SEC approves NASD and NYSE uniform branch office definition for broker-dealers

Charles S. Gittleman and Russell D. Sacks

Abstract

Purpose – To describe and to discuss the implications of the new National Association of Securities Dealers, Inc. (NASD) and New York Stock Exchange (NYSE) uniform branch office definition for broker-dealers, approved on September 9, 2005, as found in the definitions of “branch office” found in NASD Conduct Rule 3010(g)(2) and NYSE Rule 342 (the “Approved Rules.”)

Design/methodology/approach – Summarizes and analyzes the adopted rules.

Findings – The adoption of a single standard by NASD, the NYSE, and state law authorities will be welcome to broker-dealers that have to date been operating under a number of varying definitions. The Approved Rules define “branch office” very broadly, but contain important exclusions to the uniform definition such as the primary residence exclusion and exclusions for locations of limited use, locations of convenience, and locations used for other than securities business. Unfortunately, the SEC approval orders contain no discussion of how these rules might apply to the international networks that include US broker dealers.

Originality/value – A useful summary and analysis of the new uniform branch office definition, which comes at a time when US securities regulators are placing increasing emphasis on branch office supervision, control, and inspection.

Keywords Legislation, Stock exchanges, United States of America

Paper type Technical paper

I. Introduction

On September 9, 2005, the Securities and Exchange Commission (the “SEC”) approved a proposed rule change of the National Association of Securities Dealers, Inc. (NASD) relating to the definition of “branch office” found in NASD Conduct Rule 3010(g)(2), and concurrently approved a proposed rule change of the New York Stock Exchange, Inc. (the “NYSE”) relating to the definition of “branch office” found in NYSE Rule 342[1]. The Approval Orders end a comment and response process that began in August of 2002 (for the NYSE[2]) and July of 2003 (for the NASD[3]) with the filing of proposed rule changes, and that saw nearly 850 comment letters submitted to the SEC in response to the rule change proposal[4]. While the direct result of the Approval Orders is a uniform definition of “branch office” for all US-registered broker-dealers (the “Approved Rules”), the Approved Rules signal the increasing importance of branch offices in the US regulatory framework, and the increasing importance that US securities regulators place on branch office supervision, control, and inspection[5].

II. Executive summary of the adopted rules

Under the Approved Rules, a “branch office” is defined as any location “where one or more associated persons of a member [firm] regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security, or any location held out as such.”[6] The Adopted Rules contain important exclusions from the uniform definition of “branch office,” namely:
a location that operates as a back office;
a representative’s primary residence, provided it is not held out to the public and certain other conditions are satisfied[7];
a location, other than the primary residence, that is used for less than 30 business days annually for securities business, is not held out to the public as an office[8];
a location of convenience used occasionally and by appointment;
a location used primarily for non-securities business and from which less than 25 securities transactions are effected annually;
the floor of an exchange; and
a temporary location used as part of a member’s business continuity or disaster recovery plan.

A detailed description of key provisions of the Adopted Rules follows.

III. Summary of the adopted rules

3.1. New definition of “branch office”

Under the Adopted Rules, “branch office” will be defined at NASD Rule 3010 and at NYSE Rule 342 as “any location where one or more associated persons of a member regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security, or is held out as such.” This uniform definition will replace the (formerly) varying definitions found under NASD and NYSE regulation, and under state securities law[9].

3.2. Exclusions to the new definition of “branch office”

The Adopted Rules define “branch office” very broadly. As a result, and following extensive comment, the Adopted Rules contain important exclusions to the uniform definition of “branch office.” Certain of those exclusions are described below.

3.2.1. The “primary residence” exclusion. In several instances, the Approval Orders explicitly state that one purpose underlying the rule changes is to balance investor protection and the need for supervision and control of office locations with advances in technology and flexible working arrangements that are permitted thereby[10]. As a direct result of these concerns, the Adopted Rules have excluded from the definition of “branch office” any location that is the associated person’s primary residence[11], provided that a host of conditions are met. Those conditions are:

