, however, cannot act as an individual's or broker-dealer's lawyer. Therefore, you may wish to consult with a private lawyer who is familiar with the federal securities laws, to assure that you comply with all laws and regulations.

II. WHO IS REQUIRED TO REGISTER

Most "brokers" and "dealers" must register with the SEC and join a "self-regulatory organization," or SRO. This section covers the factors that determine whether a person is a broker or dealer. It also describes the types of brokers and dealers that do not have to register. Self-regulatory organizations are described in Part III.A. below.

A. Who is a "Broker"

Section 3(a)(4) of the Act defines "broker" broadly as

any person engaged in the business of effecting transactions in securities for the account of others....

Banks, however, are excluded from this definition.

Sometimes you can easily determine if someone is a broker. For instance, a person who executes transactions for others on a securities exchange clearly is a broker. However, other situations are less clear. For example, each of the following individuals and businesses may need to register as a broker, depending on a number of factors:

- "finders," or those who find buyers and sellers of businesses or find investors for registered broker-dealers and issuers;

- investment advisers and financial consultants; and

- those who provide support services to registered broker-dealers.

In order to determine whether any of these individuals (or any other person or business) is a broker, we look at the activities that the person or business actually performs. You can find analyses of various activities in the decisions of federal courts and our own "no-action" letters. Here are some of the questions that you should ask to determine whether you are acting as a broker:

- Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?

- Does your compensation for participation in the transaction depend upon the amount or outcome of the transaction? In other words, do you receive transaction-based compensation?

- Do you handle the securities or funds of others?

A "yes" answer to any of these questions indicates that you may need to register as a broker.

B. Who is a "Dealer"

Unlike a broker, who acts as agent, a dealer acts as principal.

Section 3(a)(5) of the Act defines a "dealer" as:

any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise....

Two groups are excluded from the definition of dealer—banks and "traders." A trader is someone who buys and sells securities, either individually or in a trustee capacity, but not as part of a regular business. Individuals who buy and sell securities for themselves generally are considered traders and not dealers.

Sometimes you can easily tell if someone is a dealer. For example, a firm that advertises publicly that it makes a market in securities is obviously a dealer. Other situations can be less clear. For instance, each of the following individuals and businesses may need to register as a dealer, depending on a number of factors:

- a person who holds himself out as being willing to buy and sell a particular security on a continuous basis; or

- a person who issues or originates securities that he also buys and sells.

Here are some of the questions you should ask to determine whether you are acting as a dealer:

- Do you hold yourself out as being in the business of buying and selling securities?

- Do you do a large portion of your business with the public?

- Do you make a market in, or quote prices for both purchases and sales of, one or more securities?

- Do you participate in a "selling group" or otherwise underwrite securities?

- Do you provide services to investors, such as handling money and securities, extending credit, or giving investment advice?

A "yes" answer to any of these questions indicates that you may be a dealer.

C. What to do if You Think You may be a Broker or a Dealer

If you are doing, or may do, any of the activities of a broker or dealer, you should find out if you need to register. If you aren't certain, you may want to review SEC interpretations, consult with private counsel, or ask for our advice.

D. Brokers and Dealers Generally Must Register with the Commission.

Section 15(a)(1) of the Act generally makes it unlawful for any broker or dealer to use the mails (or any other means of interstate commerce) to "effect any transactions in or to induce ... the purchase or sale of, any security" unless registered with the Commission in accordance with Section 15(b) of the Act. There are a few exceptions to this general rule that we discuss below. In addition, we discuss the special registration requirements that apply to broker-dealers of government and municipal securities in Part II.E. below.

1. "Associated Persons" of a Broker-Dealer

We call individuals who work for a registered broker-dealer "associated persons." Although these people do not have to register with the SEC, they may have to register with their employer's self-regulatory organizations. This is discussed further in Part III. D. below.

