

Client Advisory

March 2002

SEC Revises Broker-Dealer Recordkeeping Requirements

The Securities and Exchange Commission (the “SEC”) recently adopted amendments to its broker-dealer books and records rules – Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 (the “New Rules”). These New Rules are designed to clarify and expand certain recordkeeping requirements, including those regarding purchase and sale documents, customer account information, records concerning associated persons and customer complaints. They also require broker-dealers to maintain or promptly produce certain records at the particular office to which they relate. The adopting release, Release No. 34-44992 (November 2, 2001) (the “Adopting Release”), can be found at www.sec.gov/rules/final/34-44992.htm. The effective date of the New Rules is May, 2, 2003.

The New Rules were developed to assist regulators, especially state securities regulators (“State Regulators”), in their examinations of broker-dealers. The SEC originally proposed amendments to Rules 17a-3 and 17a-4 in 1996, responding to certain concerns raised by the North American Securities Administrator’s Association. Subsequently, Congress enacted the National Securities Market Improvement Act of 1996 (“NSMIA”), which, in part, prohibits States from imposing books and records rules differing from or adding to SEC rules. However, NSMIA also requires the SEC to consult periodically with the States regarding books and records

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rules. The New Rules are meant to address the States’ concerns; however, while the changes originally proposed were in some places quite burdensome, the New Rules are more limited and, as noted in the Adopting Release, self-regulatory organization (“SRO”) rules already require retention of many of the items found in the New Rules.

I. Amendments to Rule 17a-3

The amendments to Rule 17a-3 include revisions to the information required on order memoranda and new recordkeeping requirements relating to associated persons, certain customer accounts (with verification requirements), customer complaints, advertising and communications with the public. The New Rules also require broker-dealers to record the identity of persons responsible for establishing procedures and of those able to explain the firm’s records to regulators.

A. Order Memoranda. Rule 17a-3(a)(6)(i) has been amended to require that the memorandum of each brokerage order identify “the associated person, if any, responsible for the account” and “any other person who entered or accepted the order on behalf of the customer.”¹ The record also must indicate whether the order was entered pursuant to discretionary authority. The associated person responsible for the account must be identified only if the firm assigns responsibility for accounts to particular associated persons. The rule is not designed to create an affirmative obligation to assign an associated person to each account. The memorandum also must include the time the firm received the order, even if it is subsequently transmitted to another firm for execution.²

A broker-dealer may use an identification number or code instead of the associated person’s name. If the person entering the customer order does not have a specific identification number or code, the firm may use the number or code of the computer terminal on which the order was entered but must provide the identity of the person who entered the order on request from a regulator. If an order is entered on an electronic system by the customer, a notation should be made. (The SEC believes that most firms that accept orders through an electronic system already identify those orders that are entered directly by a customer and that, therefore, this requirement will not create significant additional burden.)

Under New Rule 17a-3(a)(7), records for dealer transactions with customers (other than other broker-dealers) must now generally include the same information as brokerage tickets, including time of receipt, execution and/or cancellation, price and the terms and conditions of the order and modifications thereto. This record also must identify the associated person, if any, responsible for the account, any other person who entered or accepted the order on behalf of the customer, and whether the order was entered pursuant to discretionary authority.

For transactions such as purchases of mutual funds or variable annuities, where the customer fills out an application or a subscription agreement that includes information specific to the particular type of transaction, the firm may keep a copy instead of making a separate record. Automatic dividend reinvestments are exempt from the rule.

B. Records Regarding Associated Persons. Rule 17a-3(a)(12) currently requires firms to retain records regarding each associated person, including their employment and disciplinary history. The New Rules add a requirement to maintain a record of all associated persons showing every office where each one regularly conducts business and listing the CRD number and any internal identification numbers assigned to associated persons. This is to allow regulators to interpret records that identify associated persons through such numbers. Persons whose functions are solely clerical or ministerial are excluded from this requirement.

C. Customer Account Records. New Rule 17a-3(a)(17) requires broker-dealers to record certain minimum customer information, in order to provide regulators (especially State Regulators) with access

¹ If the order is entered into an electronic system that generates the record, and that system is not capable of receiving the identity of anyone other than the responsible associated person, the firm must produce a separate record identifying such other person upon request by a regulator.

² Where the time of entry is simultaneous or nearly simultaneous with the time the order is received, the firm does not have to make a separate entry for each time. However, it must be clear from the order ticket that the time of receipt was the same as the time of entry, and the time recorded must be accurate. The SEC specifically stated that this is not to be construed as an exception to allow firms to use an *approximate* time for either entry.

to books and records to review for compliance with suitability rules. New Rule 17a-3(a)(17) also requires broker-dealers to provide that information to each customer periodically for verification. The rule is not intended to supersede or otherwise affect any federal, State, or SRO “know your customer,” suitability or supervisory requirements.

