

Expanded Broker-Dealer Books and Records Requirements

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On October 26, 2001, the Securities and Exchange Commission (“SEC” or the “Commission”) adopted amendments to Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), which prescribe minimum standards for the creation, retention and preservation of records applicable to broker-dealers.² The amended rules went into effect on May 2, 2003. They significantly expand the types of records that broker-dealers must create, and require that those records be maintained or promptly produced at each office to which they relate.

The SEC maintains that the amendments to Rules 17a-3 and 17a-4 largely require broker-dealers to make and preserve books and records that they had previously maintained as a result of good business practices and to comply with already existing laws and self-regulatory organization (“SRO”) requirements, including rules of NASD, Inc. (“NASD”) and the New York Stock Exchange, Inc. (“NYSE”). In fact, the amendments contain a number of new, substantive regulatory requirements designed to enhance investor protection.

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¹ Originally published as “Recent Amendments to Broker-Dealers’ Books and Records Requirements” in the July 2003 edition of SIFMA C&L News & Notes, by Benjamin J. Catalano.

² See Exchange Act Release No. 44992 (Oct. 26, 2001) (the “Adopting Release”).

I. AMENDMENTS TO RULE 17a-3

The amendments to Rule 17a-3 generally expand the information that must be recorded on brokerage order and dealer trade tickets, and create new record-keeping requirements with respect to persons associated with the broker-dealer, customer account records, complaints, employee compensation and communications with the public.

A. Trade Tickets

Rules 17a-3(a)(6) and (7) contain the broker-dealer record-keeping requirements for brokerage orders and dealer trades, respectively. Rule 17a-3(a)(6) requires brokers to make a memorandum (ticket) for each brokerage order received for the purchase or sale of securities, whether or not executed. Rule 17a-3(a)(7) requires similar information for dealer trade tickets for transactions executed with customers.

The amendments require that the order ticket identify the time of receipt of the order. If this time is simultaneous, or nearly simultaneous, with the time the order is entered, separate entries are not required so long as it is clear from the order ticket that the times of receipt and entry of the order are simultaneous. Most broker-dealers currently keep this information as part of their Order Audit Trail System (OATS) responsibilities under NASD rules.

The amendments also require the identification of the person responsible for the account, and any other individual who accepted or entered the order. The first requirement does not create an affirmative obligation to assign a representative to each account. And there is no need to make this record where an individual does not represent the account, as may be the case with an on-line customer or other customer given electronic access to the firm's order entry system. However, if a customer enters an order on an electronic system, the firm must make a record that the order was so entered. The number or code of a computer terminal may be used to identify the person associated with the firm who entered the order. But the name of the individual must be made available upon request of a securities regulatory authority, including any of the state securities commissions.³

The broker-dealer is not required to make a brokerage order ticket for any purchase, sale or redemption of a security on a subscription basis, in which the firm merely forwards the documents to the issuer. This exemption includes, but is not limited to, transactions relating to the purchase of mutual funds or variable annuities, and automatic dividend reinvestments. In these situations, the firm must keep a copy of the application, subscription agreement or other written purchase agreement in lieu of an order ticket.

All trade tickets must be preserved for a period of three years, two years in an easily accessible place. The SEC interprets the term "easily accessible place" generally to mean that the documents must be kept on the premises, and filed in such a way that they can be easily identified and retrieved.

B. Records Relating to Associated Persons

Rule 17a-3(a)(12) requires broker-dealers to make records relating to each person associated with the firm that include information regarding the person's employment and disciplinary history and office location.⁴

³ The amendments to Rule 17a-3 include a definition of "securities regulatory authority" in subparagraph (h)(3), which includes "the Commission, any self-regulatory organization, or any securities commission . . . of the States."

⁴ "Associated person" is a defined term under subparagraph (h)(4) of Rule 17a-3. It incorporates the definitions of associated person contained in Sections 3(a)(18) and 3(a)(21) of the Exchange Act, but excludes persons whose functions are entirely clerical or ministerial. The definition turns on a relationship of control or common control between the broker-dealer and the individual.

Specifically, Rule 17a-3(a)(12)(i) requires that the firm make and keep current a questionnaire or application for employment executed by each associated person, which must be approved in writing by an authorized representative. This subpart is substantially unchanged from the previous rule.