2. Intrastate Broker-Dealers

Any broker-dealer who conducts all its business solely in one state does not have to register with the SEC. (State registration is another matter. See Part III. C. below.) This is a very narrow exemption. To qualify, all aspects of all transactions must be done within the borders of one state. This means that, without SEC registration, the broker-dealer cannot participate in any transaction executed on a national securities exchange or the National Association of Securities Dealers Automated Quotation (Nasdaq) system. However, there is no exception from registration for intrastate broker-dealers that sell municipal or government securities; they must register as municipal or government securities broker-dealers.

3. Broker-Dealers that Limit their Business to Excluded and Exempted Securities

A broker-dealer who transacts business only in commercial paper, bankers' acceptances, and commercial bills does not need to register under Section 15(b) or any other section of the Act. On the other hand, persons transacting business only in certain "exempted securities," as defined in Section 3(a)(12) of the Act, do not have to register under Section 15(b),

but may have to register under other provisions of the Act. For example, some broker-dealers of government securities, which are "exempted securities," must register under Section 15C, as described in Part II.E. below.

4. Broker-Dealers Must Register Before Selling Unregistered Securities

A security sold in a transaction that is exempt from registration under the Securities Act of 1933 (the "1933 Act") is not necessarily an "exempted security" under the Act. **For example, if a person sells securities exempt from registration under Regulation D of the 1933 Act, he or she must nevertheless register as a broker-dealer.**

5. Issuer's Exemption *(Rule 3a4-1)*

Traditionally, the SEC does not consider a company that sells its own securities directly to the public to be either a "broker" or a "dealer". However, the employees and other related persons of an issuer who assist it in selling its securities may be "brokers," especially if they are paid for selling these securities and have few other duties. You should consult Rule 3a4-1 for further guidance.

In addition, some issuers offer dividend reinvestment and stock purchase programs. Under certain conditions, an issuer may purchase and sell its own securities through such a program without registering as a broker-dealer. To qualify for this treatment, the issuer must comply with conditions that the Division of Market Regulation has established regarding solicitation, fees and expenses, and handling of participants' funds and securities.[1]

6. Foreign Broker-Dealer Exemption
(Rule 15a-6)

The SEC generally uses a territorial approach in applying registration requirements to the international operations of broker-dealers. Under this approach, all broker-dealers physically operating within the U.S. that induce or attempt to induce securities transactions must register, even if their activities are directed only to foreign investors outside the U.S. In addition, foreign broker-dealers that, from outside the U.S., induce or attempt to induce trades by any person in the U.S. also must register. However, foreign broker-dealers may be exempt from U.S. broker-dealer registration if they meet the conditions of Rule 15a-6 under the Act.

E. Requirements Regarding Brokers and Dealers of Government and Municipal Securities

Broker-dealers that limit their activity to government or municipal securities require specialized registration. Those who limit their activity to government securities do not have to register as "general-purpose" broker-dealers under Section 15(b). However, if they are not "financial institutions" (banks, foreign banks or savings associations), they must register as government securities broker-dealers. Financial institutions that are government securities broker-dealers must file a notice with the "appropriate regulatory agency" (their federal regulator). General-purpose broker-dealers that conduct a government securities business must file a notice with the SEC regarding this activity. All firms that are brokers or dealers of government securities must comply with rules adopted by the Secretary of the Treasury, as well as SEC rules.

Firms whose securities business is limited to buying and selling municipal securities for their own account must register as general-purpose broker-dealers, with two exceptions: If they are banks or meet the requirements of the intrastate exemption discussed in Part II.D.2. above, they must register as municipal securities dealers.

F. Regulation of Financial Institutions

Since U.S. banks are excluded from the definitions of "broker" and "dealer" under the Act, the SEC does not regulate them. However, the SEC does regulate broker-dealer subsidiaries or affiliates of banks, which are required to register. Banks that act as municipal securities dealers also are required to register under the Act.

