

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 241

[Release No. 34-47910]

Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation.

SUMMARY: The Securities and Exchange Commission is publishing guidance to clarify certain issues relating to broker-dealer books and records rules. Some of these issues have been raised as a result of the amendments to these rules that were adopted on October 26, 2001.

EFFECTIVE DATE: May 29, 2003.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

I. Introduction

Section 17(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act") requires registered broker-dealers to make, keep, furnish, and disseminate reports the Securities and Exchange Commission (the "Commission") deems "necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title." Rule 17a-3¹ and Rule 17a-4² under the Exchange Act (the "Books and Records Rules") specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents relating to a broker-dealer's business must be kept.

The Commission amended its Books and Records Rules on October 26, 2001³ to clarify and expand recordkeeping requirements with respect to purchase and sale documents, customer records, associated person records, customer complaints, and certain other matters. The amendments expanded the types of records that broker-dealers must maintain and required broker-dealers to

maintain or promptly produce certain records at each office to which those records relate. The amendments were designed to assist securities regulators, particularly State⁴ securities regulators, when conducting sales practice examinations of broker-dealers. Certain interpretive questions have arisen regarding these amendments.

II. Interpretive Questions

The Commission has received questions from broker-dealers, industry representatives, and regulators, requesting clarification of certain requirements under the Books and Records Rules. These questions, along with the Commission's answers to these questions are as follows:

Question #1

New paragraphs (a)(6) and (a)(7) of Rule 17a-3 require a broker-dealer to create a record of each brokerage order and for each purchase or sale for the account of the broker-dealer showing, among other things, the time the order was received. Under Rules 17a-3(a)(6) and (a)(7), is the broker-dealer required to record the time of receipt of an order to purchase a mutual fund, variable annuity, or direct participation plan that is effected on a basis other than subscription—way where the purchase price is determined only once daily at the close of business?

Answer #1

If the time of receipt is material to an order, then the broker-dealer must record the time of receipt on the order ticket. Generally, for many types of transactions, the time of receipt may be material to the price or other terms of the execution of the order. For example, recording the time of receipt would be material if an intra-day time deadline existed that determined whether the order was priced as-of the date the order was received or the price as-of the next day. If the broker-dealer does not record the time of receipt of an order, the broker-dealer must be able to demonstrate that the time of receipt is not material to that order.

Question #2

New Rule 17a-3(a)(17) provides that each registered broker-dealer must create an account record for "each account with a natural person as a customer or owner." Broker-dealers have specifically asked whether the term "account with a natural person as

a customer or owner" would include accounts of a corporation, partnership, limited liability company, or trust, or a Uniform Gift/Transfer to Minor Act (commonly referred to as an UGMA or UTMA) account, IRA account, or 401k account?

Answer #2

The account record requirement of Rule 17a-3(a)(17) does not apply to an account for which the customer or owner is not a natural person, such as the account of a corporation, partnership, limited liability company, or REIT. Similarly, where the account is owned by the trustees of the trust or a trust that is a legal entity separate from the holders of its beneficial interests (which may be natural persons) the account record requirement does not apply. However, the term "owner" in Rule 17a-3(a)(17) would generally apply to an UGMA/UTMA account, an IRA account and a 401k account where the beneficiary of the account is a natural person.

We remind broker-dealers, however, that paragraph (a)(17)(i)(D) of Rule 17a-3 provides that the account record requirement only applies to accounts for which the broker-dealer is, or has within the past 36 months been, required to make a suitability determination under the Federal securities laws or under the requirements of a self-regulatory organization of which the broker-dealer is a member. If the firm has not been, within the past 36 months, required to make a suitability determination for recommendations about securities made to the customer of an account under federal laws or the requirements of a self-regulatory organization of which it is a member, then the firm would not be required to make the records described in new paragraph 17a-3(a)(17).

