

Supervision of Brokerage Office Personnel and Procedures

INTRODUCTION

Guidelines for the practices that a brokerage firm uses to conduct the operation of its daily business are regulated by industry, state, and federal regulators. These guidelines are the foundation for the way that the firm handles all business, from hiring a new agent to executing a customer's order. All Series 10 candidates must have a full understanding of a brokerage firm's operations and procedures to successfully complete the exam.

HIRING NEW EMPLOYEES

A registered principal of a firm will be the individual who interviews and screens potential new employees. The principal will be required to make a thorough investigation into the candidate's professional and personal backgrounds. With few exceptions, other than clerical personnel, all new employees will be required to become registered as an associated person with the firm. Additionally, all employees of the broker dealer who are involved in securities sales, have access to cash and securities, or who supervise employees must be fingerprinted. The new employee will begin their registration process by filling

out and submitting a Uniform Application for Securities Industry Registration, also known as Form U4. The Form U4 is used to collect the applicant's personal and professional history, including the applicant's:

- 10-year employment history.
- Five-year resident history.
- Legal name and any aliases used.
- Any legal or regulatory actions.

The principal of the firm is required to verify the employment information for the last three years and must attest to the character of the applicant by signing Form U4 prior to its submission to FINRA. All U4 forms will be sent to the Central Registration Depository (CRD) for processing and recording. Any applicants who have answered yes to any of the questions on the form regarding their background must give a detailed explanation in the Disclosure Reporting Pages (DRPs) attached to the form.

The applicant is not required to provide information regarding his or her:

- Marital status.
- Educational background.
- Income or net worth.

Information regarding the employee's finances that is disclosed on Form U4 includes whether the associated person has ever declared bankruptcy and if the person has any civil judgments or liens placed against them. Any development that would cause an answer on the associated person's U4 to change requires that the member update the U4 within 30 days of when the member becomes informed of the event. In the case of an event that could cause the individual to become statutorily disqualified, such as a felony conviction or misdemeanor involving cash or securities, the member must update the associated person's U4 within 10 business days of learning of the event.

RESIGNATION OF A REGISTERED REPRESENTATIVE

If a registered representative voluntarily resigns or has his or her association with a member firm terminated for any reason, the member must fill out and submit a Uniform Termination Notice for Securities Industry Registration,

known as Form U5. The member must submit the U5 to FINRA within 30 days of the termination. The member firm is also required to give a copy of the U5 to the representative upon termination. The member must also state the reason for the termination, either voluntary or for cause. An associated person's registration is nontransferable. A representative may not simply move the registration from one firm to another. The employing firm that the representative is leaving must fill out and submit a U5 to FINRA, which terminates the representative's registration. The new employing firm must fill out and submit a new U4 to begin a new registration for the associated person with the new employer. The new employer is required to obtain a copy of the U5 form filed by the old employing member either from the employee or directly from FINRA within 60 days of submitting the new U4. The previous employer is not required to provide a copy to the new member firm. If the new employing member asks the associated person for a copy of the U5, the person has two business days to provide it. If the member requests a copy of the U5 from an agent who has not received a copy of the U5 from the old employer, the agent must promptly request it from his or her old employer and provide it to the new employer within two business days of receipt. Should an agent's previous employer discover facts that would alter the information on form U5 the previous employer must file an amended form U5 within 30 days and provide a copy to the former employee. A representative who leaves the industry for more than 24 months is required to requalify by exam. During a period of absence from the industry of two years or less, FINRA retains jurisdiction over the representative in cases involving customer complaints and violations.

 **TAKENOTE!**

A firm may not allow an inactive agent to "park" his or her license with the firm and may not maintain an inactive agent's license on the books simply to ensure that the agent does not have to requalify by exam. The one exception to the rule is for agents in the military who are called to active duty. While on active duty, the agent's registration and continuing education requirements will be "tolled" until the agent returns. The agent who returns from active duty will have 90 days from the end of active duty to reenter the industry. Once the 90 days have lapsed the 24-month window begins. During active duty the agent may continue to receive commissions but may not contact customers.

REGISTRATION EXEMPTIONS

The following individuals are exempt from registration:

- Clerical personnel.
- Nonsupervising officers and managers not dealing with customers.
- Non-U.S. citizens working abroad.
- Floor personnel.

Nonregistered personnel may:

- Offer to send literature to prospective customers.
- Invite current or prospective customers to attend firm-sponsored events.
- Invite prospective customers to speak with a registered representative.
- Discuss account information with existing customers.

Nonregistered personnel may not:

- Receive compensation other than salary or hourly wage.
- Solicit orders or new accounts.
- Discuss investment products or services offered by the firm.
- Qualify prospective customers by discussing the individual's financial information.

All NYSE member firms that allow nonregistered personnel to have contact with existing or potential customers must train the personnel as to the limits on what may be discussed with existing or potential customers.

RETIRING REPRESENTATIVES/ CONTINUING COMMISSIONS

A retiring representative may continue to receive commission on the business that he or she has built over a career if a contract is in place before the representative's retirement. A retiring representative may continue to receive commissions on old business only and may not receive commissions on any new business and may not receive finder's fees. If the retired representative dies, the representative's beneficiary may continue to receive the commissions that were due the representative.

PERSONS INELIGIBLE TO REGISTER

Individuals applying for registration must meet the association's requirements in the following areas:

- Training.
- Competence.
- Experience.
- Character.

Anyone who fails to meet the association's or exchange's requirements in any of the above listed areas may not become registered. An individual may also be disqualified by statute or through rules for any of the following:

- Expulsion, suspension, or disciplinary actions by the Securities and Exchange Commission (SEC) or any foreign or domestic SRO.
- The individual caused the expulsion or suspension of a broker dealer or principal.
- The individual made false or misleading statements on the application for registration on Form U4 or Form BD.
- Felony conviction or misdemeanor involving securities, bribery, falsification of reports, perjury, or any other felony within the last 10 years.
- Court injunction or order barring the individual.



TAKENOTE!

Being charged with any felony, such as a DUI, is reportable on form U4. But not all felonies will result in an applicant being disqualified.

DISCIPLINARY ACTIONS AGAINST A REGISTERED REPRESENTATIVE

If another industry regulator takes disciplinary action against a representative, the employing member firm must notify FINRA. Actions by any of the following should be immediately disclosed to the association:

- The SEC.
- An exchange or association.

