

# Deadline Looms as Questions Abound on New Broker-Dealer Recordkeeping Requirements

by Steven W. Stone and Jack P. Drogin\*

With less than six months remaining until May 2, 2003, the effective date for last year's amendments to the SEC's broker-dealer recordkeeping rules,<sup>1</sup> many firms are rushing to make the system and operational changes necessary for compliance. The amendments to Rules 17a-3 and 17a-4 demand significant changes for many firms, particularly those with suitability obligations to customers. Still, uncertainties remain on various key issues. While SEC staff is expected to address these issues in the coming months, the timing may be tight for firms to adjust how they will implement the new requirements. In the FAQs below we address a few areas of confusion.

## ***Are accounts of legal entities treated as "accounts with a natural person as a customer or owner" for purposes of the account record requirements?***

Amended Rule 17a-3(a)(17) requires broker-dealers to create and maintain a customer account record setting forth a range of information, including investment objective, for each account with a natural person as a "customer or owner." Obviously, individual and joint accounts in the name of a natural person or persons are covered. Less clear, though, are accounts of legal entities in which a natural person may have beneficial ownership.

Informal guidance from SEC staff suggests the SEC generally will not "look through" legal entities to their underlying natural person owners. Thus, the new informational requirements would not, as a general matter, apply to an account for a trust (even a revocable trust) with natural person grantors, trustees or beneficiaries; general or limited partnerships (including family limited partnerships); or corporations and limited liability companies (including personal holding

companies). However, SEC staff probably will treat self-directed individual retirement accounts and self-employed individual retirement plans as "accounts with a natural person as a customer or owner" even though they technically are structured as trusts. 403(b) accounts may be treated like 401(k) accounts, which do not require an account record for each customer or owner.

## ***Does the requirement of account-by-account investment objectives change the traditional suitability obligation firms may owe to customers?***

The amended rules require that a broker-dealer record the investment objective for each account with a natural person customer or owner—a departure for those firms that have sought information about a customer's investment objective generally. This has led some firms to worry that suitability judgments also need to be made on an account-by-account basis.

Rules 17a-3 and 17a-4 are recordkeeping rules only; they do not purport to affect a broker-dealer's substantive obligations to customers. If a firm had an obligation to consider all of a customer's investments when making suitability judgments, that obligation does not change. Similarly, if a customer previously was able to designate one account for growth and income, and another for more speculative investments, that customer should be able to do the same when the amended rules go into effect. However, in the new environment of account-by-account investment objectives, firms may need to consider how recommended securities that fit a

\* Steven W. Stone (sstone@morganlewis.com) is a partner, and Jack P. Drogin (jdrogin@morganlewis.com) is Of Counsel, in the Washington office of Morgan, Lewis & Bockius LLP (www.morganlewis.com). Copyright © 2002 Morgan, Lewis & Bockius LLP. All rights reserved.

customer's overall investment objective may nonetheless raise issues when traded in an account with a restrictive investment objective.

***For which "associated persons" does a firm need to compile a record of employment and other arrangements with the firm?***

One of the more burdensome new recordkeeping requirements is new Rule 17a-3(a)(19)(ii), which requires each firm to maintain a record of all agreements, both written and oral, pertaining to the relationship between the firm and each "associated person," including a summary of each associated person's compensation arrangement and commission schedule. Some firms have wondered if that requirement applies solely to registered representatives and their supervisors or if it applies to others, including legal and compliance personnel.

The requirement to keep records of compensation arrangements with associated persons applies, by its terms, to all associated persons other than those whose functions are solely clerical and ministerial. Given the broad scope of this requirement, SEC staff has informally indicated the requirement would apply to legal and compliance personnel. However, staff is considering limiting this requirement to those associated persons who receive transaction-related compensation that must be recorded pursuant to Rule 17a-3(a)(19)(i).

We note that there is considerable concern about the legal ramifications of memorializing oral agreements in the form of a summary. First, there is the risk that the summary may be inaccurate. Worse, creating the summary may convert an oral understanding that otherwise might be unenforceable or invalid (perhaps due to lack of authority, the verbal nature of the agreement, or the fact that it contradicts a written agreement) into an enforceable contract. More important, the summary might evidence a contractual employment relationship, as opposed to the employment-at-will relationship that most employers in the securities industry prefer.

***Can firms satisfy the requirements to keep order tickets and associated person records if they do so only by reference to the team of which an associated person is a member?***

Paragraphs (a)(6)(i) and (a)(19)(i) of Rule 17a-3 will require firms to maintain a memorandum of each order showing, among other things, the identity of each associated person (if any) responsible for the account and of any other person who entered or accepted the order, together with records of trades attributable to each associated person for compensation purposes. If applied literally, these requirements could cause problems for firms that assign customers to teams of representatives, which typically are assigned a single production number to track their sales activity.

Broker-dealers should be able to use a single production number for teams of representatives. The SEC made clear in the adopting release that firms need only identify the associated person responsible for an account if the firm actually assigns such responsibility to a specific individual.

The SEC requires that firms have the ability to identify the specific associated person who enters an order, even if responsibility and credit for the related account is assigned to a team. However, the SEC has provided some flexibility, at least in the case of orders entered into electronic systems. For these orders, the order memorandum may omit the identity of the associated person entering the order if the memorandum identifies the originating terminal and the firm maintains a record of which associated person was using that terminal at the time of the order. While the trade memorandum might itself show only the team responsible for the order and the terminal of entry, if asked, the firm would be able to correlate the order with the associated person who entered it.

***Are there other issues?***

The amended rules raise lots of other issues with which firms are now struggling, including:

- Are indications of interest or requests for bids or quotes "orders" for purposes of Rule 17a-3(a)(6)(i)'s order ticket requirements?

- How do the order ticket and associated person record requirements apply to prime brokerage and step-out trades?
- Are accounts of sole proprietorship broker-dealers treated as natural person accounts for purposes of the customer account record requirements of Rule 17a-3(a)(17) even though they may not be treated as “customers” under SEC and SRO rules?
- How would the customer account record requirements of Rule 17a-3(a)(17) apply to accounts of natural persons managed by a registered investment adviser (and does it

matter whether the broker-dealer recommended the adviser, for example as part of a wrap fee arrangement)?

SEC staff has indicated its intention to publish a release clarifying some of the ambiguities presented by the amended rules, but it is unclear when that will happen. Due to the short deadline before the effective date, firms will have to move forward as best they can without formal SEC guidance. **W**

### **Notes**

1 Release No. 34-44992 (Oct. 26, 2001).