1. Information. New Rule 17a-3(a)(17)(i)(A) requires, for each account with a *natural* person, the customer’s name, tax identification number, address, telephone number, date of birth, employment status and occupation, indication of whether the customer is an associated person of a broker or dealer, annual income, net worth, and investment objectives. (The SEC points out that most firms already collect this information.) Firms may combine joint owners’ financial information instead of obtaining and maintaining it separately for each joint owner. The investment objectives should be those for the account and not the individual owners. Although a firm must create a single record for each account, it may consist of more than one document, such as two or more account applications. For discretionary accounts, firms must include the dated signature of each customer granting discretion and the dated signature of each natural person to whom discretion is granted.

The record must indicate whether it was signed by the associated person, if any, responsible for the account, and approved or accepted by a principal. Where the firm does not assign an associated person to each account, the record still must indicate whether a principal approved the account.

2. Furnishing the Information to the Customer. To reduce misunderstandings between customers and broker-dealers, New Rule 17a-3(a)(17)(i)(B) requires firms to periodically furnish the account information to the customer.³ This will permit the customer to review and verify the information the firm uses to make recommendations or suitability determinations. Four provisions trigger the requirement: (i) opening a new account; (ii) periodic updating of an account (which must occur at least once every 36 months); (iii) change of customer name or address; and (iv) change of other information. Firms also must describe the terms used for categories of investment objectives when furnishing the record to customers.

Firms may combine this mailing with others and may print the information on a customer account statement. A firm may mail a copy of the customer’s complete account record, reflecting any changes, no more than 30 days after the date the firm receives notice of such changes, or with the next scheduled customer statement.

3. Failure of a Customer to Provide Information. Firms are required to make a good faith effort to collect the information. Although firms are not required to record an explanation of the customer’s neglect, refusal, or inability to provide the required information (which was included in the SEC’s original proposal), if the record does not include the required information, the firm will bear the burden of explaining the absence of the information.

4. Exemption from Information Requirements. Broker-dealers are not required to create an account record for an account if the firm is not required to make suitability determinations with regard to that account. However, “suitability determination” is interpreted broadly under the recordkeeping requirement to include any obligation to perform a suitability determination under the Exchange Act,

³ Broker-dealers are not required to include the customer’s tax identification number and date of birth with the information provided to the customer, reflecting the fears of several commenters that unauthorized access to such information could facilitate fraud against the customers.

SEC rules, SRO rules or common law. If, after the account is opened, the firm engages in conduct that would require it to make a suitability determination, the firm first must obtain the information and will be required to comply thereafter with the verification obligation. For accounts existing on the effective date of the New Rules, a firm will not be required to create or update account records if the firm has not been required to make a suitability determination for that account in the immediately preceding 36-months.

Rule 17a-3(a)(17) does not change or limit a broker-dealer's obligation to make suitability determinations. Even if a firm is not required to create an account record under Rule 17a-3(a)(17), it still must comply with all other applicable laws, rules and regulations requiring collection of account information.

5. Grace Period. For accounts opened on or after the effective date, firms must obtain the required information under New Rule 17a-3(a)(17)(i)(A) when the account is opened. Firms will have 36 months to obtain the required information for accounts existing on the effective date. The 36-month cycle for furnishing information to the customer begins the day the firm obtains the account information for the first time.

6. Written Customer Agreements. To allow customers to review the terms to which they are subject and to better understand their rights and responsibilities (and those of the broker-dealer), New Rule 17a-3(a)(17)(iii) requires firms to record that each customer was furnished with a copy of any written agreement entered into on or after the effective date and that a fully executed copy of any agreement relating to their account was provided upon the customer's request.

D. Complaints. New Rule 17a-3(a)(18)(i) requires a separate record for each associated person containing the details of any written customer complaint (including those received electronically). Alternatively, firms may keep originals of written complaints, with a record of disposition (by name of associated person). Under New Rule 17a-3(a)(18)(ii), firms also must provide customers with an address and telephone number to which complaints may be directed and must maintain a record that this has been done. This rule does not change or limit a broker-dealer's responsibilities under SRO and other regulations regarding customer complaints.

E. Compensation. New Rule 17a-3(a)(19)(i) requires a record of each securities transaction attributable for compensation purposes to each associated person, which must include the amount of monetary compensation and a description and estimate of the value of any non-monetary compensation. Firms must record all commissions, concessions, overrides, and other compensation to the extent that they are earned or accrued for transactions. In lieu of making this record, the firm may choose to produce the information promptly upon request of a regulator. "Non-monetary compensation" includes sales incentives, gifts, or trips provided to associated persons if certain sales goals are reached. If sales would be counted toward these goals, a record of the sales should be made whether or not the goal is reached. Non-monetary compensation does not include items of *de minimus* value distributed by the firm.

Under New Rule 17a-3(a)(19)(ii), firms must maintain a record of all agreements regarding the relationship between the firm and each associated person, including a summary of each person's compensation arrangement. Where compensation is based upon factors other than per trade remuneration, the firm must record the method for determining compensation. This includes verbal agreements and any records, such as commission schedules, that may change periodically.

F. Communications with the Public. New Rule 17a-3(a)(20) requires each firm to document that it has complied with or adopted policies and procedures reasonably designed to establish compliance with

federal regulations and SRO rules that require a principal to approve advertisements, sales literature or other communications with the public. This is to allow State Regulators to examine for compliance with SRO rules and, according to the SEC, should not establish any new responsibilities. The SEC did not delineate specific types of advertisements or sales literature, instead deferring to SRO rules.

