

MEMO# 14153

November 16, 2001

SEC ADOPTS REVISIONS TO BROKER-DEALER RECORDKEEPING REQUIREMENTS

[14153] November 16, 2001 TO: BROKER/DEALER ASSOCIATE MEMBERS No. 9-01 COMPLIANCE ADVISORY COMMITTEE No. 56-01 SEC RULES MEMBERS No. 77-01 RE: SEC ADOPTS REVISIONS TO BROKER-DEALER RECORDKEEPING REQUIREMENTS The Securities and Exchange Commission recently adopted revisions to Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934, which govern the recordkeeping requirements of federally registered brokers and dealers.¹ These revisions, which will be effective May 2, 2003, are the culmination of a rulemaking initiative begun by the SEC in 1996. We are pleased that the final amendments include revisions recommended by the Institute. Significant aspects of the revised rules that are of particular interest to members are summarized below.

I. CUSTOMER ACCOUNT INFORMATION A. Required Information in Account Records As proposed, Rule 17a-3(a)(16) would have required every broker or dealer to maintain for each account that has a natural person as the beneficial owner extensive information about the customer including, but not limited to, marital status, number of dependents, annual income, net worth, and investment objectives or risk tolerance. The Institute strongly objected to the application of this provision to those accounts for which the broker or dealer was not obligated to make a suitability determination. We are pleased to report that, as adopted, Rule 17a-3(a)(17)(i)(D) of the rule provides that the customer account information required by the rule “shall only apply to accounts for which the member, broker or 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.”² 1 SEC Release No. 34-44992 (October 26, 2001), 66 Fed. Reg. 55818 (November 2, 2001)(the “Adopting Release”). The Adopting Release is available through the SEC’s website, www.sec.gov. 2 According to the Adopting Release, “the term ‘suitability determination’ should be interpreted broadly” and would include obligations under the Exchange Act, SEC rules, SRO rules, or common law. Adopting Release at p. 55822. 2 B. Furnishing/Updating Account Records Rule 17a-3 was also amended to add a requirement that a broker-dealer furnish its account record information to each customer or account owner on a periodic basis. In particular, new Subsection (a)(17)(i)(B) requires that a broker-dealer provide a copy of the account record to each customer or account owner within thirty days of opening the account and, thereafter, in intervals of no greater than 36 months. The required information may be combined with other mailings to the customer or it may be printed on a customer’s account statement. Importantly, as with the exemption provided in Rule 17a-3(a)(17)(i)(A), accounts for which the broker-dealer is not required to make a suitability determination are exempt from this requirement. They are, however, subject to the provisions of Rule 17a-3(a)(17)(i)(B)(2) and (3), which are also new to the

rule and which require a broker-dealer to notify a customer within 30 days of any change to the name or address of the customer or owner or any change to the account's investment objectives.

II. MEMORANDA OF BROKERAGE ORDERS AND DEALER TRANSACTIONS Rule 17a-3(a)(6), which requires a broker-dealer to maintain a memorandum of each brokerage order or other instruction given or received for the purchase or sale of a security, has been revised to require that the memoranda include the following additional information: (1) the identity of the associated person, if any, responsible for the account and any other person who entered or accepted the order on behalf of the customer; (2) whether the order was entered subject to discretionary authority; (3) the time at which the broker-dealer received the order, even if the order is subsequently transmitted for execution; and (4) any information regarding modifications to the order. When the revisions to this portion of the rule were proposed, the Institute expressed concern with their application to investment company underwriters. We are pleased to report that, as adopted, the rule provides relief to investment companies. In particular, new Paragraph (a)(6)(ii) of the rule exempts from the memoranda requirement transactions involving "a purchase, sale or redemption of a security on a subscription way basis directly from or to the issuer" if the broker-dealer maintains a copy of the subscription agreement. According to the Adopting Release, this provision was added in recognition of the fact that for certain transactions, "such as purchases of mutual funds or variable annuities," the customer may simply fill out an application or a subscription agreement that is forwarded to the issuer.³ Moreover, the Release notes that this exemption extends to transactions such as automatic dividend reinvestments.⁴

III. COMPLIANCE WITH REQUIREMENTS FOR COMMUNICATIONS WITH THE PUBLIC Rule 17a-3 has been amended to add a new paragraph (a)(20) that requires each firm to make a record documenting that the firm has complied with, or adopted policies and procedures reasonably designed to establish compliance with, applicable federal requirements and rules of SROs that require a principal to approve any advertisements, sales literature, or 3 Adopting Release at p. 55819. 4 Id. 3 other communications with the public. According to the Adopting Release, this new provision does not establish a new source of supervisory responsibility, and the policies and procedures that a firm currently uses to evidence compliance with SRO rules may be used to fulfill this requirement if such procedures require principal approval of any advertisements, sales literature, or other communications with the public.⁵