- A state regulator.
- A clearing firm
- A commodity regulatory body.

All disclosures must include the type of action brought as well as the name of the party bringing the actions and the name of the representative involved. FINRA members are required to regulate the activities of its associated people and must disclose to the association any action that the member takes against a registered representative.

TERMINATION FOR CAUSE

A member may terminate a registered representative for cause if the representative has:

- Violated firm policy.
- Violated the rules of FINRA, the SEC, or any other industry regulator.
- Violated state or federal securities laws.

A firm may not terminate a representative who is the subject of investigation by any securities industry regulator until the investigation is completed.

OUTSIDE EMPLOYMENT

If a registered representative wants to obtain employment outside of his or her position with a member firm, the registered representative must first provide written notification to the employing member firm. The member firm may reject or limit the representative's outside employment. Exceptions to this rule are if the registered representative is a passive investor in a business or if the representative owns rental property. All other outside business activities must be disclosed to the member firm. If the member is a NYSE member, it must provide the representative with prior written approval before the representative engages in any outside activity.

PRIVATE SECURITIES TRANSACTIONS

A registered representative may not engage in any private securities transactions without first obtaining the broker dealer's prior written approval. The

registered representative must provide the employing firm with all documentation regarding the investment and the proposed transaction. An example of a private securities transaction would be if a representative helped a startup business raise money through a private placement. If the representative is going to receive compensation, the employing member firm must supervise the transaction as if the firm itself executed the transaction. If a representative sells investment products that the employing member does not conduct business in without the member's knowledge, then the representative has committed a violation known as selling away. An exception to this is if the representative is helping an immediate family member to raise money and the representative receives no compensation for his or her role in the private transaction. In this case, the notification and permission of the member is not required.

GIFT RULE

Broker dealers may not pay compensation to employees of other broker dealers. If a broker dealer wants to give a gift to an employee of another broker dealer, it must:

- Be valued at less than \$100 per person per year.
- Be given directly to the employing member firm for distribution to the employee.
- Have the employing member's prior approval for the gift.

The employing member must obtain a record of the gift, including the name of the giver, the name of the recipient, and the nature of the gift. These rules have been established to ensure that broker dealers do not try to influence the employees of other broker dealers. An exception to this rule would be in cases where an employee of one broker dealer performs services for another broker dealer under an employment contract. The following are also excluded from the \$100 limit:

- Occasional meals.
- Occasional tickets to sporting events.
- Business-related travel.

Records of gifts and employment contracts must be retained for three years. Prior FINRA approval is not required for employment contracts between members. The gift rule also applies to gifts given to or received

from customers of the firm or agent. In the case of a mutual fund holding a seminar, the mutual fund may pay for registered representative's travel-related expenses and the seminar must be held at a "reasonable" location. Spouses of agents are allowed to attend; however, the mutual fund may only pay for the travel expenses of the agent. The agent's expenses may not be paid for by the fund in exchange for past sales or the promise of sales in the future.

 **TAKENOTE!**

Firms and agents also may not give a gift to influence any report or dissemination of information designed to influence the price of a security.

COMMUNICATIONS WITH THE PUBLIC

Member firms will seek to increase their business and exposure through the use of both retail and institutional communications. Strict regulations are in place in order to ensure that all communications with the public adhere to industry guidelines. Some communications with the public are available to a general audience and include:

- Television/radio
- Publicly accessible websites
- Motion pictures
- Newspapers/magazine
- Telephone directory listings
- Signs/billboards
- Computer/Internet postings
- Video displays
- Other public media
- Recorded telemarketing messages

Other types of communications are offered to a targeted audience. These communications include:

- Market reports
- Password-protected websites

- Telemarketing scripts
- Form letters or e-mails (sent to more than 25 people)
- Circulars
- Research reports
- Printed materials for seminars
- Option worksheets
- Performance reports
- Prepared scripts for TV or radio
- Reprints of ads or sales literature

FINRA RULE 2210 COMMUNICATIONS WITH THE PUBLIC

FINRA Rule 2210 replaces the advertising and sales literature rules previously used to regulate member communications with the public. FINRA Rule 2210 streamlines member communication rules and reduces the number of communication categories from six to three. The three categories of member communication are:

- Retail communication
- Institutional communication
- Correspondence

RETAIL COMMUNICATION

Retail communication is defined as any written communication distributed or made available to 25 or more retail investors in a 30-day period. The communication may be distributed in hard copy or in electronic formats. The definition of a *retail investor* is any investor who does not meet the definition of an institutional investor. Retail communications now contain all components of advertising and sales literature. All retail communications must be approved by a registered principal prior to first use. The publication of a post in a chat room or other online forum will not require the prior approval of a principal so long as such post does not promote the business of the member firm and does not provide investment advice. Additionally, generic advertising will also be exempt from the prior approval requirements. All retail communication must be maintained by the member for three years. If the member firm is a

new member firm that has been in existence for less than 12 months based on the firm's approval date in the Central Registration Depository (CRD), the member must file all retail communications with FINRA 10 days prior to its first use unless the communication has been previously filed and contains no material changes or has been filed by another member, such as an investment company or ETF sponsor. Member firms that have been established for more than 12 months may file retail communications with FINRA 10 days after the communication is first used. Retail communications regarding Investment companies, ETF sponsors, and variable annuities must be filed 10 days prior to first use. Should FINRA determine that a member firm is making false or misleading statements in its retail communications with the public, FINRA may require the member to file all of its retail communication with the public with the association 10 days prior to its first use.

 **TAKENOTE!**

Research reports concerning only securities listed on a national securities exchange are excluded from Rule 2210's filing requirements. Additionally, a free writing prospectus is exempt from filing with the SEC and is not subject to Rule 2210's filing or content standards.

INSTITUTIONAL COMMUNICATIONS

Institutional communication is defined as any written communication distributed or made available exclusively to institutional investors. The communication may be distributed in hard copy or in electronic formats. Institutional communications do not have to be approved by a principal prior to first use so long as the member has established policies and procedures regarding the use of institutional communications and has trained its employees on the proper use of institutional communication. Institutional communication is also exempt from FINRA's filing requirement, but like retail communications it must be maintained by a member for three years. If the member believes that the institutional communication or any part thereof may be seen by even a single retail investor, the communication must be handled as all other retail communication and is subject to the approval and filing requirements as if it was retail communication. An institutional investor is a person or firm that trades securities for his or her own account or for the accounts of others. Institutional investors are generally limited to large financial companies.

