

CHAPTER 3

Regulation of Broker-Dealers

So far, everything discussed in this study guide has pertained to investment advisers and their representatives. These are people and firms who, for a fee, provide investment advice. It's very important to note though, that they receive their fee for providing advice, regardless of whether or not the advice actually leads to the purchase or sale of securities (investments). In other words, sometimes they get paid for simply telling people to stay put and not move their money from one investment to another.

By contrast, broker-dealers and their agents (more on their agents in Chapter 4) get paid when their customers actually complete a transaction (buying or selling). If no buying or selling takes place in an account, no fees or commissions are generated. Any investment advice a broker-dealer or their agent gives, even though some seem to give a lot, is considered "incidental" to the transaction itself, unless a separate agreement is in place to provide investment advice.

While that may seem like a pretty cloudy line between being an investment adviser and a broker-dealer, it's one that regulators take very seriously. To operate in either capacity, you have to be appropriately registered to do so. Interestingly enough, regulators have no problem with the same person or firm acting in both capacities, even for the same client, as long as it is done in an ethical manner. But again, the professional or firm must be properly registered in each capacity.

Broker-Dealer – Definition

While the term "investment adviser" from Chapter 1 is fairly self-explanatory, the term "broker-dealer" is often much more confusing for test takers. Take a look at the definition from the Uniform Securities Act and see if the picture comes any more into focus.

"Broker-dealer" means any person engaged in the business of effecting transactions in securities for the account of others or for [the person's] own account.

That’s a pretty straightforward definition compared to the lengthy definitions of investment adviser and investment adviser representatives, is it not? But, it still doesn’t tell you exactly what a broker or dealer is, does it?

The easiest way to understand these two terms is to start with the heart of the definition above. Brokers and dealers help people *effect transactions in securities* (buy or sell stocks, bonds, etc.). That means they actually are involved in the mechanics of money and securities changing hands on behalf of their customers.

The difference between operating as a broker or a dealer comes in the second part of that definition, where it says they do it “for the account of others or for [their] own account.” In short, brokers act as the go-between for two parties interested in making a transaction, whereas dealers are simply buying from or selling to the consumer out of the inventory of securities that they already own.

An easy way to visualize this is by thinking about the sale of real estate. A real estate *broker* helps a buyer find a seller, or a seller find a buyer. They’re a financial “matchmaker” if you will. Someone who decides to skip the middleman, list their home “For Sale By Owner,” essentially handles the *deal* themselves. Their home is their *inventory* that they’re selling directly to the public.

So does that mean that everyone who helps two people complete a transaction, or buys and sells for their account is a broker-dealer? As always, there’s a list of exceptions that will very likely be tested on the Series 63.

Exceptions to the definition of a broker-dealer at the state level:

(1) an agent

 **Explanation:** Just like an investment adviser representative is an employee of an investment adviser, an agent is the proper terminology for employees of broker-dealers. Since there is actually a separate type of registration for agents of broker-dealers, they don’t have to register as a broker-dealer.

(2) an issuer

 **Explanation:** Issuers (creators) of securities, as well as the securities they issue, are subject to separate registration requirements from broker-dealers when they conduct these activities.

(3) a bank, savings institution, or trust company

 **Explanation:** Under the Uniform Securities Act of 1956, banks, savings institutions, and trust companies are exempt from registration as a broker-dealer.

Registration of Broker-Dealers

Persons or firms who do not have a physical office in a state do not have to register in the state if their only clients are:

(i) the issuers of the securities involved in the transactions

 **Explanation:** In other words, if the only transactions someone does in the state are with the people who actually created the securities being bought or sold, registration is not required. So, if IBM were to issue a new type of bond and a person or firm were to buy those bonds directly from IBM, the person or firm would not be required to register in the state in which IBM is selling them the bonds.

(ii) other broker-dealers



 **Explanation:** Similar to not being required to register when dealing with a security's issuer, someone dealing only with another broker-dealer is not required to register in that state. In essence, the law basically does not require a person or firm to jump through the hoops of registration if they're dealing only with individuals or firms who are industry professionals and don't need nearly as much regulatory protection.

(iii) [institutional investors]

 **Explanation:** Like dealing with the actual issuers of securities and other broker-dealers, individuals and firms dealing only with *institutional* investors don't need to register. These institutional investors, who handle very large amounts of money, are viewed as having enough sophistication to watch their own backs without as much help from regulators.

