

# THE *St. Louis Broker-Dealer*<sup>TM</sup>

## *A NEW LOOK FOR THE ST LOUIS BROKER-DEALER!*

We've got a fresh new look! Though our look is different, our purpose is not. We're still committed to presenting the St. Louis region's small broker-dealers and banks with useful information on securities activities and related topics.

## Recent Changes to Branch and Small Office Requirements: Getting Out in the Neighborhood

by: Joe Soraghan (jsoraghan@dmfirm.com)

The structure of the regulation of the securities industry continues to change to accommodate changes in customer demand and technological capabilities of the industry. As discussed in detail below, the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE) and the North American Securities Administrators Association (NASAA) have proposed, and the Securities and Exchange Commission (SEC) has approved, a new and uniform definition of "branch office" (the "Uniform Definition") and the transition to a centralized, CRD-based branch office application system, using a new Form BR. The new Form BR will allow member organizations to submit a single filing to simultaneously fulfill the branch office registration/approval requirements of the NASD, the NYSE and most states. And, in a more recent development, the SEC has approved the NYSE's proposed Interpretation of its Rule 342 (concerning supervision and control of offices) to permit waiver of the otherwise normally required level of supervisory qualifications of resident branch office managers for "limited purposes offices" which have more than three registered representatives (RRs).

### Changes in Customer Demand Conflicting with Regulation

*Branch Offices.* The securities brokerage industry has realized there are would-be investors who do not want to come to big offices, but who do want face to face meet-

ings with brokers rather than trade online. So for some time the industry has "gone out into the neighborhoods", opening smaller offices (often offices with one and two representatives). This movement was somewhat hampered by the intense regulation of the industry and particularly the definition of "branch office." Indeed, the SEC, NASD, MSRB and NYSE and many state regulators had defined "branch office" differently.

Prior to the Uniform Definition becoming effective, there was no uniform definition among regulators of "branch office" (each of which must meet significant supervisory requirements.) For example, the NASD defined a branch office as "any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business" (with four narrow exceptions.) NYSE Rule 342.10 defined a branch office as "any location where [as few as] one or more associated persons of a member... regularly conduct" transactions in securities (apparently with no exceptions. Both of these definitions could, for example, require that branch office onsite supervisory capability be present for a registered representative (RR) to conduct business temporarily from his home by tele-

### *Inside this issue...*

- ◆ Selling Away: You and Your RR Can Both Be Honest and Still Be Liable to Someone Who is Not Your Client—page 5

phone, or another location used primarily for non-securities business, but from which three or four securities transactions might be effected in a year.

*“Limited Purpose” Offices.* And, until recently, NYSE Rule 342 required that any “office” with three or more RRs must have – onsite – a resident branch office manager who is “qualified”, i.e. has passed one of the Series 9 or 10 (general sales supervisor), options/general or Series 24 (general securities principal) examinations – a significant expense for any small broker-dealer.

And changes demanded by customers in the structure of financial services, of which securities brokerage is only a part, have pressured securities brokerage firms to change **their** structures in ways that now “bump up against” legal regulations, including this on-site supervisory requirement. In particular, many customers want to deal with one office near their homes for all of their securities, insurance and commercial banking (and possibly other financial) services. In meeting this demand, many small broker-dealers seek to increase the number of their small multi-functional offices offering such combined services. In creating these offices, such firms frequently limit the securities activities of such offices, and the training of the RRs therein, to, for example, mutual funds and variable contracts products. And, frequently, in order to provide all of securities, banking and insurance services, such an office requires more than three RRs. However, notwithstanding the limited nature of the securities services provided, there was until recently no exception or exemption of such four-RR-plus offices from the requirement of on-site “qualified” branch office manager supervision and control.

The concerns and reasons for the regulation of “branch offices” and “limited purpose” offices are simply assurance of adequate **supervision**. But technological advances in the recent (and not so recent) past have produced increasingly sophisticated supervisory abilities enabling members to more effectively supervise the activities of their associated persons in off-site locations remote from the supervisor. And although as usual the law has trailed technology, in these two areas the regulatory community is catching up to technology. But the blessings are mixed.

Regulation is Catching Up – with Some Pain

*Branch Offices.* On September 9, 2005 the SEC approved amendments to NASD Rule 3010 and NYSE Rule 342 which would provide a uniform industry definition (the “Uniform Definition”) of the term “branch office”. The amendments were the result of a proposal made jointly to the SEC by the NASD, NYSE and NASAA in December, 2003. They became effective with the NYSE on October 6, 2005, and will be effective within the NASD on March 1, 2006.