Because of their size and sophistication, fewer protective laws cover institutional investors. It is important to note that there is no minimum size for an institutional account. Institutional investors include:

- Broker dealers.
- Investment advisers.
- Investment companies.
- Insurance companies.
- Banks.
- Trusts.
- Savings and loans.
- Government agencies.
- Employment benefit plans with more than 100 participants.
- Any non-natural person with more than \$50,000,000 in assets.

CORRESPONDENCE

Correspondence consists of electronic and written communications between the member and up to 25 retail investors in a 30-day period. With the increase in acceptance of email as business communication, it would be impractical for a member to review all correspondence between the member and a customer. The member instead may set up procedures to review a sample of all correspondence, both electronic and hard copy. If the member reviews only a sample of the correspondence, the member must train its associated people on the firm's procedures relating to correspondence and must document the training and ensure that the procedures are followed. Even though the member is not required to review all correspondence, the member must still retain all correspondence. The member should, where practical, review all incoming hard copy correspondence. Letters received by the firm could contain cash, checks, securities, or complaints.



TAKENOTE!

All electronic communications must be kept for three years total and readily accessible for the first two years.

BROKER DEALER WEBSITES

A broker dealer will not be deemed to have a place of business in a state where it does not maintain an office simply by virtue of the fact that the publicly available website established by the firm or one of its agents is accessible from that state so long as the following conditions are met:

- The website clearly states that the firm may only conduct business in states where it is properly registered to do so.
- The website only provides general information about the firm and does not provide specific investment advice.
- The firm or its agent may not respond to Internet inquiries with the intent to solicit business without first meeting the registration requirements in the state of the prospective customer.

The content of any website must be reviewed and approved by a principal prior to its first use and must be filed with FINRA within 10 days of use. If the firm or its agent updates the website and the update materially changes the information contained on the website, the updates must be reapproved by a principal and refiled with FINRA. The website may use the FINRA logo so long as the use is only to demonstrate that the firm is a FINRA member and a hyperlink to the FINRA website is included in close proximity to the logo.

TESTIMONIALS

From time to time, firms will use testimonials made by people of national or local recognition in an effort to generate new business for the firm. If the individual giving the testimonial is quoting past performance, relating to the firm's recommendations, it must be accompanied by a disclaimer that past performance is not indicative of future performance. If the individual giving the testimony was compensated in any way, the fact that the person received compensation must also be disclosed. Should the individual's testimony imply that the person making the testimony is an expert, a statement regarding the person's qualifications as an expert must also be contained in the ad or sales literature. Research prepared by outside parties must disclose the name of the preparer.

FREE SERVICES

If a member firm advertises free services to customers or to people who respond to an ad, the services must actually be free to everyone and with no strings attached.

SHARING IN A CUSTOMER'S ACCOUNT

It is permissible for a representative to maintain a joint account with a customer as long as the firm approves it in advance. The representative may share in the profit and loss of the account only in direct relation to his or her contribution to the account. A registered representative is precluded from sharing in the profit and loss of an account without making any financial contribution to the account.

BORROWING AND LENDING MONEY

A registered representative generally may not borrow money or securities from a client unless the client is a bank or other financial institution that is in the business of lending money. If the firm has written policy regarding the borrowing of money from a customer, a representative may borrow from a client if:

- The client is an immediate relative, such as a husband, parent, in-law, uncle, child, etc.
- The client and the representative have a business relationship other than that of a client.
- The client and the representative have a personal relationship and that relationship is the basis for the loan being made.
- Both parties to the transaction are registered personnel at the same firm.

Broker dealers are also generally prohibited from lending money or securities to a client. Broker dealers making margin loans or lending securities to effect a short sale are excluded from this rule.

ORDER TICKETS

Prior to executing a customer's order the representative must fill out the appropriate order ticket and present it to the trading department or wire room for execution. All order tickets will include the following information:

- Buy or sell.
- Name of the security.

- Number of shares or bonds.
- Account name and number.
- Account type (i.e., cash or margin).
- Price and time limits if any.
- Solicited or unsolicited.
- Discretionary authority exercised or discretionary authority not exercised, if applicable.
- Time stamp when entered, executed, changed, or canceled.

EXECUTING AN ORDER

An important part of executing a customer's order lies in the operational procedures that route the order to the markets and handle trade input functions for the order once it has been executed. The brokerage firm assigns specific departments to handle all of the important functions of trade execution and input. The departments are:

- Order room/wire room.
- Purchase and sales department.
- Margin department.
- Cashiering department.

ORDER ROOM/WIRE ROOM

Once a representative has received an order from a client, the representative must present the order for execution to the order room. The order room will promptly route the order to the appropriate market for execution. Once the order has been executed, the order room will forward a confirmation of the execution to the registered representative and to the purchase and sales department.

PURCHASE AND SALES DEPARTMENT

Once the order has been executed, the purchase and sales department inputs the transaction into the customer's account. The purchase and sales department, sometimes called P&S, is also responsible for mailing customer confirmations and for billing customers.

MARGIN DEPARTMENT

All transactions, regardless of the type of account, are sent through the margin department. The margin or credit department calculates the amount of money owed by the customer and the date when the money is due. The margin department will also calculate any amount due to a customer.

CASHIERING DEPARTMENT

The cashiering department handles all receipts and distributions of cash and securities. All securities and payments delivered from clients to the firm are processed by the cashiering department. The cashiering department will also issue checks to customers and, at the request of the margin department, will forward certificates to the transfer agent.

BECOMING A STOCKHOLDER

Although some people purchase shares directly from the corporation when the stock is offered to the public directly, most investors purchase shares from other investors. These investor-to-investor transactions take place in the secondary market on the exchange or in the over-the-counter (OTC) market. Although the transaction in many cases only takes seconds to execute, trades actually take several days to fully complete. Let's review the important dates regarding transactions, which are done for a regular-way settlement.

