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SEC Updates Guide to Broker-Dealer Registration; Financial Institutions Should Consider Broker-Dealer Status

Broker-Dealers

The SEC has recently updated its Guide to Broker-Dealer Registration, prompting banks, thrifts, and other financial institutions to evaluate whether they engage in broker-dealer activities.

Following the enactment of the Gramm-Leach-Bliley Act (GLBA) in 1999, banks are no longer excepted from the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934. Since October 1, 2003, banks that buy and sell securities must determine whether they are "dealers" or whether they meet certain targeted exemptions and exceptions.

The Guide to Broker-Dealer Registration has been updated regarding a variety of new topics, including:

- Regulation R, which addresses bank brokerage activity and was instituted in 2007;
- A broker-dealer's obligation to recommend only investment strategies that are suitable for its customers and for which the broker-dealer has an "adequate and reasonable basis" for the recommendation;
- Regulation ATS, which allows broker-dealers to operate automated trading platforms without registering as a national securities exchange or as an exempt exchange; and
- Broker-dealer privacy policies and practices.

The primary focus of the Guide continues to be determining broker-dealer status. The Securities and Exchange Commission (SEC) requires that brokers and dealers register with the SEC and a self-regulatory organization such as the Financial Industry Regulatory Authority. A broker is generally any entity engaging in transactions in securities for the account of others, whereas a dealer acts as a principal that buys and sells securities for its own account, through a broker or otherwise.

Brokers include investment advisers, financial consultants, marketers of real estate investment interests, and "finders" of investors, investment banking clients, and buyers and sellers of businesses. Dealers engage in the actual buying and selling of securities. For example, all transactions that go through a bank's own accounting

books are potential dealer transactions under the Exchange Act. Factors that indicate a bank is engaging in dealer activities include:

- Holding itself out as being in the business of buying and selling securities;
- Engaging in transactions (either retail or institutional) with the public;
- Making a market in, or quoting prices for, both purchases and sales of securities;
- Participating in a "selling group" or otherwise underwriting securities; or
- Holding a dealer inventory or trading with an affiliate that is a dealer.

Exceptions and Exemptions

Banks that engage in dealer activity may qualify for transaction-specific exceptions from the definition of "dealer." Such exceptions include:

- Permissible securities transactions, such as the buying and selling of commercial paper, bankers acceptances, or commercial bills;
- Investment transactions, such as the buying and selling of securities for investment purposes for the bank itself;
- Certain asset-backed transactions; and
- Identified banking products, such as the buying and selling of deposit accounts, savings accounts, certificates of deposit, and other deposit instruments issued by a bank.

By rule, the SEC also permits exemptions from the definition of "dealer," including exemptions for certain riskless principal transactions and securities lending transactions. The exceptions and exemptions described above allow banks and thrifts to avoid registration; however, the relevant exceptions and exemptions that apply to banks and thrifts do not apply to subsidiaries and affiliates that engage in broker-dealer activities. These entities must register as broker-dealers under the Exchange Act.

Furthermore, the exceptions and exemptions of banks and thrifts do not apply to other financial institutions, such as credit unions; however, the SEC permits credit unions to make securities available to customers without registering as broker-dealers. Credit unions are permitted to engage in "networking" arrangements that allow credit unions to share commissions from brokerage services with affiliated or third-party broker-dealers.

The rules that implement GLBA allow banks to engage in brokerage activities and services traditionally offered by banks without becoming subject to full SEC regulation. Careful attention to the specific exemptions and exceptions to broker-dealer activity are essential for proper compliance.