The new Uniform Definition of a “branch office” is “any location where one or more associated persons of a member regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security, or any location held out as such.” Perhaps more important than this basic definition, however, are the seven **exceptions** to the Uniform Definition. Excluded from the definition (and the requirements) of “branch office” are: (1) a back office; (2) an RR’s primary residence, provided certain other conditions are satisfied; (3) a non-residence location used for less than thirty (30) days per year for securities business; (4) a location of convenience used occasionally and only by appointment; (5) a location used primarily for non-securities business [e.g. sale of insurance or bank products] from which less than twenty-five (25) securities transactions are effected in any calendar year; (6) the floor of an exchange; and (7) a temporary location used as part of a business continuity plan.

As noted above, prior to the adoption of the Uniform Definition the SEC, NYSE, NASD and state securities regulators all defined the term “branch office” differently thereby requiring members to comply with differing requirements in each jurisdiction in which they conduct securities business. This required tracking numerous definitions, filing multiple forms to register, meeting differing deadlines and continually monitoring each jurisdiction for changes in its rules or procedures.

For example, in addition to the above NYSE definition, the state of Illinois defines “branch office” as “any office, residence or other place or location in this state where the business of a registered dealer is being con-

ducted... and where the business of a dealer is conducted by a principal, salesperson or sales persons for such registered dealer.” (No exception is made for residence of a RR used occasionally to make business telephone calls and other similar logical exceptions are made in Illinois, and in many other state definitions.) (Illinois reportedly will not renew its branch office notice requirement; the Missouri Securities Commission has no registration or notice requirement.)

Similarly, the term “branch office” was previously defined by the NYSE as “any location other than the main office from which the business of a member . . . is conducted.” Accordingly, locations such as a RR’s primary residence, purely administrative offices, and locations utilized only temporarily or intermittently (“offices of convenience”) were required to be registered as branch offices if any securities sales activities were undertaken there.

And, a “branch office” under NASD rules must pay an annual registration fee and have a branch manager **on-site**. And, under prior definitions, even small, temporary or residential locations were required to meet branch office requirements even if used primarily for non-securities activities (such as for insurance and commercial banking purposes) with few securities sales annually.

In addition to introducing uniformity into the “branch office” definition, the new definition – primarily through its exceptions - gives small broker-dealers added flexibility. That is, the Uniform Definition exempts from branch office registration and on-site supervisory presence non-residence locations used less than thirty (30) business days per calendar year and “offices of convenience”. Importantly, the Uniform Definition also exempts from branch office registration and other requirements any location used **primarily** in non-securities activities (e.g. insurance) provided the RR effects no more than twenty-five (25) securities transaction per calendar year.

Of course the locations which under the Uniform Definition may be excluded from the definition of a branch

office are subject to significant restrictions, including that such locations may not be held out to the public as branch offices, neither customer funds nor securities may be handled there, the RR’s communications to the public to and from such locations must be subject to the firm’s supervision by being placed through the firm’s systems, all orders must be entered through the actual designated branch office or main office and written supervisory procedures for such locations must be maintained by the member. NASD Interpretation IM-3010-1, promulgated with the new rule, emphasizes the existing requirement that members supervise all locations, including non-traditional offices not excluded from the definitions of “branch office”. The interpretation, to this writer, implies that regulatory oversight of such remote locations will be especially careful.

*Registration on new Form BR.* Concurrently with the development of the Uniform Definition, the NYSE, NASD and NASAA developed and proposed to the SEC the adoption of Form BR. Form BR would enable members to submit branch office application information to the NYSE, NASD, other SROs and states by electronically filing a single Form BR through the central registration depository (CRD). (Members currently furnish “branch location” information on Schedule E of Form BD, the Uniform Application for Broker Dealer Registration, and on various different state branch office registration forms.) Form BR may simplify filing requirements, but it is not necessarily simple. It is thirteen pages long (as compared with Schedule E, one page in length) and is accompanied by ten pages of instruction.

The Form BR eliminates duplicative forms and questions and reconciles inconsistencies among existing branch office filings with various SROs and states. To some extent, it also uses the same terms presently used in existing uniform forms. The Form BR was developed on the premise that firms would file it through the Web CRD, which will also benefit regulators. The system cross-checks between the Form BR and present and proposed Forms U4 and U5 will provide regulators greater assurances of the accuracy of information they receive concerning the locations from which RRs conduct busi-

ness. Also regulators will be able to generate reports through CRD-based information reported on the Form BR in conjunction with other information reported in the CRD system.

Now that the Form BR has been implemented, firms will be required to file it for each branch office in place of the existing NYSE branch office application, i.e., Schedule E of Form BD, and forms required by participating states. Firms will also be required to link registered individuals with the branch offices responsible for their supervision.