Under new Rule 17a-3(a)(12)(ii), however, the broker-dealer must create a record listing all of its associated persons. The listing must show every office where the person regularly conducts securities-related business. The listing must include a record of the person's Central Registration Depository (CRD) number, as well as all internal identification numbers or codes assigned to the person by the firm.

Under Rule 17a-4(e)(1), the records described above must be preserved in an easily accessible place for at least three years after the person's association with the firm has ended.

C. Customer Account Records

Broker-dealers are now required to maintain minimum customer account information under new Rule 17a-4(a)(17). The purpose of the new rule is to document compliance with applicable suitability requirements. The new rule also requires firms to update the information periodically, and to record delivery of written account agreements to customers.

Account Profile Information

A broker-dealer must make a good faith effort to collect and make a record of the following information for each account with a natural person as a customer: the customer's name, tax identification number, address, telephone number, date of birth, employment status, annual income, net worth and the account's investment objectives. The account record must indicate whether it has been signed by the associated person responsible for the account, and approved or accepted by a principal of the firm. Again, no record needs to be made in this regard if no person has been assigned to the account. However, under SRO rules, all accounts must be approved by a principal, and the approval must be appropriately recorded. For discretionary accounts, the firm must prepare a record containing the dated signature of each natural person to whom discretionary authority is granted, and the dated signature of each customer or owner granting the authority.

The record should include personal information for each owner of the account, unless the personal information for each owner is the same, in which case the record should indicate that the information is the same for each owner. The financial information for joint accounts may be combined. The record for joint accounts should reflect the investment objectives for the overall account – not the investment objectives for the individual owners. While the firm must create a record for each account, that record may consist of more than one document, such as two or more account applications.⁵

The firm must make a good faith effort to collect and update the required account record information. However, the firm will be excused from its responsibility to obtain the required information based on the customer's neglect, refusal, or inability to provide the information. Although the rule does not require the firm to record an explanation of the customer's failure to provide the information, the firm bears the burden of explaining any missing information to regulatory authorities.

The account records described above must be preserved for a period of six years. The 6-year period begins to run at the time the information was replaced or updated, or the account closed.

⁵ For accounts opened on or after May 2, 2003, a broker-dealer must obtain the customer account record information when the account is opened. For accounts existing before May 2, 2003, the firm has a 36-month grace period to obtain the requisite information and to update its records.

Confirmation of Account Profile Information

Under the new rule, a broker-dealer must record that it has initially confirmed, and periodically updated, account record information. Account record verification is required on four occasions: (1) the opening of a new account, (2) the renewal of account information, which must occur at least once every 36 months, (3) a change in the customer's investment objectives, and (4) a change in name or address of the customer. The rule is intended to rectify any misunderstanding that might exist between the firm and a customer with respect to the customer's circumstances or investment objectives. In this regard, it contains substantive account record confirmation requirements designed to promote compliance with broker-dealers' suitability obligations.

New Accounts and Renewal of Account Information

Specifically, a broker-dealer must furnish each customer or owner of an account with a complete record of the account profile information required by Rule 17a-3(a)(17) for confirmation within 30 days after the account is opened.⁶ For security reasons, the firm is not required to include the customer's tax identification number or date of birth. Thereafter, the firm must furnish the same, complete record of account information to the customer for verification at least once every 36 months.

The account record provided to the customer must contain an explanation of the terms used to describe the customer's investment objectives. It must also include a prominent statement that the customer or owner should mark any corrections and return the account record to the firm, and advise the firm of any subsequent changes to the information. The information with respect to new accounts may be transmitted with the first statement mailed to the customer after the account is opened. Thereafter, the information may be sent separately or included with the customer's account statement or other mailings.

The 36-month update requirement does not alter a broker-dealer's responsibilities under the relevant "know your customer" rules. The SEC emphasized that a firm is not prevented from sending out renewals more frequently than every 36 months. The Commission also noted that in some instances it may be necessary to obtain confirmation of the information sooner than 36 months, in order to comply with the know your customer rules.

Changes to Investment Objectives

In addition, the firm must send a complete record of the account information to each customer or owner of the account (and to the registered representative responsible for the account) for confirmation within 30 days after receiving notice of any change in the account's investment objectives, or, absent such notice, within 30 days after making any change to the account's investment objectives. The information may be included with the next statement scheduled to be mailed for the account.⁷

Change in Name or Address of Account

For any change in the name or address of a customer or owner of an account, the firm must send a notice confirming the change to the customer at the customer's old address (and to the registered representative responsible for the account) within 30 days after receiving notice of the change. Notice of a change of name or address must be sent to each owner of a joint account.