IV. CUSTOMER COMPLAINT INFORMATION; NEW NOTICES REQUIRED New paragraph (a)(18) of Rule 17a-3 requires every broker-dealer to maintain a record indicating that each customer has been provided a notice containing the name, address, and telephone number of the department of the broker-dealer to which any complaints as to the account may be directed.⁶ In addition, this new rule requires that the firm's record for each associated person include every written customer complaint received by the firm concerning such person, including those received electronically.⁷ In particular, the record must include: the complainant's name, address, and account number; the date the complaint was received; the name of each associated person identified in the complaint; a description of the nature of the complaint; and, the disposition of the complaint. In lieu of creating this new record, a broker-dealer may instead keep the original complaint along with a record of its disposition provided this information is retained by name of the associated person.

V. PERSONS TO EXPLAIN RECORDS AND THEIR CONTENT New Paragraph (a)(21) of Rule 17a-3 requires broker-dealers to maintain a listing, by name or title, of all personnel at an office who, without delay, can explain the types of records the firm maintains at that office, and the information contained therein. This provision has been added to address concerns expressed, primarily by the states, that recordkeeping practices differ from firm to firm.

VI. LIST OF FIRM PRINCIPALS New Paragraph (a)(22) of Rule 17a-3 requires firms to make a record listing each principal of the firm responsible for establishing policies and procedures reasonably designed to ensure compliance with any applicable

securities regulatory requirements that require acceptance or approval of a record by a principal. This provision is to assist regulators in identifying persons in the firm responsible for designing the firm's compliance procedures and managing the firm. 5 Adopting Release at p. 55823. 6 According to the staff of the SEC, unlike the grace period afforded in the amendments to Rule 17a-3(a)(17) relating to customer account information, the notice required by Rule 17a-3(a)(18) must have been sent by the effective date of the rule (i.e., by May 2, 2003). Also according to the staff, such notice is not required to be a stand-alone document but may be incorporated on the account statement, an envelope, or other information provided to the customer. 7 The Adopting Release notes that the revised rule does not limit a broker-dealer's responsibility under SRO rules and other regulations that may require creation and maintenance of records relating to oral complaints. Adopting Release at p. 55822-55823. 4 VII. RULE 17a-4: LOCAL OFFICES; AMENDMENTS TO THE RETENTION REQUIREMENTS As repropoed by the SEC, Rule 17a-4(l) would have required that certain of the records listed in Rule 17a-3 be maintained in the "local office" to which they pertained; and Rule 17a- 3(g)(1) would have defined "local office" as "any location at which two or more associated persons regularly conduct the business of" effecting transactions on behalf of the broker-dealer. As noted in the Adopting Release, this provision "was the requirement most seriously disputed" by the firms that commented on the proposal. To address the concerns expressed by the industry, while at the same time addressing concerns expressed by the states regarding the examination delays resulting from firms not having records available at local offices, the SEC has added a new Paragraph (k) to Rule 17a-4. New paragraph (k) revises Rule 17a-4 in three significant ways. First, the term "office" as used in the rule has been revised to mean "any location where one or more associated persons regularly conduct" the business of effecting transactions on behalf of the broker-dealer.⁸ Secondly, and more importantly, however, Rule 17a-4(k) provides that, "rather than maintain the records at each office, the member, broker or dealer may choose to produce the records promptly at the request of a representative of a securities regulatory authority at the office to which they relate or at another location agreed to by the representative." This provision was added to accommodate those broker-dealers that maintain their records at a central facility in lieu of having them decentralized among some or all of their offices. As regards the use of the word "promptly" in this provision, according to the Adopting Release, while this word was deliberately not defined in the rule, "[g]enerally, requests of certain records which are readily available at the office (either on-site or electronically) should be filled on the day the request is made. If a request is unusually large or complex, then the firm should discuss with the regulator a mutually agreeable time-frame for production."⁹ Third, it expands the requirement to maintain certain records at each office location from one year to two years. A copy of the Adopting Release is attached. Tamara K. Reed Associate Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 14153, or call the ICI Library at (202) 326-8304 and request the attachment for memo 14153. Attachment (in .pdf format) ⁸ This definition of "office" is found in Rule 17a-3(g)(1), which is referenced in Rule 17a-4(l)(1). Rule 17a-4(k), which governs the records that must be maintained in such "office" includes special provisions relating to an office that is a private residence. The Adopting Release notes that the definition of "office" as used in these rules may be broader and more inclusive than the definition of "branch." Adopting Release at p. 55825. ⁹ Id.