TRADE DATE

The trade date is the day when the order is actually executed. Although an order has been placed with a broker, it may not be executed on the same day. Certain types of orders take several days or even longer to execute. A market order, however, will be executed as soon as it is presented to the market, making the trade date the same day the order was entered.

SETTLEMENT DATE

The buyer of a security actually becomes the owner of record on the settlement date. When an investor buys a security from another investor, the selling investor's name is removed from the security and the buyer's name

is recorded as the new owner. Settlement date is three business days after the trade date. This is known as T + 3 for all regular-way transactions in common stock, preferred stock, corporate bonds, and municipal bonds. Government bonds and options all settle the next business day following the trade date. Any trade done on a cash basis settles on the same day regardless of the security involved in the transaction. Settlement dates are set by the Uniform Practice Code.

PAYMENT DATE

The payment date is the day when the buyer of the security has to have the money to the brokerage firm to pay for the purchase. Payment date for securities under industry rules is five business days after the trade date, or T + 5. Payment dates are regulated by the Federal Reserve Board under Regulation T of the Securities Exchange Act of 1934. Although many brokerage firms require their customers to pay for their purchases sooner than the rules state, the customer has up to five business days to pay for the trade.

VIOLATION

If the customer fails to pay for the purchase within the five business days allowed, the customer is in violation of Regulation T. As a result, the brokerage firm will “sell out” and freeze the customer’s account. On the sixth business day following the trade date, the brokerage firm will sell out the securities that the customer failed to pay for. The customer is responsible for any loss that may occur as a result of the sell out, and the brokerage firm may sell out shares of another security in the investor’s account in order to cover the loss. The brokerage firm will then freeze the customer’s account, which means that the customer must deposit money up front for any purchases in the next 90 days. After the 90 days have expired, the customer is considered to have reestablished good credit and may then conduct business in the regular way and take up to five business days to pay for the trades. A customer may get an additional five business days to pay for the trade by requesting an extension. An extension request must be submitted to the NYSE or FINRA before the expiration of the fifth business day. A broker dealer may ignore a call for cash of \$1,000 or less. In cases where a customer has sold securities and fails to deliver the securities to the broker dealer, the broker dealer is required to buy in the customer 10 business days after settlement.

CLEARLY ERRONEOUS REPORTS

If a registered representative reports the execution of a trade to a customer and that report is clearly an error, then that report is not binding on the agent or the firm. The customer must accept the trade as it actually occurred, not as it was erroneously reported, so long as the transaction was in line with the terms of the customer's order.

EXECUTION ERRORS

If a transaction is executed away from a customer's limit price or is executed for too many shares of stock, the customer is not obligated to accept the transaction. A registered representative who is informed of an execution error should immediately inform the principal of the error. If a customer makes an error entering the terms of an order over an online trading platform the customer is obligated to accept the execution in line with the terms entered.

AS/OF TRADES

An as/of trade is a trade that is booked into an account "as of" the prior business day. A trade may be booked into an account on an as/of basis simply due to an input or execution error. However, a pattern of as/of trades attributable to one agent may be a sign of problems with the way an agent is conducting business. An agent who displays a pattern of as/of trades may be showing favoritism to one or more clients or may be trying to cover up errors.

CORPORATE AND MUNICIPAL SECURITIES SETTLEMENT OPTIONS

Regular-way transactions in corporate stocks and bonds and municipal bonds settle on the third business day, or T + 3. However, sometimes either party to the transaction may request an alternative settlement. Other settlement options include:

- Cash.
- Next day.
- Seller's option.
- Buyer's option.
- RVP/DVP/COD.

CASH

A transaction done on a cash basis settles the same day. A cash trade requires that the buyer have the funds available for payment and the seller have the securities available for delivery on the day the trade is executed. Cash trades executed prior to 2:00 p.m. EST settle by 2:30 p.m. EST. Trades executed after 2:00 p.m. EST settle within 30 minutes.

NEXT DAY

A transaction executed for a next-day settlement requires that the buyer has the cash available for payment and the seller has the securities available for delivery on the next business day.

SELLER'S OPTION

A seller who wishes to lock in a sale price for the securities but who, for some reason, is not able to deliver the securities may elect to specify a seller's option settlement. The seller may specify the date when the securities will be delivered but may not deliver the securities any sooner than the fourth business day. If the seller wants to deliver the securities earlier than specified in the contract, the buyer must be given one day written notice of the seller's intention to settle the trade early.

BUYER'S OPTION

A buyer may specify the date when payment will be made for the securities and delivery of the securities will be accepted, much the same as a seller's option.

RVP/DVP/COD

Many trusts and other fiduciaries will not allow cash to be paid out until the securities they have purchased are delivered. Alternatively, in the case of a sale, they will not allow the securities to be delivered until payment is received. A bona fide RVP/DVP account will allow the transaction to settle no sooner than regular way of T + 3, but no later than 35 calendar days. The account is given up to 35 days to settle the transaction. In the case of a purchase, the securities have to be registered in the buyer's name by the transfer agent and delivered.

WHEN-ISSUED SECURITIES

When a corporate issuer declares a stock split, the stock will trade in the marketplace on a when-issued basis, prior to the distribution of the new shares. Sellers of the stock during this time may sell the stock on a when-issued basis or may deliver the old securities with a due bill attached for the new shares. Corporate securities sold on a when-issued basis will normally

settle three business days after the securities are issued. Municipal securities that are sold prior to the certificate being available for delivery are sold on a when-issued basis. The purchaser will receive a when-issued confirmation and a final confirmation three days prior to the certificate's delivery.

GOVERNMENT SECURITIES SETTLEMENT OPTIONS

Regular way transactions in government securities settle on the next business day, or T + 1. However, sometimes either party to the transaction may request an alternative settlement. Other settlement options include:

- Cash.
- Next day.
- Seller's option.
- Buyer's option.
- RVP/DVP/COD.

The settlement options available to investors in government securities are similar to those for corporate and municipal securities. However, government securities that are traded on a when-issued basis settle the day after the securities are available for delivery.

ACCRUED INTEREST

Most bonds pay interest semiannually, based on their maturity date. An investor who wishes to sell a bond between the interest payment dates will be owed the interest that has become due or that has accrued during the holding period. Investors who purchase the bonds between interest payment dates will receive the full semiannual interest payment on the bond's next interest payment date. As a result, the purchaser of the bonds must pay the seller the portion of the interest payment that the seller has earned, which is known as accrued interest. Most bonds trade with accrued interest, also known as "and interest."