The Act's exclusion for "banks" does not extend to other types of financial institutions, such as savings and loan associations and credit unions, which generally must register if they act as brokers or dealers. The SEC staff may permit these financial institutions, as well as insurance agencies, to make securities products available to their customers without registering as broker-dealers. This is done through "networking" arrangements, where a broker-dealer provides brokerage services for the financial institution's or insurance agency's customers, according to conditions stated in no-action letters. Those interested in structuring such an arrangement should consult our no-action letters[2] or contact private counsel or the SEC staff for further information. Also, see the discussion in Part II.E. above for financial institutions acting as government securities broker-dealers.

III. HOW TO REGISTER AS A BROKER-DEALER

If a broker-dealer does not qualify for any of the exceptions outlined above, it must register with the Commission under Section 15(b) of the Act. Broker-dealers register by filing an application on Form BD, which you may obtain from the SEC. You also use Form BD to:

- apply for membership in an SRO, such as the National Association of Securities Dealers, Inc. (NASD) or a registered national securities exchange;

- give notice that you conduct government securities activities; or

- apply for broker-dealer registration with the states.

Form BD asks questions about the background of the broker-dealer and its principals, controlling persons, and employees. The broker-dealer must meet the statutory requirements to engage in a business that involves high professional standards, and quite often includes the more rigorous responsibilities of a fiduciary.

You register with the SEC by filing one executed copy of Form BD through the Central Registration Depository operated by the NASD. (The only exception is for banks registering as municipal securities dealers, which file Form MSD directly with the SEC.) The SEC does not charge a filing fee, but the

SROs or the states may. Applicants that reside outside the U.S. must appoint the SEC as agent for service of process using a standard form. The SEC will return the application if it is incomplete.

After you file a completed application, within 45 days the SEC will either grant registration or begin proceedings to determine whether it should deny registration. The SROs, however, do not have to act within 45 days.

A broker-dealer must also update the Form BD by filing amendments whenever the information on file becomes inaccurate or incomplete for any reason.

A broker-dealer may not begin business until:

- **the SEC has granted its registration,**
- **it has become a member of an SRO and (in most cases) the Securities Investor Protection Corporation,**
- **it complies with state requirements, and**
- **its "associated persons" have satisfied qualification requirements.**

A. SRO Membership

A broker-dealer must become a member of an SRO before it begins business. The NASD and the registered national securities exchanges are all SROs. SROs assist the SEC in regulating the activities of broker-dealers. If a broker-dealer does transactions solely on one national securities exchange, the broker-

dealer is only required to be a member of that exchange. If a broker-dealer effects transactions in securities over-the-counter, however, it must be a member of the NASD. A broker-dealer that does both exchange and over-the-counter business must become a member of the exchange(s) and the NASD.

Firms that engage in transactions in municipal securities must also comply with the rules of the Municipal Securities Rulemaking Board, or MSRB. The MSRB is an SRO that makes rules governing municipal securities dealers, but unlike other SROs, it does not enforce compliance with its rules. Compliance with MSRB rules is monitored and enforced by the NASD (in the case of broker-dealers), and the Federal bank regulators (in the case of banks).

B. SIPC Membership

Every registered broker-dealer must be a member of the Securities Investor Protection Corporation, or SIPC, unless its principal business is conducted outside of the United States or consists exclusively of the sale or distribution of investment company shares, variable annuities, or insurance. Each SIPC member must pay an annual fee to SIPC. SIPC insures that its members' customers receive back their cash and securities in the event of a member's liquidation, up to $500,000 per customer for cash and securities (claims for cash are limited to $100,000). For further information, contact SIPC, 805 15th St., N.W. Suite 800, Washington, D.C. 20005.

C. State Requirements

Every state has its own requirements for a person conducting business as a broker-dealer within that state. Each state's securities regulator can provide you with information about that state's requirements. You can obtain a list of these regulators from the North American Securities Administrators Association, Inc., One Massachusetts Avenue, N.W., Suite 310, Washington, D.C. 20001.

D. Associated Persons (Rule 15b7-1)

An "associated person" of a broker-dealer is any partner, officer, director, branch manager, or employee of the broker-dealer, or any person controlling, controlled by, or under common control with, the broker-dealer. A broker-dealer must file a Form U-4 with the applicable SRO for each associated person who effects transactions in securities, when the person is hired. Form U-4 is used to register individuals and to record these individuals' prior employment and disciplinary history.