As noted in the Adopting Release, application of new paragraph 17a-3(a)(17) does not limit any other Federal law or regulation or SRO rule that requires that a broker-dealer collect information regarding its customers.⁵

Question #3

New Rule 17a-3(a)(17) applies to an "account with a natural person as a customer or owner." Would the Commission consider a 401k account where the employer has established an omnibus account at the broker-dealer holding the assets of all its employees to be within the purview of this rule? How about a bank trust account where the bank has established an omnibus

⁵ See text accompanying note 43 in the Adopting Release. 66 FR 55818, at 55822 (Nov. 2, 2001).

¹ 17 CFR 240.17a-3.

² 17 CFR 240.17a-4.

³ See Exchange Act Release No. 44992 (October 26, 2001), 66 FR 55818 (Nov. 2, 2001) (the "Adopting Release").

⁴ Exchange Act § 3(a)(16) states, "the term 'State' means any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States" (15 U.S.C. 78c(a)(16)).

account at the broker-dealer holding the co-mingled assets of the banks customers and the bank's customers are not aware that their assets are held by the broker-dealer?

Answer #3

No. The 401k account or bank trust account described above would not be subject to Rule 17a-3(a)(17).

Question #4

New Rule 17a-3(a)(17) provides that each registered broker-dealer must keep a record indicating that the broker-dealer has furnished all information required by paragraph (a)(17)(i)(A) to each customer or owner at specified intervals. To whom should this account record information be sent in the case of a trust?

Answer #4

In the case of a trust, the account record information should be sent to the same person that receives account statements for that account.

Question #5

A broker-dealer is required, pursuant to new paragraph 17a-3(a)(17)(i)(B), to provide a copy of the account record to the customer (i) Within 30 days after opening an account and thereafter at intervals no greater than every 36 months, and (ii) within 30 days after certain account record information has been changed. If one customer has a personal account, a separate IRA account, and a trust account for his child at the same broker-dealer, and has agreed in writing to receive account-related documentation, such as account statements, on a combined basis, may the firm meet its requirements under Rule 17a-3(a)(17) by combining in one mailing the account record information for all three accounts? Would the answer be different if spouses living at the same address each had a personal account and agreed to receive account documents on a combined basis for their personal accounts?

Answer #5

If the customer has agreed in writing to receive account-related documentation on a combined basis for multiple accounts at the same address, the broker-dealer may send account record information regarding each of those accounts to the customer in a combined mailing. However, the account record information should be separated by account so the customer can easily identify the account record information that relates to each account. If spouses living at the same address have agreed to receive account

documents on a combined basis for their personal accounts, the broker-dealer may send account record information regarding each of those accounts to the customer in a combined mailing.

Question #6

New paragraph (a)(17)(iii) of Rule 17a-3 requires that a broker-dealer create a record for each account indicating the customer or owner was furnished with a copy of each written agreement entered into on or after the effective date of the rule and that, if requested by the customer or owner, the customer or owner was furnished with a fully executed copy of each agreement. Would an instruction to wire monies out of a customer's account be considered a "written agreement," a copy of which must be provided to the customer pursuant to the new rule?

Answer #6

An instruction received by the broker-dealer from the customer would not constitute a written agreement for purposes of this rule. Examples of written agreements contemplated by this new paragraph would include customer account agreements, margin agreements, options agreements, or securities lending agreements. However, a written instruction sent by the customer to the broker-dealer would constitute a communication received by the broker-dealer relating to its business as such, and should be maintained in accordance with paragraph 17a-4(b)(4).

Question #7, Parts A and B

Background

A broker-dealer may create a team of associated persons to handle business with a particular customer rather than designating one associated person as being responsible for the account. In this situation, no individual team member is directly compensated for a particular transaction; instead, each transaction by that customer is credited to the team for compensation purposes. Consequently, when a member of the team creates an order ticket, the broker-dealer often only records the identity of the team on its order ticket as having entered the order.

Part A

New provisions to paragraphs (a)(6) and (a)(7) of Rule 17a-3 require a broker-dealer to record on the order ticket the identity of the associated person responsible for the account and the identity of the person who entered or accepted the order on behalf of the customer. If a broker-dealer has assigned a team of associated persons to a customer's account, must it record the

identity of a particular associated person on the order ticket to meet these new requirements?