Since it'll come up again and again, you should memorize the fact that an institutional investor is someone or something that fits into one of the following categories:

- a bank, savings institution, or trust company
- an insurance company
- an investment company (mutual fund)
- a broker-dealer
- a pension or profit-sharing trust
- another financial institution or institutional buyer

 **Test Note:** A person or firm who has an office in a state must register in that state. A person or firm who does not have an office in a state does not have to register in a state if they have only institutional clients. A person or firm who does not have an office in a state does have to register in a state if they have even one non-institutional client.

 **Test Note:** Different rules use different standards for who counts as an institutional client. For example, broker-dealers may avoid registration based on the above list of "institutional buyers." Investment advisers, on the other hand, have a registration exemption based on limiting their business to "institutional investors" (plus up to five non-institutional investors). FINRA has its own definition of who counts as an "institutional investor" for purposes of communications. While there is much overlap between these

three categories (“institutional buyers” and “institutional investors” in the Uniform Securities Act, and “institutional investors” in FINRA’s rules), they are not identical.

A person is also not considered to meet the definition of a broker-dealer in a given state if:

the person is licensed under the securities act of a state in which the person maintains a place of business and the person offers and sells in this state to a person who is an existing customer of the person and whose residence is not in this state.

🧠 **Explanation:** In other words, selling to an existing customer while they’re in a state that is not their state of residence, does not by itself, require a broker-dealer to register in that state.

📌 **Test Note:** Subsidiaries of bank holding companies that effect securities transactions with the public must register as broker-dealers. Commercial banks are exempt.

EXCEPTIONS FOR CANADIAN BROKER-DEALERS

While a broker-dealer from Canada may not come and set up shop in any state without jumping through the required regulatory and registration hoops, there are some exceptions that permit them to operate within a state using a limited registration.

These exceptions are built around the basic premise that the Canadian firm does not have offices in that state, in which case they can transact securities with a client located in that state if:

1. the client is from Canada, and is temporarily in that state, and had a relationship with the Canadian broker-dealer prior to entering the state
2. the client is engaging in transactions for a self-directed tax advantaged retirement plan held in Canada, for which they are the holder or contributor
3. the client is an institutional investor

Agents (stockbrokers) working for one of the broker-dealers in the previous three situations may also use a limited registration.

To obtain this limited registration, the Canadian broker-dealer would have to:

- file an application in the form required by the jurisdiction in which it has its principal office
- file a consent to service of process
- provide evidence of good standing in the jurisdiction where the broker-dealer is registered
- file proof of membership in a Canadian Self Regulatory Organization (SRO) or Canadian stock exchange
- make records available to the Administrator on business done in that state
- inform the administrator of any criminal action taken against it

- disclose to clients in the state that the Canadian broker-dealer is not subject to the state's full regulatory requirements
- pay a filing fee

THE REGISTRATION PROCESS

Broker-dealers must almost always register at a federal level, in addition to meeting state registration requirements. The only way that registration is permitted *only* at the state level is if all transactions and all aspects of the transactions are conducted or expected to be conducted within state boundaries. Since the vast majority of broker-dealers will at some point use third-party services located out of their state, virtually no broker-dealers choose to go this route.

To federally register, a broker-dealer must use the Central Depository Registration system to file a Form BD. This form requires important background information on the broker-dealer including key personnel, contact information, and disclosures of any previous regulatory violations. Additionally, the broker-dealer must register with the appropriate self-regulatory organizations (SROs) and the Securities Investor Protection Corporation (SIPC).

An application for registration becomes effective at noon on the 30th day after the application is initially filed, unless the state requires additional information or denies the application. If a state's administrator wishes to initiate a hearing based on an applicant's admission of a final judicial or administrative order made against them prior to registration, they have 90 days to do so following registration or they may no longer use that information to challenge a broker-dealer's registration.

A broker-dealer's registration remains in effect until midnight of December 31st of the year for which the registration is filed. If a renewal was not filed, the registration is considered revoked. This means that a broker-dealer who initially registers on November 15th must renew their registration less than two months later.

When a broker-dealer files an application for a successor firm for the unexpired portion of the year (from the time of filing to December 31st), they do not need to pay a filing fee.

NET CAPITAL REQUIREMENTS

As with investment advisers, states require broker-dealers to meet net capital requirements both prior to registration and at all times while their registration remains active. Unlike the simpler investment adviser's requirements however, the broker-dealer capital requirements use complex formulas that go beyond the scope of the Series 63 exam. It's sufficient to say that you need to know that broker-dealers are subject to substantial net capital requirements.

You will also need to know that the state cannot require broker-dealers to meet net capital requirements that exceed SEC net capital requirements.