An associated person who effects or is involved in effecting securities transactions also must meet qualification requirements. These include passing an SRO securities qualification examination. Most individuals take the comprehensive "Series 7" exam. If individuals engage only in activities involving sales of particular securities, such as municipal securities, direct participation programs (limited partnerships) or mutual funds, they may take an examination focused on that type of security, instead of the general securities examination. Similarly, there is a special exam for assistant representatives, whose activities are limited to

accepting unsolicited customer orders for execution by the firm. Supervisory personnel and those who engage in specialized activities, such as options trading, must take exams that cover those areas. These examinations require the Series 7 exam as a prerequisite.

You can obtain copies of Form U-4 as well as information on securities qualification examinations from an SRO.

E. Successor Broker-Dealer Registration (Rules 15b1-3, 15Ba2-4, and 15Ca2-3)

A successor broker-dealer assumes substantially all of the assets and liabilities, and continues the business, of a registered predecessor broker-dealer. A successor broker-dealer must file a new Form BD (or, in special instances, amend the predecessor broker-dealer's Form BD) within 30 days. The filing should indicate that the applicant is a successor.

F. Withdrawal from Registration (Rule 15b6-1)

When a registered broker-dealer stops doing business, it must file a Form BDW with the SEC and with the SROs where it is a member. This form requires the broker-dealer to disclose the amount of any funds or securities it owes customers, and whether it is the subject of any proceeding, unsatisfied judgments, liens, or customer claims. These disclosures help to ensure that customers of a defunct firm receive back their funds and securities to the extent possible. The SEC may also cancel a broker-dealer's registration if it finds that the firm is no longer in existence or has ceased doing business as a broker-dealer.

IV. CONDUCT REGULATION OF BROKER-DEALERS

Broker-dealers, like other securities market participants, must comply with the general "antifraud" provisions of the federal securities laws. Broker-dealers must also comply with many requirements that are designed to maintain high industry standards. We discuss some of these provisions below.

*A. **Antifraud Provisions** (Sections 9(a), 10(b), and 15(c)(1) and (2))*

The "antifraud" provisions prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities.[3] While these provisions are very broad, we have adopted rules, issued interpretations, and brought enforcement actions that define some of the activities we consider manipulative, deceptive, fraudulent, or otherwise unlawful.[4] Broker-dealers must conduct their activities so as to avoid these kinds of practices. We discuss some of these rules and interpretations in this Section.

1. Duty of Fair Dealing

Broker-dealers owe their customers a duty of fair dealing. This fundamental duty derives from the Act's antifraud provisions referred to above. Under the so-called "shingle" theory, by virtue of engaging in the brokerage profession (e.g., hanging out the broker-dealer's business sign, or "shingle"), a broker-dealer represents to its customers that it will deal fairly with

them, consistent with the standards of the profession. Based on this important representation, over time the SEC and the courts have set forth, through interpretive statements and enforcement actions, certain duties for broker-dealers. These include the duties to execute orders promptly, disclose material information (i.e., information the customer would consider important as an investor), charge prices reasonably related to the prevailing market, and fully disclose any conflict of interest.

The SRO rules reflect the importance of fair dealing. For example, NASD members must comply with the NASD's Rules of Fair Practice. These rules generally require that a broker-dealer observe high standards of commercial honor and just and equitable principles of trade in conducting its business. The exchanges and the MSRB have similar rules.

2. Duty of Best Execution

The duty of best execution, which also stems from the Act's antifraud provisions, requires a broker-dealer to seek to obtain the most favorable terms available under the circumstances for its customer orders. This applies whether the broker-dealer is acting as agent or as principal.

The SRO rules also include a duty of best execution. For example, NASD members must use "reasonable diligence" to determine the best market for a security and buy or sell the security in that market, so that the price to the customer is as favorable as possible under prevailing market conditions.