A bond may only pay interest on two dates during the month: the 1st and the 15th. Interest on a new issue of bonds begins to accrue on the dated date. It is not unusual for an investor who purchases a new issue of debt securities to owe accrued interest to the issuer for bonds that are delivered after the dated date.

CALCULATING ACCRUED INTEREST

Interest on all bonds accrues from the last interest payment date up to, but not including, the settlement date. Accrued interest calculations for corporate and municipal securities use a 360-day year in which all months contain 30 days.

CLOSE OUTS

In the case where the selling broker dealer fails to deliver the securities to the buying broker dealer, the buying broker dealer may close out the trade by purchasing the securities in the open market. This is known as a buy in, and the selling broker dealer will be responsible for any loss as a result of the buy in. Notice of the buying broker dealer's intention to buy in the selling broker dealer may be done no sooner than three business days past settlement or trade date plus six business days. The broker dealer executing the buy in must send notice to the contra party no later than 12 noon, two business days prior to buying the broker dealer in. If a selling broker dealer delivers securities in good form to the buying broker dealer and the securities are rejected, the selling broker dealer may sell out the securities immediately. UPC Rule 11830 requires the mandatory close out of certain naked short positions. If a firm or a customer has a naked short position and fails to deliver the subject securities 10 business days after the settlement date, the position is subject to a mandatory buy in. A special notation next to their symbol on the Nasdaq workstation identifies securities subject to the mandatory buy in. UPC 11830 securities must have a net short position of at least 10,000 shares and the net short position must be at least 1/2% of the issuer's outstanding stock. A full list of all UPC 11830 subject securities is available online. The mandatory close out does not apply to short positions established as a result of bona fide market making, fully hedged, or arbitrage positions.

CUSTOMER CONFIRMATIONS

All customers must be sent a confirmation at or before the completion of the transaction. Industry rules consider the completion of the transaction to be the settlement date. For buyers of the security, it is the time when the payment is made. If the customer has the funds available in the account, it is the time when the funds are moved through a bookkeeping entry. For the seller, it is when the security is delivered. If the security is delivered prior to its due date, completion will occur when the payment is credited into the account.

It is unlawful to settle a transaction without having sent a confirmation of the transaction to the customer. All customer confirmations must include the following:

- Customer's name and account number.
- Description of the transaction, such as buy or sell.
- Trade date and settlement date.
- Number of shares, bonds, or units.
- Price.
- CUSIP number.
- Amount due or owed.
- Commission charged for agency transactions.
- Markup charged for riskless principal transactions.
- Markup charged for principal transactions in Nasdaq Global Market stocks and third-market trades ("reported securities"), as required under SEC Rule 10b-10.
- Markup charged for Nasdaq Capital Market stocks under FINRA rules.
- Yield information for bonds.
- If the bond or preferred stock is callable.
- Whether the firm acted as an agent or principal.
- Whether the firm acted as an agent for the other side of the transaction (i.e., dual-agency).
- Amount of commission or markup or markdown.
- If the firm makes a market in the security.
- If there is a control relationship between the firm and the issuer of the security.
- Information regarding where the transaction was executed.
- If the firm received payment for executing the order with another firm.
- The time of execution or a statement that the time will be furnished upon request.

If the customer requests additional information within 30 days of the transaction, as detailed on the confirmation, the firm has five business days to provide it. If the customer's request is made after 30 days, the firm may take up to 15 days to provide the information. If the firm receives payment for executing

orders with other firms (payment for order flow), the firm must disclose this at the time the customer opens the account and annually thereafter.

RULES FOR GOOD DELIVERY

All securities delivered by a customer or another broker dealer must be in good condition and must:

- Be signed by all owners, and all owners must be alive.
- Be in the correct denominations, such as number of shares or par value of bonds.
- Have all attachments.
- Be accompanied by a uniform delivery ticket.

The owner of a security must endorse the certificate at the time of sale to ensure its negotiability or sign a stock or bond power, also known as a power of substitution. The stock power, when attached to the certificate, will make it negotiable and includes an irrevocable power of attorney. All signatures must be accepted by the transfer agent. To ensure that the transfer agent accepts the signatures on certificates delivered by NYSE member firms, the NYSE started the Medallion Signature Guarantee Program, which allows NYSE members to stamp the certificates with a medallion rather than sign them. This stamp ensures that the transfer agent will accept the certificates for transfer and provides indemnification insurance for fraud. Medallion Program members pay to participate.

The following are examples of invalid signatures:

- The signature of a minor.
- The signature of a deceased person.
- The signature of only one owner, if jointly registered.
- A forged signature.

REJECTION OF DELIVERY

The buying firm may reject the delivery of securities from the selling member if:

- The certificates are mutilated.
- The certificates are not in the proper denominations.

- All attachments are not present.
- The signatures are invalid.
- The signatures have not been guaranteed.
- The securities are delivered prior to settlement.
- The wrong securities are delivered.
- If the specific bond being delivered has been called and was not identified as being called at the time of the trade.

A firm may not reject a partial delivery of securities that are delivered on proper denominations and in good condition.

RECLAMATION

A broker dealer may return or demand the return of securities previously accepted for delivery through a process known as reclamation. A broker dealer using the reclamation process must make the demand by submitting a Uniform Reclamation Form to the contra broker dealer. The reasons for rejecting delivery listed above are also valid reasons for instituting the reclamation process.

MARKING TO THE MARKET

A broker dealer who has an open contractual commitment to another broker dealer will monitor the market value of the securities involved relative to the contract or trade price. This process is known as marking to the market. A broker dealer who is partially unsecured can issue a call or demand for more collateral. If a firm sends a mark to the market demand to another broker dealer, the demand must be met promptly.

EXAMPLE

If a broker dealer borrows \$20,000 worth of securities for a customer who is executing a short sale for \$20,000 worth of ABC, the borrowing broker dealer would have to deposit \$20,000 with the lending broker dealer as collateral for the securities. If the market value of ABC increases to \$25,000, the broker dealer who loaned the securities may demand that the borrowing broker dealer deposit an additional \$5,000 as collateral. Alternatively if the market value of ABC had fallen to \$15,000, the borrowing broker dealer may demand a return of \$5,000.