The Uniform Definition is Particularly Tough on "Limited Purpose" Brokers.

The combination of the Uniform Definition and the new Form BR has its detractors. A majority of the commenters to the NASD concerning the new definition expressed concerns about a perceived negative effect upon limited purpose broker-dealers, most frequently affiliated with life insurance and investment companies and banks. Such broker-dealers perform a much narrower range of services, frequently handling only variable contracts and mutual funds, and are licensed only therefore. They have generally structured their operations based upon the current definitions and will be presented with significant administrative and other costs complying with the Uniform Definition. Other commenters objected to the requirements concerning meeting with customers at a RR's primary residence, and suggested that the new Uniform Definition simply state that RRs shall not "regularly meet with customers at their residence." The NASD rather lightly dismissed this objection, stating that "there are certain fundamental costs associated with regulating any branch office, regardless of size or activity."

The NYSE has Adopted a New Interpretation Concerning "Limited Purpose" Broker-Dealers

But, recognizing that technology teamed with *properly structured* regulations of its members may significantly enhance the flexibility of the industry, the NYSE has proposed a new "Interpretation" of its Rule 342

which may significantly assist such limited-purpose brokers, and the SEC has approved it.

As noted above, except for "small offices", all NYSE member branch offices were required to have an onsite qualified manager, and under its Rule 342.15 "small offices" were restricted to three RRs or less. The SEC on November 29, 2005 approved the NYSE's proposal to permit member organizations to seek a waiver of the qualified supervisory branch office manager requirement for "Limited Purpose Offices" which have more than three RRs. The Limited Purpose Office is a new category of offices with RRs that conduct only limited business activities, or that have limited registration qualifications (e.g. Series 6 – mutual funds and variable contract products representatives or Series 52 -- municipal securities representatives) or may not offer a full range of products. The proposed interpretation sets forth a process by which members may seek a waiver of the NYSE's onsite branch office manager requirement on a case-by-case basis following prescribed criteria as set forth in the Interpretation.

The Exchange noted that it believes that more flexibility and discretion is needed to determine whether an onsite qualified branch office manager is required for limited purpose offices with more than three RRs. The interpretation would achieve that and would give added flexibility to members that acquire new offices through mergers, acquisition or regulatory changes, or who wish to structure their offerings with fewer than the full range of securities products (thus not requiring fully qualified supervision) sold in offices of more than three RRs. Under the Interpretation, members seeking a waiver would be required to provide a written plan of supervision and control acceptable to the NYSE, and of course all such Limited Purposes Offices would still be required to be under the close supervision of a main office or other designated branch office. The NYSE noted when it proposed the Interpretation that it in fact allocated supervisory requirements based on the risks actually involved by the specific activities which would actually take place, rather than based upon the simple fact of there being more than three RRs at a location. (In its proposal the

NYSE analogized this to the functional approach of the Gramm-Leach-Bliley Act, which used a similar actual risk-based approach, discontinuing the total exemption of any “bank” from the definition of and restrictions upon broker-dealers, and required such banks to be registered as broker-dealers when they were actually performing the functions of broker-dealers. See *St. Louis Broker-Dealer*, July, 2003.)

*Conclusion.* The combination of the new Uniform Definition of “branch office”, the CRD-based Form

BR and the NYSE Interpretation allowing waiver of the requirement of full supervisory capacity for Limited Purpose Offices of more than three RRs will significantly assist broker-dealers in placing their offices – and their RRs – out in the neighborhood, close to their clients. However, at least in the short run, these amendments, particularly the first two, may cause significant added expense and administrative requirements on small broker-dealers who have tailored their operations to the prior definitions of “branch office.”

## **Selling Away: You and Your RR Can Both Be Honest and Still Be Liable to Someone Who is Not**

by: Joe Soraghan (jsoraghan@dmfirm.com)

“Selling away”, as you know, occurs when an RR invests his client’s money without doing so at or through the brokerage firm at which he is employed. Although it occurs in all types of brokerage situations, it occurs most frequently in non-traditional, generally off-site situations. According to the NASD, selling away is the most frequently committed violation by off-site RRs. For example, RRs who also sell insurance products frequently operate in off-site locations, and selling away frequently occurs on the part of independent insurance agents registered only as Series 6 investment company and variable contract products representatives. These RRs are frequently targeted by issuers, promoters and marketing agents to sell variable contracts and promissory notes to their customers. In many instances these products constitute securities, but their promoters market them to RRs as non-securities products that do not have to be sold through the RR’s broker-dealer.