3. Customer Confirmation Rule
(Rule 10b-10 and MSRB Rule G-15)

A broker-dealer must provide its customers, at or before completion of a transaction, with certain information, including:

- the date, time, identity, price, and number of shares involved;

- its capacity (agent or principal) and compensation: commission and whether it receives payment for order flow[5] (if it acts as agent) or in some cases mark-up or mark-down (if it acts as principal);

- other information, both general (such as if the broker-dealer is not a SIPC member) and transaction-specific (such as the yield, in most transactions involving debt securities).

A broker-dealer may also be obligated under the antifraud provisions mentioned above to disclose additional information to the customer at the time of his or her investment decision.

4. Disclosure of Credit Terms *(Rule 10b-16)*

Broker-dealers must notify customers purchasing securities on credit about the credit terms and the status of their accounts. A broker-dealer must establish procedures for disclosing this information before he extends credit to a customer for the purchase of securities. A broker-dealer must give the customer this information at the time the account is opened, and must also provide credit customers with account statements at least quarterly.

5. Restrictions on Short Sales *(Rule 10a-1)*

A "short sale" is generally a sale of a security that the seller doesn't own. Rule 10a-1 is designed to limit short selling in a declining market. The rule generally bars a person from selling an exchange-listed security that he or she does not own, unless the sale is at a price above the price of the last sale, or at the last sale price if that price was above the next preceding different price. Similarly, the NASD rules restrict short selling in the over-the-counter markets.

In addition, Rule 105 of Regulation M, described in the next section, restricts the covering of short sales.

6. Trading During an Offering *(Regulation M)*

Regulation M contains the rules governing activities of persons with an interest in a securities offering. These rules are aimed at preventing broker-dealers and other persons participating in an offering from manipulating the price of the offered security.

Rule 101 generally prohibits underwriters, broker-dealers and other participants from purchasing the security being offered, or "subject security," during the "quiet period." The "quiet period" begins one or five business days (depending on the trading volume value of the security and the public float value of the issuer) before the offering's pricing and continues through the end of the offering.

There are several exceptions to the rule's prohibitions. For example, underwriters can continue to trade in actively-traded securities of larger issuers (securities

with an average daily trading volume, or ADTV, value of $1 million or more and whose issuers have a public float value of at least $150 million). In addition, the following activities, among others, may be excepted from Rule 101, if they meet specified conditions:

- disseminating research reports;
- making unsolicited purchases;
- purchasing a group, or "basket" of 20 or more securities;
- exercising options, warrants, rights, and convertible securities;
- transactions that total less than 2% of the security's ADTV; and
- transactions in securities sold to "qualified institutional buyers."

Rule 102 prohibits issuers, selling security holders, and their affiliated purchasers from bidding for or purchasing any subject security and certain other related securities during the quiet period.

Rule 103 governs passive market making by broker-dealers participating in an offering of a Nasdaq security.

Rule 104 imposes disclosure, recordkeeping, notification, and pricing conditions on underwriters that stabilize, or maintain, the price of a subject security at a desirable level to facilitate the offering.

Rule 105 prevents manipulative short sales in anticipation of an offering by prohibiting the covering of short sales with securities obtained from an underwriter, broker, or dealer that is participating in the offering.

7. Restrictions on Insider Trading

The SEC and the courts interpret Rule 10b-5 to bar the use by any person of material nonpublic information in the purchase or sale of securities, whenever that use violates a duty of trust and confidence owed to a third party. Section 15(f) requires that broker-dealers have and enforce written policies and procedures reasonably designed to prevent their employees from misusing material nonpublic information. Because employees in the investment banking operations of broker-dealers frequently have access to material nonpublic information, firms create procedures designed to limit the flow of this information so that their employees cannot use the information in the trading of securities. Broker-dealers thus can use these information barriers as a defense to a claim of insider trading. Such procedures typically include:

- training to make employees aware of these restrictions;
- employee trading restrictions;
- physical barriers;
- isolation of certain departments; and
- limitations on investment bank proprietary trading.[6]

B. Trading by Members of Exchanges, Brokers and Dealers *(Section 11(a))*

Broker-dealers that are members of national securities exchanges are subject to additional regulations regarding transactions they effect on exchanges. For example, they generally cannot effect transactions on exchanges for their own accounts, the accounts of their associated persons, or accounts that they or their associated persons manage. However, there are several exceptions to this restriction, including exceptions for transactions by market makers, and transactions routed through other members. Exchange members may wish to seek guidance from their exchange regarding these provisions.