Accounts for which No Suitability Determination Is Required

⁶ All broker-dealers must provide this information with respect to accounts existing before May 2, 2003, by May 1, 2006.

⁷ For accounts with no activity, the next scheduled mailing of an account statement may not take place until the end of the next quarter. In that case, a firm should send a separate verification within 30 days of receiving the notice or making the change, or reschedule delivery of the next statement for the current monthly cycle.

As previously mentioned, the customer account record confirmation requirements are intended to foster compliance with federal and SRO suitability requirements. Thus, the rule provides that a broker-dealer that is not required to make a suitability determination with respect to a customer account is not required to create an account profile record for the account.

Specifically, if, within the past 36 months, a broker-dealer has not recommended securities or other investments to the customer, or exercised discretion over the customer's account, or performed other activities that would require a suitability determination under the federal securities laws or SRO rules, then the firm is not obliged to create the complete account record (or to confirm the information periodically). If, at any time thereafter, the firm would recommend securities or engage in conduct that would require the firm to make a suitability determination, then it must obtain the requisite customer account information before engaging in such activity. The firm would then be required to confirm the information periodically.

Written Account Agreements

In addition, under Rule 17a-3(a)(17), a broker-dealer is required to create a record for each account of a natural person indicating that the customer or owner of the account was furnished with copies of all written account agreements entered into on or after May 2, 2003. The firm is also required to make a record indicating that the customer or owner was provided with fully executed copies of the agreements upon request.

The records with respect to customer accounts must be preserved for a period of six years from the date the information is replaced or updated, or the account is closed.⁸

D. Customer Complaints

Under the expanded federal record-keeping requirements, broker-dealers are now required to make special records of complaints against representatives and other persons associated with the firm. Rule 17a-3(a)(18) requires firms to make a record for each associated person of each written customer complaint that is received concerning the person, including those received electronically. The record must include:

- > The customer's name, address and account number;
- > The date the complaint was received;
- > The name of any other associated person identified in the complaint;
- > A description of the nature of the complaint; and
- > The disposition of the complaint.

SEC Rule 17a-4(b)(4) separately requires the preservation of all incoming and outgoing communications relating to the broker-dealer's business; and the various SROs have their own rules regarding the preservation of customer correspondence. Therefore, rather than make a separate record under Rule 17a-3(a)(18), the firm may comply with this requirement by keeping a copy of each complaint, along with a record of the disposition of the complaint, in a file in the name of the associated person.

⁸ Rules 17a-4(b)(6) and (7) require a broker-dealer to preserve all written agreements, including account agreements, powers of attorney and corporate authorizations for a period of three years (two years in an easily accessible place). However, since the broker-dealer is required to make a record that the customer or owner of an account was provided with copies of fully executed account agreements on request, all written agreements and related documents for the account of a natural person should be preserved for six years from the date the agreement is replaced or amended, or the account is closed.

In another substantive sales practice requirements embedded in the new record-keeping rules, the broker-dealer must make a record indicating that each customer has been provided with a notice containing the address and telephone number of the department receiving customer complaints with respect to account activity. The method for providing such notice is left to the broker-dealer: the firm may choose to deliver the notice separately, or to include the information with account opening documents, customer statements or other documents mailed to customers.

Complaint records must be preserved for a period of three years.

E. Compensation of Associated Persons

The amended rules contain extensive new record-keeping requirements pertaining to employee compensation arrangements.

These rules were among the most controversial, with many firms arguing that the changes would require costly new systems to track compensation arrangements. The rules were adopted substantially as proposed, with an accommodation that broker-dealers may elect to produce certain compensation records on request.

Rule 17a-3(a)(19), broker-dealers are required to make a record of all agreements (written and oral) pertaining to the employment or contractual relationship between the firm and each associated person, including a summary of the person's compensation arrangement. Where the person's compensation is based on a commission schedule, a record of the commission schedule must be kept as part of the record. Where compensation is based on factors other than remuneration on a per trade basis, the record must describe the method by which that compensation is determined.

The rule also requires broker-dealers to make a record for each associated person listing each purchase and sale of a security attributable to that person for compensation purposes. The record for each transaction must include:

- > The amount of compensation, if monetary, including all commissions, concessions, overrides and other compensation to the extent earned or accrued for the transaction; and
- > A description of any compensation that is non-monetary, including gifts or trips provided if certain sales goals are achieved, and an estimate of its value. (*De minimus* gifts need not be recorded.)