CUSTOMER ACCOUNT STATEMENTS

A customer must receive a statement every month in which there is activity in the account. All customers must receive account statements at least quarterly when there has been no activity in the account. Examples of activity include:

- Purchases and sales.
- Dividend and interest received.
- Interest charged.
- Addition or withdrawal of cash or securities.

Customer account statements must show:

- All positions in the account.
- All activity since the last statement.
- All credit and debit balances.

Brokerage firms are required to disclose their financial condition to their clients by sending them a balance sheet every six months or on the request of a customer with cash or securities on deposit.

CARRYING OF CUSTOMER ACCOUNTS

Not all brokerage firms maintain physical possession of customers' cash and securities. A brokerage firm that maintains the accounts of its customers and holds their cash and securities is known as a carrying firm or self-clearing member. A broker dealer may find it easier to have another member provide the clearing and custodial functions for its customers' accounts. This type of broker dealer is known as an introducing broker dealer. Anytime a clearing agreement is executed or amended it must be sent to FINRA for review. The clearing member must notify the introducing member of the reports it offers clearing members to monitor customer accounts when it executes the agreement and at least annually no later than July 31. Additionally, the introducing member must notify the clearing member of the reports it needs to supervise customer accounts. The introducing member forwards all cash and securities to the carrying or clearing member for deposit into the customers' accounts. The clearing firm sends the customers' statements and confirmations to the introducing firm's customers. If a firm clears all of its transactions on a fully

disclosed basis, all customers of the introducing firm must be notified of the fact in writing when the account is opened. An introducing member may also choose to clear its trades through an omnibus account maintained at the clearing firm. In this case, all transactions are cleared through one account, and the clearing member does not know for whom the trade was executed. The introducing member is required to send customer confirmations if it clears through an omnibus account. Omnibus accounts are not allowed to purchase securities on margin for customers. All securities must be paid for in full.

DIVIDEND DISTRIBUTION

If a corporation decides to pay a dividend to its common stockholders it may not discriminate as to who receives the dividend. The dividend must be paid to all common stockholders of record. Existing stockholders do not need to notify the company that they are entitled to receive the pending dividend—it will be sent to them automatically. However, new purchasers of the stock may or may not be entitled to receive the dividend, depending on when they purchased the stock relative to when the dividend is going to be distributed. Let's examine the dividend distribution process.

DECLARATION DATE

The declaration date is the day that the board of directors decides to pay a dividend to common stockholders of record. The declaration date is the starting point for the entire dividend process. The company must notify the regulators at the exchange or FINRA, depending where the stock trades, at least 10 business days prior to the record date.

EX DIVIDEND DATE

The ex dividend date, or the ex date, is the first day when purchasers of the security are no longer entitled to receive the dividend that the company has declared for payment. Stated another way, the ex date is the first day when the stock trades without (ex) the dividend attached. The exchange or FINRA set the ex date for the stock based on the record date determined and announced by the corporation's board of directors. Because it takes three business days for a trade to settle, the ex date is always two business days prior to the record date. For a stock split or a stock dividend of more than 25%, the ex date is the day after the payable date.

RECORD DATE

The record date is the day when investors must have their name recorded on the stock certificate in order to be entitled to receive the dividend that was declared by the board of directors. Stockholders whose names are on the stock certificates (owners of record) will be entitled to receive the dividend. The investor must have purchased the stock before the ex dividend date in order to be an owner of record on the record date. The record date is determined by the corporation's board of directors and is used to determine which shareholders will receive the dividend.

PAYMENT DATE

This is the day when the corporation actually distributes the dividend to shareholders and it completes the dividend process. The payment date is controlled and set by the board of directors of the corporation and is usually four weeks following the record date.

STOCK PRICE AND THE EX DIVIDEND DATE

It is important to note that the value of the stock prior to the ex dividend date reflects the value of the stock with the dividend. On the ex dividend date, the stock is now trading without the dividend attached, and new purchasers will not receive the dividend that had been declared for payment. As a result, the stock price will be adjusted down on the ex dividend date in an amount equal to the dividend.

EXAMPLE

TRY declares a \$.20 dividend payable to shareholders of record as of Thursday, August 22. The ex dividend date will be two business days prior to the record date. In this case, the ex date will be Tuesday, August 20. If TRY closed on Monday, August 19, at \$24 per share, the stock would open at \$23.80 on Tuesday.

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	31

DIVIDEND DISBURSEMENT PROCESS

The corporation's dividend disbursement agent is responsible for the distribution of dividends and will send the dividends to the shareholders of record on the record date. Most investors, for convenience, have their securities held in the name of the broker dealer, which is also known as the street name. As a result, the dividend disbursement agent will send the dividends directly to the broker dealer. The broker dealer's dividend department will collect the dividends and distribute them to the beneficial owners. The dividend department also handles:

- Stock dividends
- Stock splits
- Bond interest payments
- Rights distributions
- Warrant distributions

It is fair and reasonable for a brokerage firm to charge a fee for the collection of dividends and other services as long as the fee is not excessive and is in line with the fees charged by similar firms.

DUE BILLS

Should the wrong party receive a dividend or any other type of distribution, the buying broker dealer whose customer is owed the dividend will send a due bill to the selling broker for the amount of the dividend owed. In most cases, this would happen when the buyer purchased the stock just prior to the ex date and the security was delivered late to the buyer.

PROXIES

Common stockholders have the right to vote on major corporate issues. Most stockholders, however, do not have the time to attend the meetings and must therefore vote using an absentee ballot, known as a proxy. The Securities Exchange Act of 1934 requires that all corporations that distribute proxies solicit votes from their shareholders. The corporation will send proxies to the shareholders of record. Stockholders who have their securities held in street name will have the proxies forwarded to them by the brokerage firm. The brokerage firm will then cast the beneficial shareholders' votes as indicated

on the proxy as the shareholder of record. Proxies that have been signed and returned without indicating how to vote must be voted in accordance with the issuer's management's recommendation. If a shareholder fails to return the proxy to the member at least 10 days prior to the annual meeting, the member may vote the shares as it sees fit, as long as the matter is not of major importance. If the vote concerns a major issue, such as a merger, the member may never cast the votes. Member firms are required to forward proxies and other corporate communications, such as annual and quarterly reports, to the beneficial owner, and the issuer is required to reimburse the member for reasonable expenses.