G. Persons to Explain Records. New Rule 17a-3(a)(21) requires a record, by name or title, of each person at an office who, without delay, can explain the types of records the firm maintains at that office and the information contained in those records. A firm may identify more than one person, with a list of the records that each person is able to explain.

H. Listing of Firm Principals. New Rule 17a-3(a)(22) requires a list of each principal responsible for establishing policies and procedures reasonably designed to ensure compliance with applicable regulatory requirements. For these purposes, “principal” includes any person registered as a principal or branch manager or any other person who has been delegated supervisory responsibility. (New Rule 17a-3(g)(2).)

II. Office Records

Originally, the State Regulators wanted a requirement that records as to a particular office be maintained at that office, even if only electronically, because they had encountered costly delays in conducting examinations when records were maintained at another office. According to the SEC, this requirement was the one most seriously disputed by broker-dealers.

As a compromise, New Rule 17a-4(k) requires certain records pertaining to a particular office to be maintained at that office for the first two years after their creation. These include employment records (including compensation arrangements), records regarding complaints and communications with the public, written procedures and records of principals and persons who can explain records and their contents. The definition of “office” includes any location where an associated person regularly conducts business (except a customer’s office that an associated person may visit on a regular basis).⁴ However, as an alternative, a firm may choose not to maintain the records at the local office *provided* it produces the records “promptly” upon request of a regulator. Although “promptly” is not defined in the New Rules, the Adopting Release states that for records available on-site or electronically, “promptly” generally should be the day of the request. For unusually large or complex requests, the firm should establish with the regulator a time-frame for production. Records for foreign offices may be maintained at the firm’s main office.

III. Rule 17a-4

A. General Requirements. Presently, Rules 17a-4(a) and 17a-4(b)(1) list certain records required under Rule 17a-3 that must be kept for six and three years, respectively. Amendments have been made to these paragraphs so as to remain consistent with the changes to Rule 17a-3.

⁴ When an associated person’s residence is an office, the broker-dealer is not required to produce records at the residence if only one associated person (or multiple associated persons residing at that location that are members of the same immediate family) regularly conducts business at the office, the office is not held out to the public as an office, and neither customer funds nor securities are handled there. Instead, the firm may either maintain the records at another location within the State or promptly produce them at an agreed upon location. Where an associated person works from multiple offices, a firm may treat all the locations as a single office.

B. Retention of Communications. Rule 17a-4(b)(4) currently requires retention of originals of all communications (paper or electronic) received and copies of all communications sent by the firm relating to its broker-dealer business, including inter-office memoranda and communications. The New Rules add retention of communications, such as advertising, subject to SRO “communications with the public” rules (to provide State Regulators with access to the records). Any written procedures a firm uses for reviewing communications must be maintained in accordance with new Rule 17a-4(e)(7) (see ¶F, below).

C. Organizational Documents. Current Rule 17a-4(d), which requires maintenance of certain organizational records, has been modified to clarify that organizational records of entities not specifically mentioned in the existing rule (for example, Limited Liability Companies) must be preserved. Also, every firm is required to maintain copies of its Form BD and all amendments thereto. According to the SEC, this requirement simply codifies current practice.

D. Account Record Information. New Rule 17a-4(e)(5) requires broker-dealers to retain account record information for six years, beginning either when the account is closed or when the information is replaced or updated.

E. Special Reports. New Rule 17a-4(e)(6) requires a firm to keep for three years, copies of all reports that a regulator has requested or required the firm to create, including those requested or required under an order or settlement requiring the firm to produce such report.

F. Compliance, Supervisory and Procedures Manuals. New Rule 17a-4(e)(7) requires retention of copies of all compliance, supervisory and procedures manuals currently in use and for three years after the last use of each manual (including updates, modifications and revisions).

G. Exception Reports. New Rule 17a-4(e)(8) requires maintenance of copies of exception reports used to review activity in customer accounts. Alternatively, a firm may elect to promptly re-create reports upon request by a regulator. If the broker-dealer elects to re-create reports, but changes its systems so that it is unable to do so, the firm may provide a copy of the report in the format presently available using historical data, with an explanation of any system change that affected such report. If the firm is unable to re-create the report in any format, the firm may instead provide the parameters that were used to generate the report for the specified period.

IV. Technical Amendments

A. Electronic Storage Media. Currently, Rule 17a-4 allows firms to use electronic storage media to maintain records. Currently, a broker-dealer that uses electronic storage must be ready to provide a copy on request by the SEC or its representatives and to contract with a third party download provider that will furnish promptly to the SEC, its designees or representatives, the information necessary to download electronically stored information. The New Rules provide SROs and State Regulators with access to these records as well.

B. Other Technical Amendments. The SEC also updated the list of stock exchanges in Rule 17a-3(a)(12)(i) for which an associated person’s application for registration or approval may be used to satisfy that paragraph’s requirements, and amended Rules 17a-3 and 17a-4 to replace masculine references with gender neutral references.

We Can Help

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