“Selling away”, also known as “private securities transactions”, is a violation by the RR of his obligation to submit to the supervision of his BD, and to allow it is a violation by the BD of its duty to supervise all securities transactions by the RR. “Selling away” is easy to

do even without knowing it. For example, the RR may innocently (he thinks) encourage friends and relatives, including some who do not have accounts with the RR or his BD but know he works for you, the BD, to loan some money to a real estate agency being started by the RR’s brother, and from which the RR may even derive no benefit. Believing the ventures to be unrelated to his day-to-day responsibilities as a RR, the RR does not advise his BD of these transactions. As luck would have it, the start-up real estate agency soon goes “belly up”, and those who made the loan - - i.e., invested in it - - lose their money. Of course, they are upset and some sue the RR. For the BD, the worst is yet to come: the investors in the real estate agency also sue you, the BD, and you learn that the law makes the claimants customers of your BD firm despite their never having an account with you. (This level of innocence by the RR is rare, but it happens. More often, of course, the RR intends that the client believe that he is operating for his BD.)

The unfortunate investors can sue the BD based on two theories: (a) the securities law requirement that a BD supervise the activities of its RRs, including establishing a reasonable supervisory system to detect an

# THE *St. Louis Broker-Dealer*<sup>TM</sup>

...continued

RR's improper activities away from the BD firm; and (b) the agency theory of "respondeat superior," which makes employers liable for the actions of their employees, including independent contractors, because they clothed the employee with the "apparent authority" to engage in these outside business activities. (Courts and arbitrators usually hold that only the claim of *failure to supervise* is available to customers of BDs, but some have given recovery under the doctrine of respondeat superior. "Selling away" also subjects BDs and RRs to sanctions by regulators, but that is not the topic here.)

However, the BD will not be liable for the RR's actions if the BD "has established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect...such violations..." and has reasonably implemented those procedures. The BD must vigorously investigate "red flags," i.e. suggestions of irregularity or unusual trading activity.

Of course, the standard techniques for supervision and investigation of RRs will disclose many, if not most, indications of the possibility of past or future "selling away" by an RR. Examples of *general* methods include, prior to employment of the RR, detailed review of the RR's U-4s and U-5s, followed after employment by generation and review of exception reports, questioning customer complaints, large number of elderly customers, etc. However, some techniques can be used to focus *specifically* on "selling away," such as credit checks to determine when an RR is in a precarious personal financial situation (which may be reduced by revenue generating outside activities not requiring him to reimburse the brokerage firm), checks concerning a life style seemingly not supported by the RR's production through the BD, detailed reviews of the RR's correspondence, personal and otherwise, surprise inspections (particularly at off-

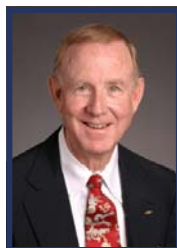
site and other non-traditional locations), in-person interviews of not only the RR, but also the RR's assistant or support staff about the office's business and any unusual evidence of activity in the RR's office or of outside activities not disclosed to the BD (typically found in surprise inspections), dramatic decrease in the funds of customers, showing their withdrawal of funds to purchase investments being "sold away" from the BD, dramatic declines in RR production as the assets under the BD's management decline through the customers' purchase of outside investments, the appearance in the RR's personal account of investments not sold through the BD, and review of all e-mails received and sent by the RR. If suspicious activity is found, follow-up could include more intense review, such as monitoring usage of the firm's stationery (which the RR may use with customers to falsely indicate he is operating with, or that the outside investment has the approval of, the BD), directing the RR's secretary or assistant to assist in monitoring, checking the office of the Secretary of State to determine if any entities have been created using the RRs name or names similar to it, or if his/her name appears as an officer of any such entity, etc.

Obviously, determining whether "selling away" has occurred is very difficult and the investigations therefore must be sophisticated. Also they may, of necessity, be more intrusive than investigations of other violations. Of course, every BD's operations are different, and a through analysis thereof will indicate "selling away" determination methods better than, or in addition to, those above.

Questions? Call 314.726.1000

[www.dannamckitrick.com](http://www.dannamckitrick.com)

150 N. Meramec, Fourth Floor  
St. Louis, MO 63105



*Joe Soraghan represents broker-dealers and registered representatives in court, in arbitrations and mediations, and before the SEC and state securities commissions. He is a frequent arbitrator and mediator for the NASD. Published in several law reviews and a frequent speaker on securities, Joe also teaches Securities Law Litigation and Arbitration as an adjunct professor at Washington University School of Law.*

Copyright©2006 Danna McKitrick, P.C. All rights reserved.