If a transaction would be counted toward achieving a sales goal, then a notation of the transaction should be made regardless of whether the goal is achieved.

Instead of recording this information, the firm may choose to produce the records promptly upon the request of a securities regulatory authority.

The records relating to agreements and compensation arrangements of associated persons must be preserved for a period of three years after the agreement has been amended or terminated, or the person's association with the firm has ended.

F. Communications with the Public

New Rule 17a-3(a)(20) requires broker-dealers to document that they have complied with, or adopted policies and procedures reasonably designed to comply with, federal and SRO rules requiring that advertisements, sales literature and other communications with the public be approved by a supervisory principal. In the Adopting Release, the SEC made clear that the rule does not establish a new source of supervisory responsibility. Instead, it allows securities regulatory authorities to examine firms for compliance with other, applicable rules regarding communications with the public. Accordingly, the Commission will defer to SRO

rules, such as NASD Rule 2210 and NYSE Rule 472, for specific requirements regarding the content of advertisements, sales literature and general correspondence, and guidance as to which communications must be approved by a principal.

G. Principals Responsible for Policies and Procedures for Approving Records

Newly adopted Rule 17a-3(a)(22) requires broker-dealers to prepare a list of each principal of the firm responsible for establishing policies and procedures reasonably designed to ensure compliance with any applicable federal or SRO rule requiring the acceptance or approval of a record by a principal.⁹

II. AMENDMENTS TO RULE 17a-4

Rule 17a-4 generally prescribes the length of time and the manner in which the records specified in Rule 17a-3, and other records, must be preserved. Rule 17a-4 has been amended to reflect the changes made to Rule 17a-3, and to create additional record retention requirements with respect to regulatory reports, compliance manuals and exception reports.

A. Retention of Communications

Rule 17a-4(b)(4) continues to require that each broker-dealer keep originals of all communications received and copies of all communications sent by the firm relating to its business as a broker-dealer, including interoffice memoranda, e-mails and other communications, for a period of three years (two years in an easily accessible place). As amended, Rule 17a-4 further requires that firms retain all documents that are subject to SRO rules regarding “communications with the public.” These rules, particularly NASD Rule 2210 and NYSE Rule 472, relate to advertisements, market letters and sales literature. Rule 17a-4(b)(4) expressly provides that sales scripts used to solicit customers are considered communications subject to the 3-year record retention requirement. However, advertisements that are not released to the public are not subject to the rule.

B. Organizational Documents

Rule 17a-4(d) continues to require that broker-dealers maintain organizational documents such as partnership agreements, articles of incorporation, minute books and stock certificates for the life of the enterprise and of any successor. The amendments to paragraph (d), however, clarify that the rule applies to similar documents for legal entities other than partnerships and corporations. The rule was also expanded to require the preservation of all Forms BD, Forms BDW and amendments to such forms, as well as all state securities licenses and records evidencing membership in an SRO.

C. Special Regulatory Reports and Examination Reports

New Rule 17a-4(e)(6) requires broker-dealers to preserve any report that a securities regulatory authority has requested or required the firm to make and to provide to the regulator pursuant to an order or settlement. The rule also requires the preservation of all examination reports by regulators. The reports must be preserved for three years following the date of the report, in an easily accessible place.

D. Written Supervisory Procedures and Exception Reports

Under Rule 17a-4(e)(7), broker-dealers are required to retain copies of all compliance, supervisory and procedures manuals describing the firm’s policies and practices for complying with applicable laws and supervision of associated persons. The manuals must be kept for a period of three years after the termination

⁹ Under Rule 17a-3(h)(2), a “principal” means any individual registered as a principal or branch manager of the firm, or any other person who has been delegated supervisory responsibility over associated persons by the firm.

of the use of the manual. All prior sections of the manuals that were withdrawn, updated, modified or revised also must be kept for three years following their withdrawal, modification or revision. The last requirement is intended to provide regulators with access to an historical record of the firm's compliance procedures in various areas. The new rule does not create an independent, substantive requirement with respect to the creation or content of written supervisory procedures. Those procedures continue to be governed by SRO rules such as NASD Rule 3010, and select federal securities laws such as Section 15(f) of the Exchange Act, which requires written policies and procedures for the prevention of insider trading and other abuses of material, non-public information.