C. Extending Credit on New Issues (Section 11(d))

A broker-dealer that is a member of a national securities exchange, or that transacts business through a member, must comply with restrictions on extending credit to a customer for the purchase of a new issue if the broker-dealer participated in the distribution of the new issue. Such broker-dealers must also disclose to their customers in writing at or before completion of each transaction, the capacity in which they are acting.

D. Order Execution Obligations (Rules 11Ac1-1 and 11Ac1-4)

Broker-dealers that are exchange specialists or Nasdaq market makers must comply with particular rules regarding publishing quotes and handling customer orders. These two types of broker-dealers have special

functions in the securities markets, particularly because they trade for their own accounts while also handling orders for customers. These rules, which include the "Quote Rule" and the "Limit Order Display Rule," increase the information that is publicly available concerning the prices at which investors may buy and sell exchange-listed and Nasdaq National Market System securities.

The Quote Rule requires specialists and market makers to provide quotation information. The quote information the specialist or market maker publishes must be the best prices at which he is willing to trade (the lowest price the dealer will accept from a customer to sell the securities and the highest price the dealer will pay a customer to purchase the securities). A specialist or market maker may still trade at better prices in certain private trading systems, called electronic communications networks, or "ECNs," without publishing an improved quote. This is true only when the ECN itself publishes the improved prices and makes those prices available to the investing public. Thus, the Quote Rule ensures that the public has access to the best prices at which specialists and market makers are willing to trade even if those prices are in private trading systems.

Limit orders are orders to buy or sell securities at a specified price. The Limit Order Display Rule requires that specialists and market makers publicly display certain limit orders they receive from customers. If the limit order is for a price that is better than the specialist's or market maker's quote, the specialist or market maker must publicly display it. The rule benefits investors because the publication of trading interest at prices that improve specialists' and market

makers' quotes present investors with improved pricing opportunities.

*E. **Penny Stock Rules** (Rules 15g-2 through 15g-9)*

Broker-dealers that engage in transactions in "penny stocks" have certain enhanced suitability and disclosure obligations to their customers. The term "penny stock" generally refers to low-priced speculative securities, largely traded in the NASD's Bulletin Board Service or the "pink sheets."[7] Before a broker-dealer may effect transactions in penny stocks for or with a customer it must first approve the customer for transactions in penny stocks and receive from the customer a written agreement to the transaction. A broker-dealers also must give each penny stock customer:

- a document describing the risks of investing in penny stocks;
- information on market quotations, if any;
- information on the compensation of the broker-dealer and its salesperson in the transaction; and
- monthly account statements showing the market value of each penny stock held in the customer's account.

V. FINANCIAL RESPONSIBILITY OF BROKER-DEALERS

Broker-dealers must be financially sound. We regulate this through financial responsibility rules that are designed to:

- provide safeguards with respect to customer funds and securities that broker-dealers hold;
- ensure accountability for those funds and securities; and
- require accurate books and records.

These rules also require a broker-dealer to maintain sufficient liquid assets so that, if necessary, it could be liquidated in an orderly manner without a formal proceeding.

A. Net Capital Rule (Rule 15c3-1)

The purpose of this rule is to require broker-dealers to have at all times enough liquid assets to promptly satisfy the claims of customers if the broker-dealer goes out of business. Under this rule broker-dealers must meet certain ratio tests. They must also maintain minimum net capital levels based upon the type of securities activities they conduct. For example, broker-dealers that clear and carry customer accounts must maintain at least $250,000 in net capital. Other categories of broker-dealers can operate with lower levels of net capital.

