

Section One

Brokerage Office 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 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. They 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. 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:

- ✓ 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 the NASD. All U4 forms will be sent to the Central Registration Depository (CRD) for processing and recording. Any applicant who has answered yes to any of the questions on the form regarding their background must give a detailed explanation in the DRP pages attached to the form. The applicant is not required to provide information regarding:

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

The only information regarding the employee's finances that is disclosed on the U4 form is if the associated person has ever declared bankruptcy. 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 a 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 their 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 the NASD 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 non-transferable. A representative may not simply move their registration from one firm to another. The employing firm that the representative is leaving must fill out and submit a U5 to the NASD, 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 the NASD. 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, they have two business days to provide it. A representative who leaves the industry for more than 24 months is required to re-qualify by exam. During a period of absence from the industry of two years or less the NASD retains jurisdiction over the representative in cases involving customer complaints and violations.

Registration Exemptions

The following individuals are exempt from registration:

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

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 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 Exchange Commission (SEC) or any foreign or domestic self-regulatory organization (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 B-D
- ✓ Felony conviction or misdemeanor involving securities within the last 10 years
- ✓ Court injunction or order barring the individual

Disciplinary Actions Against a Registered Representative

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

- ✓ SEC
- ✓ An exchange or association
- ✓ State regulator
- ✓ Clearing firm
- ✓ 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. NASD 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 the New York Stock Exchange (NYSE), NASD, 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 their 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, they 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 start-up 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 raise money and the representative receives no compensation for their 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 NASD 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.

Note: 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.

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 their 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 or an investment advisor 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. They are also prohibited from lending money or securities to a client. Broker dealers making margin loans are excluded from this rule.

Becoming a Stockholder

We need to review how someone becomes a stockholder. While some people purchase the shares directly from the corporation when the stock is offered to the public directly, most investors purchase the shares from other investors. These investor-to-investor transactions take place in the secondary market on the exchange or in the over-the-counter 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. There are certain types of orders that may 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 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 all settle the next business day following the trade date and a 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 the 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. While 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 they want to make 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 their 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 NASD before the expiration of the fifth business day. A broker dealer may ignore a call for cash of \$1,000 or less.

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

- ✓ 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
- ✓ Amount due or owed
- ✓ Whether the firm acted as an agent or principal
- ✓ Whether the firm acted as agent for the other side of the transaction—known as “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

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 may 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 member 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. The Medallion Program members pay to participate.

Examples of invalid signatures are:

- ✓ 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

Customer Account Statements

A customer must receive a statement every month that 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
- ✓ 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 the physical possession of the customers' cash and securities. A brokerage firm that maintains the account of its customers and holds their cash and securities is known as a "carrying firm" or a 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." 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. An introducing member may also choose to clear their 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 they clear through an omnibus account. Omnibus accounts are not allowed to purchase securities on margin for customers. All securities must be paid for in full.