Answer #7, Part A

In the Books and Records Release, the Commission stated that a firm may comply with Rule 17a-3(a)(6) and (a)(7) if it records on the order ticket an identification number or code assigned to the person entering or accepting the order or the computer terminal at which an order was entered or accepted, provided that the firm has created and maintained as part of the order ticket records a companion record that can be used to identify the associated person entering the order. Similarly, the broker-dealer may record the identity of the team on the order ticket, provided it creates and maintains a companion record that can be used to identify the associated person that entered that order. The companion record would be part of the firm's order ticket records and must be maintained, preserved, and available for examination in the same manner as the firm's order tickets.

Part B

New Rule 17a-3(a)(19)(i) requires a broker-dealer to create a record, as to each associated person, listing each purchase and sale of a security attributable for compensation purposes to that associated person. If a broker-dealer has created a team of associated persons as described above, must it create a separate duplicate record for each associated person listing each transaction attributed to the team to comply with this rule?

Answer #7, Part B

To comply with Rule 17a-3(a)(19)(i), a broker-dealer that has created a team of associated persons as described above may create a single record that identifies each transaction attributable to a particular team for compensation purposes provided that the firm also creates and maintains as part of this record a companion record that identifies each associated person that has been a member of that team, including the dates the person joined and left the team, and the manner in which compensation is allocated among the members of the team.

Question #8

New Rule 17a-3(a)(19)(i) requires each broker-dealer to create a record as to each associated person listing each purchase and sale of a security attributable, for compensation purposes, to that associated person. The record shall include the amount of compensation if monetary and a

description of the compensation if non-monetary. The Books and Records Release states that:

The term "non-monetary compensation" includes compensation such as sales incentives, gifts, or trips that would be provided to associated persons if certain sales goals were achieved. Such non-monetary compensation should be recorded if directly related to sales. If sales would be counted toward achieving these goals, then a notation of the sales should be made regardless of whether that goal is actually achieved.⁶

Assume the following fact pattern. A broker-dealer with 100 registered representatives, at the end of each year, reviews the sales performance of all of its registered representatives, and sends the five representatives that have generated the most commission revenues for the firm to Hawaii for a week. Under this sales incentive plan, registered representatives do not receive additional credit for earning commissions on any particular product or type of products. The broker-dealer has created a record pursuant to Rule 17a-3(a)(19)(i) for each associated person listing each transaction that contributed to their achievement of this non-monetary compensation because those persons received monetary commissions for each transaction. Would the firm be required under Rule 17a-3(a)(19)(i) to separately note on the record for each associated person the trip to Hawaii as potential compensation?

Answer #8

In this circumstance, a broker-dealer would be in compliance with Rule 17a-3(a)(19)(i) if it created a single record describing the firm's practice of providing an end-of-year non-cash bonus to a certain number of representatives, a description of the non-cash bonus, the criteria used to select which representatives would achieve such a bonus, a list or description of the representatives eligible to receive the bonus, and the names of the registered representatives that received the non-cash bonus.

Question #9

Rule 17a-3(a)(19)(ii) requires that a broker-dealer maintain a record of agreements pertaining to the relationship between each associated person and the broker-dealer, including a summary of each associated person's compensation arrangements such as commission and concession schedules. Some associated persons do not directly participate in securities transactions with customers. One example is an

attorney who is an associated person and is compensated based on a fixed salary and a discretionary bonus determined by the firm's management based on the profits of the firm as a whole. Another example would be a branch manager who does not generally receive sales-related compensation, but does receive a bonus if the branch achieves a certain yearly sales goal (for instance, \$10 million in annual commissions). Must a broker-dealer create the record required under Rule 17a-3(a)(19)(ii) for the attorney or the branch manager based on the compensation schemes described above where they do not directly participate in securities transactions with customers?