BOX COUNTS

All broker dealers that maintain custody of securities must conduct a quarterly count of the securities they have in their possession or control. Securities that are considered to be in a broker dealer's control are securities in transfer or transit. The quarterly count must be made no less than two months apart and not more than four months apart. If a broker dealer's physical count reveals fewer certificates than are recorded on its books, the firm has a short securities difference. A short securities difference will result in a deduction from the broker dealer's net capital if not resolved in seven business days (four business days past the settlement date). On the fifth business day past settlement date, the broker dealer will have to take a haircut on the current market value of the security. If the broker dealer's physical count reveals more certificates than it has on its records, the broker dealer has a long securities difference. A long securities difference has no effect on a broker dealer's net capital.

MISSING AND LOST SECURITIES

The Securities Information Center, or SIC, is in charge of keeping reports for all lost and stolen securities. SEC Rule 17f-1 outlines the requirements for reporting an inquiry with respect to missing, lost, counterfeit, or stolen securities. When it is believed criminal activity was involved, the theft must be reported within one business day of discovery to the SIC, the registered transfer agent for the issue, and the Federal Bureau of Investigation (FBI). When criminal activity is not believed to be involved and securities have been missing or lost for at least two business days, a report must be made within one business day by the end of this period to the SIC and the registered transfer

agent for the issue. When securities are found to be counterfeit, a report must be made within one business day of discovery to the SIC, the registered transfer agent for the issue, and the FBI. If securities are discovered to be missing after an internal audit or count, and no criminal activity is suspected, a report must be filed with the SIC within 10 business days of discovery or as soon as the securities can be identified by certificate number. When stolen, missing, lost, or counterfeit securities have been recovered, the appropriate authority must be notified within one business day of the recovery. Required inquiries must be made by the SIC whenever securities come into the possession of a reporting institution, unless:

- The institution compares the securities against bondholder or stockholder lists as part of its business.
- The securities certificate came directly from the issuer or the issuer's agent.
- The securities certificate is received from another reporting institution and is registered in the name of the customer or was previously sold to the customer and verified through internal records.
- The transaction did not exceed a face value of \$10,000 for bonds or a market value of \$10,000 for stocks.
- The securities certificate is received as part of a normal drop by the reporting institution.

The SIC will accept reports on securities not listed above.

The following securities are not subject to the above provisions:

- Securities without Committee on Uniform Securities Identification Procedures (CUSIP) numbers.
- Bond coupons.
- Uncertified securities.
- A securities issue that is represented by a single master certificate registered in the name of the clearing agency (a global securities issue).
- Securities that do not provide negotiable securities certificates.

THE CUSTOMER PROTECTION RULE

The Customer Protection Rule ensures that customer funds held by a broker dealer are maintained in safe areas of the business related to servicing its

customers or are deposited in a special reserve bank account. The broker dealer must make the following monthly computation to determine the amount required to be on deposit in its special reserve bank account for the exclusive benefit of the customers:

$$\text{(credit items - debit items)} \times 105\% = \text{the amount to be deposited in the special reserve account}$$

This calculation may be required at the end of each week at the close of business, and the funds must be deposited no later than one hour after the opening of banking business on the second business day after computation date, usually a Tuesday. If the broker dealer computes weekly rather than monthly, only 100% of the credit excess must be deposited in the reserve account. A broker dealer must compute weekly if at any time its aggregate indebtedness exceeds 300% of its net capital or if its aggregate funds owed to customers exceeds \$1,000,000. Weekly reporting must continue until neither condition occurs for four successive weeks. The special reserve bank account may not be used for any of the following purposes:

- To secure a loan to the broker dealer.
- Be subject to a lien by a bank against the broker dealer.
- Be used to allow bank offset privileges against other accounts of the broker dealer.

Also note the following relating to the special reserve account:

- It may only contain cash or U.S. government securities.
- If debit items exceed credit items, no deposit need be made.
- The funds contained in the account reduce the amount of the broker dealer's aggregate indebtedness.
- A broker dealer may withdraw excess beyond the required deposit in the special reserve account.
- A broker dealer must buy in all short security differences within 45 calendar days after the date of recovery.
- A broker dealer must also buy in a customer who does not deliver securities as a result of a long sale within 10 business days after settlement date.

 **TAKENOTE!**

A broker dealer must obtain notification from the bank that it is informed of these restrictions and that the money is being held for the exclusive benefit of customers of the broker dealer.

BROKER DEALER BOOKS AND RECORDS

All broker dealers are required to prepare and maintain reports and records according to industry regulations. The content and timing of the reports depends on the nature of the report. SEC Rule 17a-3 sets forth the requirements for broker dealer reporting, timing, and content. SEC Rule 17a-4 sets the retention requirements for those records. Records subject to these rules must be maintained anywhere from three years to the life of the firm. Records that are required to be maintained must be readily accessible for the first two years.

Under SEC Rule 17a-3 a significant number of records must be filed and maintained by broker dealers. The following is a list of those records and their definitions.

BLOTTERS

Blotters are records of original entry and must reflect transactions as of the trade date. Blotters must be prepared no later than the following business day, or T + 1. This would include a historical account of all the daily transactions, such as:

- Purchases and sales of securities.
- Receipts and disbursements of cash.
- Receipts and deliveries of securities.

GENERAL LEDGER

The general ledger reflects the firm's assets, liabilities, income, and expenses and capital accounts. The firm's trial balance and other financial reports can be prepared from this to show the broker dealer's financial condition. It must be prepared monthly.

CUSTOMER ACCOUNTS

Customer accounts are itemized records of each cash and margin account for each customer. This reflects all purchases, sales, receipts, and deliveries of cash and securities for each customer, as well as the new account form and margin agreement, if applicable.

SUBSIDIARY (SECONDARY) RECORDS

These are records prepared from the blotter, including:

- Securities in transfer: Securities in the process of being transferred into a customer's name.
- Dividends and interest received: A record of all dividends and interest due to the customer (long), or payable by the customer (short).
- Securities borrowed and loaned: Records of the broker dealer's borrowing or loaning of securities to complete its transactions.
- Monies borrowed, monies loaned: This also includes any collateral used in connection with a loan.
- Securities failed to receive or deliver: These records must show the date due as well as the date received or delivered.