B. Use of Customer Balances *(Rule 15c3-2)*

Broker-dealers that use customers' free credit balances in their business must establish procedures to provide specified information to those customers, including:

- the amount due to those customers,
- the fact that such funds are not segregated and may be used by the broker-dealer in its business, and
- the fact that such funds are payable on demand of the customer.

C. Customer Protection Rule *(Rule 15c3-3)*

This rule protects customer funds and securities held by broker-dealers. Under the rule, a broker-dealer must have possession or control of all fully-paid or excess margin securities held for the account of customers, and determine daily that it is in compliance with this requirement. The broker-dealer must also make periodic computations to determine how much money it is holding that is either customer money or obtained from the use of customer securities. If this amount exceeds the amount that it is owed by customers or by other broker-dealers relating to customer transactions, the broker-dealer must deposit the excess in a special reserve bank account for the exclusive benefit of customers. This rule thus prevents a broker-dealer from using customer funds to finance its business.

D. Required Books, Records and Reports (Rules 17a-3, 4, 5 and 11)[8]

Broker-dealers must make and keep current books and records detailing, among other things, securities transactions, money balances, and securities positions. They also must keep records for required periods and furnish copies of those records to the SEC on request. Broker-dealers also must file with the SEC periodic reports, including quarterly and annual financial statements. The annual statements generally must be certified by an independent public accountant. In addition, broker-dealers must notify the SEC and the appropriate SRO[9] regarding net capital, recordkeeping, and other operational problems, and in some cases file reports regarding those problems, within certain time periods. This gives us and the SROs early warning of these problems.

VI. OTHER REQUIREMENTS

In addition to the provisions discussed above, broker-dealers must comply with other requirements. These include:

- submitting to Commission and SRO examinations;
- participating in the lost and stolen securities program;
- complying with the fingerprinting requirement;
- maintaining and reporting information regarding their affiliates; and

- following certain guidelines when using electronic media to deliver information.

A. Examinations and Inspections (Rules 15b2-2 and 17d-1)

Broker-dealers are subject to examination by the SEC and the SROs. The appropriate SRO generally inspects newly-registered broker-dealers for compliance with applicable financial responsibility rules within six months of registration, and for compliance with all other regulatory requirements within twelve months of registration. A broker-dealer must permit the SEC to inspect its books and records at any reasonable time.

B. Lost and Stolen Securities Program (Rule 17f-1)

In general, all broker-dealers must register in the lost and stolen securities program. The limited exceptions include broker-dealers that effect securities transactions exclusively on the floor of a national securities exchange solely for other exchange members and do not receive or hold customer securities, and broker-dealers whose business does not involve handling securities certificates. Broker-dealers must report securities losses, thefts, and instances of counterfeiting on Form X-17F-1A, and in some cases must make inquiries regarding securities coming into their possession. Broker-dealers file these reports and inquiries with the Securities Information Center, which operates the program for the SEC. A registration form can be obtained from Securities Information Center, P.O. Box 421, Wellesley Hills, Massachusetts 02181.

C. Fingerprinting Requirement (Rule 17f-2)

Generally, every partner, officer, director, or employee of a broker-dealer must be fingerprinted and submit his or her fingerprints to the U.S. Attorney General. This requirement does not apply, however, to broker-dealers that sell only certain securities that are not ordinarily evidenced by certificates (such as mutual funds and variable annuities) or to persons who do not sell securities, have access to securities, money or original books and records, and do not supervise persons engaged in such activities. A broker-dealer claiming an exemption must comply with the notice requirements of Rule 17f-2. SRO members may obtain fingerprint cards from their SRO and should submit completed fingerprint cards to the SRO for forwarding to the Attorney General.

D. Risk Assessment Requirements (Rules 17h-1T and -2T)

Broker-dealers must maintain and preserve certain information regarding those affiliates, subsidiaries and holding companies whose business activities are reasonably likely to have a material impact on their own financial and operating condition (including the broker-dealer's net capital, liquidity, or ability to conduct or finance operations). Broker-dealers must also file a quarterly summary of this information. This information is designed to permit the SEC to assess the impact these entities may have on the broker-dealer.