Answer #9

Generally, if an associated person is not directly involved with or compensated based on securities transactions with customers, the broker-dealer would not be required to create the record required pursuant to Rule 17a-3(a)(19)(ii). In the example of the attorney who is compensated based on a salary and discretionary yearly bonus based on the profits of the firm as a whole, the broker-dealer would not be required to create the record required under Rule 17a-3(a)(19)(ii). However, in the example of the branch manager that receives a bonus tied to the yearly sales goal for that branch, the broker-dealer would be required to create the Rule 17a-3(a)(19)(ii) record, even though the branch manager is not directly involved in the customer's securities transactions, because the compensation is intended to reward the branch manager for encouraging sales.

Question #10

New Rule 17a-4(e)(6) requires every broker-dealer to preserve each report that a securities regulatory authority has requested or required the broker-dealer to make and furnish to it pursuant to an order or settlement. Under this rule, is a broker-dealer required to preserve documents or other materials delivered to the Commission in response to a Commission subpoena?

Answer #10

Rule 17a-4(e)(6) does not require a broker-dealer to preserve documents or other materials delivered to the Commission in response to a subpoena. However, if those documents are otherwise required to be created and maintained pursuant to Rules 17a-3 and 17a-4, the broker-dealer must preserve them in compliance with those provisions. In addition, we note that a broker-dealer, under other applicable laws or rules, may have an obligation to

preserve such reports, documents or other materials.

Question #11

Rule 17a-3(a)(1) requires that a broker-dealer make and keep current blotters containing, among other things, an itemized daily record of all purchases and sales of securities and all receipts and disbursements of cash. When purchasing a mutual fund, variable annuity, or a direct participation program a broker-dealer's participation in the transaction may be limited to forwarding the customer's completed application and check to the fund. In other purchase transactions, a registered representative may make a recommendation to a customer and assist the customer in completing the purchase application, but the customer may send the application and check to the fund. With relation to sale transactions, the customer may request that the broker-dealer send the sale instruction to the fund on the customer's behalf. Alternatively, the customer may write or call the fund directly and request that the fund sell those shares and the broker-dealer may not be compensated for participating in the sale. In some instances, the purchase of a variable contract would automatically initiate the sale of another variable contract, such as in a 1035 exchange. When must the broker-dealer record these transactions on its purchase and sales blotter?

Answer #11

Under Rule 17a-3(a)(1), a broker-dealer must record all purchases or sales of mutual funds, variable contracts, or direct participation programs. For example, if the broker-dealer forwards an application and check to the fund on behalf of the customer, sends a purchase or sale instruction to the fund (including an instruction resulting in a 1035 exchange), or calls the fund to place an order on behalf of the customer, the transaction must be recorded on the broker-dealer's purchase and sales blotter, regardless of whether the firm received compensation for the transaction. Further, if the broker-dealer forwarded an instruction regarding a 1035 exchange, the firm must record both the relevant sale and purchase transactions on its blotter.

If a customer wrote or talked to the registered representative or if the registered representative helped the customer fill out the subscription agreement but the customer subsequently took that paperwork when departing from the broker-dealer's office, the broker-dealer generally would not be required to record the transaction

⁶ 66 FR 55818, at 55823 (November 2, 2001).

on its purchase and sales blotter. However, the broker-dealer may be required to create and maintain other types of records relating to these transactions, for example, pursuant to new paragraph 17a-3(a)(19)(i) and SRO rules.⁷

III. Change to Code of Federal Regulations

List of Subjects in 17 CFR Part 241

Brokers, Reporting and recordkeeping requirements, Securities.

⁷ See e.g., NYSE Rule 405 and NASD Rule 3110(c).

Amendments to the Code of Federal Regulations

■ For the reasons set out in the preamble, title 17 chapter II of the Code of Federal Regulations is amended as set forth below:

PART 241—INTERPRETIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

■ Part 241 is amended by adding Release No 34-47910 and the release date of May

22, 2003 to the list of interpretive releases.

By the Commission.

Dated: May 22, 2003.

Margaret H. McFarland,

Deputy Secretary.

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