SECURITIES POSITION BOOK (LEDGER) STOCK RECORD

A securities position book or stock record is a record of the long and short position in each security, whether carried for the account of the broker dealer or for the account of a customer. The location of these securities must also be maintained.

ORDER TICKETS

An order ticket, also known as an order memorandum, is a record detailing the terms and conditions of an order to purchase or sell a security. Records must be maintained whether or not the order is executed.

CONFIRMATIONS AND NOTICES

A confirmation is a notice of the terms and conditions of an executed order. Copies of all confirmations and notices of other debits and credits must be maintained.

MONTHLY TRIAL BALANCES AND NET CAPITAL COMPUTATIONS

Monthly trial balances and net capital computations serve as a check on the current status and accuracy of the firm's ledger account and financial condition. Firms are required to file their net capital computations with regulators via the FOCUS form.

EMPLOYMENT APPLICATIONS

A copy of the registration application or Form U4 will suffice as an employment application. Applications must be approved in writing by an authorized representative of the member.

RECORDS REQUIRED TO BE MAINTAINED FOR THREE YEARS

The following is a list of records that must be maintained by the firm for three years:

- Advertising.
- Order tickets.
- Confirmations.
- Option records.
- FOCUS reports.
- Monthly trial balances.
- Written customer complaints.
- Subsidiary ledgers.
- Long and short securities differences.
- Compliance and policy and procedure manuals (kept after changes).
- U4, U5, fingerprints, and employment applications for terminated employees.

RECORDS REQUIRED TO BE MAINTAINED FOR SIX YEARS

The following is a list of records that must be maintained by the firm for six years:

- Blotters.
- General ledgers.

- Customer ledgers.
- Customer account records.
- Stock records/position records.

RECORDS REQUIRED TO BE MAINTAINED FOR THE LIFE OF THE FIRM

The following records must be maintained for the life of the firm:

- Articles of incorporation.
- Corporate stock certificate books.
- Minute books from meetings of the board of directors.
- Partnership records.
- Form BD.

The following chart outlines SEC Rule 17a-3 (records that must be kept) and SEC Rule 17a-4 (how long records must be kept).

SEC RULE 17a-3 Records that must be kept current by broker dealers	SEC RULE 17a-4 Time period records must be preserved	SEC RULE 17a-4 Time period records must be kept in a readily accessible place
Subsidiary records	3 years	First 2 years
Trial balance	3 years	First 2 years
Employment application for associated persons	Until 3 years after person has terminated employment	Until 3 years after person has terminated employment
Order tickets	3 years	First 2 years
Checkbooks, bank statements	3 years	First 2 years
Blotters (records of original entry)	6 years	First 2 years
General ledger	6 years	First 2 years
Security position records (each long and short position)	6 years	First 2 years
Customer ledgers	6 years	First 2 years
Director's minutes	Life of enterprise	First 2 years
Stock certificate books	Life of enterprise	First 2 years
Partnership articles and articles of incorporation	Life of enterprise	First 2 years

Pretest

SUPERVISION OF BROKERAGE OFFICE PERSONNEL AND PROCEDURES

1. When hiring a new employee, the principal must perform all of the following, EXCEPT:
 - a. confirm the agent's employment for the last three years.
 - b. obtain a U5 directly from the employee.
 - c. attest to the employee's character.
 - d. sign the U4 form prior to submission.

2. As it relates to influencing the employees of member firms, which of the following are true?
 - I. The gift may be given to the employee.
 - II. A record of the gift must be maintained by the employing firm.
 - III. The gift must be given to the employer for distribution.
 - IV. A contractual relationship is excluded from the rule.
 - a. I and IV
 - b. II and III
 - c. II, III, and IV
 - d. I, II, and IV

3. All of the following personnel are exempt from the registration requirement, EXCEPT:
 - a. a manager who acts as a liaison between the firm and the board of directors.
 - b. a clerk in the back office who inputs new account information into the firm's computer.
 - c. the firm's Web designer, who posts information about market conditions on the firm's website.
 - d. a sales assistant who occasionally accepts a customer's order.

4. As it relates to securities held in street name, which of the following is true?
 - I. The corporation will send proxies to the broker dealer.
 - II. The corporation will not reimburse the broker dealer for forwarding the proxies.
 - III. The broker dealer may vote blank proxies any way it wishes.
 - IV. Shareholders who attend the annual meeting will have their proxies voided.
 - a. I and III
 - b. II and III
 - c. I and IV
 - d. II and IV

5. A broker dealer that does not carry customer accounts is required to do all of the following, EXCEPT:
 - a. clear all trades on an omnibus basis.
 - b. forward all securities to the carrying firm.
 - c. forward all checks to the carrying firm.
 - d. in the case of market making, have the carrying firm stand behind all trades.

6. Which of the following is NOT a reason to reject delivery?
 - a. The signatures are not guaranteed.
 - b. The customer has determined that the investment is unsuitable.
 - c. The certificate is unclear.
 - d. A bond is missing a coupon.

7. A security has been delivered late to the buying member after the record date for a dividend distribution. Which of the following is true?
- I. The seller will keep the dividend.
 - II. The buyer will be owed the dividend.
 - III. The buying member will send a due bill.
 - IV. The selling member will receive the dividend.
- a. I and II
 - b. II and III
 - c. I only
 - d. II, III, and IV
8. A customer who purchased 1,000 shares of XYZ on margin two months ago and has not executed any order since must:
- a. receive a statement this month.
 - b. not receive a statement this month.
 - c. have received a statement for the last two months only.
 - d. have received a statement for the last two months and must receive one this month as well.
9. A brokerage firm may charge a fee for which of the following?
- I. The safekeeping of securities
 - II. The collection of dividends
 - III. Lack of activity in the account
 - IV. The clipping of coupons
- a. I and II
 - b. II and III
 - c. I, II, and IV
 - d. I, II, III, and IV
10. A wealthy customer has just made a purchase in his margin account. There are substantial assets in the account. The brokerage firm, as a courtesy to the client, may ignore a call for cash for up to:
- a. \$1,000.
 - b. \$10,000.
 - c. \$5,000.
 - d. \$500.

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