E. Use of Electronic Media by Broker-Dealers

We have issued an interpretive release discussing the issues that broker-dealers should consider in using electronic media for delivering information to customers.[10] These issues include the following:

- Will the customer have notice of and access to the communication?

- Will there be evidence of delivery?

- Did the broker-dealer take reasonable precautions to ensure the integrity, confidentiality, and security of any personal financial information?

VII. Where to Get Further Information

For general questions regarding broker-dealer registration and regulation:

Office of Interpretations and Guidance
Office of Chief Counsel
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
(202) 942-0069
E-mail address: marketreg@sec.gov

For additional information about how to obtain official publications of SEC rules and regulations:

Superintendent of Documents
Government Printing Office
Washington, D.C. 20402-9325

For copies of SEC forms and recent SEC releases:

Publications Section
U.S. Securities and Exchange Commission
450 Fifth Street, N.W., Stop C-11
Washington, D.C. 20549
(202) 942-4046

Other useful addresses, telephone numbers, and Web sites:

SEC's World Wide Web site: www.sec.gov

National Association of Securities Dealers, Inc.
1390 Pickard Drive
Rockville, MD 20850
(301) 590-6500
World Wide Web site: www.nasd.com

New York Stock Exchange, Inc.
20 Broad Street
New York, NY 10005
(212) 656-3000
World Wide Web site: www.nyse.com

North American Securities Administrators Association, Inc.
Ten G Street, N.E., Suite 710
Washington, D.C. 20002
(202) 737-0900
World Wide Web site: www.nasaa.org

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As we noted on page 1, we have published this Compliance Guide as an introduction to the federal securities laws that apply to brokers and dealers. It only highlights and summarizes some of the significant provisions, and does not relieve anyone from complying with all regulatory requirements. You should not rely on this Guide without referring to the actual statutes, rules, regulations, and interpretations.

Endnotes

[1] See Securities Exchange Act Release No. 35041 (December 1, 1994), 59 FR 63393.

[2] Letters re: Chubb Securities Corporation (Nov. 24, 1993); First of America Brokerage Services, Inc. (Sept. 28, 1995).

[3] Section 9(a) prohibits particular manipulative practices regarding securities registered on a national securities exchange. Section 10(b) is a broad "catch-all" provision that prohibits the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security. Sections 15(c)(1) and 15(c)(2) apply to the over-the-counter markets. Section 15(c)(1) prohibits broker-dealers from effecting transactions in, or inducing the purchase or sale of, any security by means of "any manipulative, deceptive or other fraudulent device," and Section 15(c)(2) prohibits a broker-dealer from making fictitious quotes.

[4] These include Rules 10b-1 through 10b-18, 15c1-1 through 15c1-9, 15c2-1 through 15c2-11, and Regulation M.

[5] In addition, Rule 11Ac1-3 requires broker-dealers to inform their customers, upon opening a new account and annually thereafter, of their policies regarding payment for order flow and for determining where to route a customer's order.

[6] SEC, Report by Division of Market Regulation, Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-Public Information, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,520, at 80,620-25 (March, 1990).

[7] Rule 3a51-1 generally defines "penny stock" as any equity security other than any security that is listed on a national securities exchange or approved for quotation on Nasdaq, has a price of five dollars or more, is issued by an investment company or by the Options Clearing Corporation, or whose issuer has certain minimum net tangible assets or average revenues. Exemptions from Rules 15g-2 through 15g-6 are provided for non-recommended transactions, broker-dealers doing a minimal business in penny stocks, trades with institutional investors, and private placements.

[8] Rules 17a-2, 7, 8, 10 and 13 contain additional recordkeeping and reporting requirements that apply to broker-dealers.

[9] Where a broker-dealer is a member of more than one SRO, the SEC designates the SRO responsible for examining such broker-dealer for compliance with financial responsibility rules (the "designated examining authority").

[10] Securities Exchange Act Release No. 37182 (May 15, 1996), 61 FR 24644.

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