In addition, under Rule 17a-4(e)(8), a broker-dealer must maintain and preserve copies of reports produced for the review of unusual activity in customers' accounts, commonly known as "exception reports." Exception reports are typically computer-generated reports or screens designed to identify unusual account activity that might indicate inappropriate sales practices such as unauthorized trading, churning, excessive commissions or mark-ups, or front-running. The rule does not establish an independent duty to create exception reports. Nevertheless, the SEC is hopeful that broker-dealers will continue to create these reports, which the Commission deems "are necessary to adequately supervise their business."

Copies of exception reports must be preserved for a period of 18 months from the time the reports are generated. Instead of retaining a copy of the report, a broker-dealer may re-create the report at the request of a securities regulatory authority. If the firm has changed its computer systems so that it cannot re-create the report, it may produce a report in the format presently available using historical data, and a record explaining each system change affecting the report. If the firm is unable to re-create the report in any format due to a systems change, it may, instead, provide a record of the parameters of the report for the time period specified by the securities regulatory authority, and the frequency with which the report was generated.

III. LOCAL ADMINISTRATION AND PRODUCTION OF RECORDS

The rules, as originally proposed and re-proposed, would have required broker-dealers to maintain records related to each office at that office location either physically or in electronic format. The requirement was intended to enable securities regulatory authorities, especially state securities regulators, to obtain these records quickly during local sales practices examinations. Firms complained that local storage and production of records would require redundant systems that would be costly and unduly burdensome to maintain. They also expressed concern that a decentralized record-keeping system would compromise supervisory controls.

The final rules attempt to strike a balance between these two positions.

Under Rule 17a-4(l), a broker-dealer is required to maintain certain records at the office to which they relate for a period of two years.¹⁰ The records that must be maintained at the office location include the following: blotters; order tickets; personnel records for associated persons located at the office; account record information; customer complaint information; customer correspondence; transaction based compensation and other compensation arrangements for associated persons located at the office; a list of supervisory principals; supervisory procedures; and a list of the persons responsible for records at the office.

¹⁰ The term "office" is defined in Rule 17a-3(h)(1) to mean "any location where one or more associated persons regularly conduct the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security." Where an associated person works out of multiple offices, the firm may treat all locations where the person works as a single office.

If an office is a private residence where one or more associated persons who are immediate family members reside, and it is not held out to the public as an office, and neither funds nor securities are handled there, the records for that office may be held at another location in the state.

Alternatively, the firm may, at the request of a securities regulatory authority, promptly produce the records at the office to which they relate, or at another place as agreed to by the regulator. The SEC interprets “promptly” to mean that the records should ordinarily be produced on the same day the request is made. Records relating to foreign offices may be kept at the firm’s main office.

Rule 17a-3(a)(21) requires a record listing, by name or title, all persons at an office who, without delay, can explain all of the various types of records maintained in the office and the information contained in the records. The persons must be ready to explain to regulators how the firm makes, keeps, and titles those records.

Of course, SRO rules generally require member firms to establish, maintain and enforce written procedures to supervise the activities of associated persons that are reasonably designed to achieve compliance with applicable securities laws, including the federal record-keeping requirements. In the wake of these comprehensive amendments to Rules 17a-3 and 17a-4, and the significant sanctions recently levied by the SEC, NASD and NYSE against five of the largest broker-dealers for alleged failures to preserve e-mail communications as required by federal and SRO rules,¹¹ firms would be well advised to review their compliance procedures to ensure that they adequately address all pertinent record-keeping responsibilities under federal, state and SRO rules.

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Please contact us if you would like to discuss any issues raised herein.

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¹¹ On December 3, 2003, the SEC, NASD and NYSE announced joint actions against Deutsche Bank Securities Inc., Goldman, Sachs & Co., Morgan Stanley & Co. Incorporated, Salomon Smith Barney Inc. and U.S. Bancorp Piper Jaffray Inc. for failing to maintain e-mail correspondence as required by Section 17(a) of the Exchange Act and Rule 17a-4 thereunder, and NASD Rule 3110 and NYSE Rule 440. The firms were also cited for failing to implement adequate supervisory procedures to ensure compliance with federal and SRO record-keeping requirements in violation of NASD Rule 3010 and NYSE Rule 342. The firms consented to the imposition of fines totaling \$8.25 million; \$1.65 million per firm.