- Only one associated person[12] or associated persons who are members of the same immediate family and reside at the location may conduct business at such location.
- The location cannot be held out to the public and the associated person may not meet with customers at the location.
- Customer funds and securities may not be handled at the primary residence location.
- The associated person must be assigned to a designated branch office, and the branch office must be reflected on all business cards, stationery, advertisements, and other communications to the public[13].
- The associated person’s correspondence and communications with the public must be subject to the firm’s supervision.
- Electronic communications must be made through the firm’s systems.
- All orders must be entered through the designated branch office or an electronic system established by the member and reviewable at such location.
- Written supervisory procedures pertaining to supervision of sales activities conducted at the residence must be maintained by the member.
- The member must maintain a list of its non-branch locations that are primary residences.
The NASD Approval Order describes the criteria set out by the uniform definition as having been the subject of a number of comments. Specifically, some commenters took exception to the criteria that customer funds or securities cannot be handled at primary residence locations, and that associated persons are not permitted to meet with customers at primary residence locations[14]. In response, NASD stated that it “believes strongly that the limitations on the use of a primary residence are important safeguards intended to protect investors.” NASD states, without further elaboration, that activities outside the scope of the conditions set forth in the proposed definition should be subject to the monitoring and examination by regulators[15]. However, in response to concerns that certain electronic systems may cause persons acting as traders from a residence location to fail to meet one or more of the exception’s criteria, NASD importantly states: “to the extent any particular scenario raises questions as to the meaning of any of these limitations, NASD believes such issues can be addressed, as appropriate, through its interpretive process without requiring amendment to the proposed rule.”[16] Such interpretive guidance could become an important tool for NASD and the NYSE in maintaining the flexibility – and the balance – described by the SEC in the Approval Orders.

3.2.2. Locations of limited use and locations of convenience. The Adopted Rules contain two exclusions from the uniform definition of “branch office” for locations that are used for limited periods of time. Specifically, the following offices are excluded from the definition of “branch office”:

1. Any location, other than a primary residence, that is used for securities business for less than 30 business days in any one calendar year, provided that most of the criteria for primary residence offices are met.

2. Any office of convenience, where associated persons occasionally and exclusively by appointment meet with customers, which is not held out to the public as an office.

In respect of those “limited use” offices at which securities business is conducted for no more than 30 days each year, it is important to note that each such office must meet virtually all of the criteria that apply to personal residence offices, including that the associated person does not meet with customers or the public at that location[17]. As well, it is noteworthy that each of the Adopted Rules excludes partial business days from the required count, provided that “the associated person spends at least four hours on such business day at his or her designated branch office during normal business hours.”[18]

The Adopted Rules acknowledge the practice of broker-dealers arranging for “offices of convenience,” which is a term used in the securities industry to generally describe the practice of broker-dealers arranging for the use of non-branch office space for meetings and other temporary use, including by broker-dealers whose business involves travel to locations near the offices of convenience. However, the Adopted Rules also place three noteworthy limitations on the use of certain offices of convenience: first, the office must be used for customer meetings “occasionally and exclusively by appointment.”[19] Second, the location cannot be held out as a branch office, and finally, where an office of convenience is located on bank premises, signage necessary to comply with NASD and other regulations may be required in order to avoid customer confusion[20].

3.2.3. Locations used for other than securities business. The Adopted Rules also exclude from the uniform definition of branch office any location that is primarily used to engage in non-securities activities[21] and from which the associated person effects no more than 25 securities transactions in any one calendar year[22]. The Adopted Rule also provides that advertisements or sales literature identifying any such location must also set forth the location from which the associated person is directly supervised[23]. As well, such securities activities must be conducted through, and supervised by, the associated person’s designated branch office.

3.3. No SEC discussion of effect on international broker-dealers

The Approval Orders contain no discussion of the international nature of the US securities industry. Many NASD and NYSE members operate within larger international enterprises,
and many such members maintain registrations for securities professionals that work outside the United States. The NASD currently recognizes the international nature of its members’ workforces by, for example, (a) expressly permitting the registration of persons that are engaged in the securities business of a foreign affiliate of the member[24], and (b) providing a special category of registration for associated persons of a member that operate outside the United States[25] The SEC has recognized the international nature of the securities industry by permitting an exception from broker-dealer registration for certain non-US securities brokers and dealers, which exception is widely used by international securities enterprises conducting business with certain US persons through affiliated US-registered broker-dealers[26].

Though interpretive issues will likely arise as to whether non-US locations affiliated with NASD and NYSE member firms may be deemed to be locations where one or more associated persons of a member “regularly” conduct the business of effecting any transactions in any security, or whether any such non-US locations are being held out as such locations, it is possible that one or more of the organizational structures used by international financial institutions may fit that description. The challenges associated with identifying any such locations as “branch offices” of the US broker-dealer (rather than as non-branch locations or offices of convenience) include US and local tax issues for the US broker-dealer, regulatory issues and burdens relating to the specific supervisory requirements for branch offices[27], and substantial issues under local law relating to the conduct of securities activities by entities located outside the local jurisdiction (in this case, the USA).

IV. Conclusion

The adoption of a single standard by NASD, the NYSE, and state law authorities will be welcome to broker-dealers that have to date been operating under a number of varying definitions. In addition, the regulators involved in the adoption of the uniform definition found in the Adopted Rules have made an explicit attempt to recognize the increasing role of technology in the operations of broker-dealers, and to recognize the increasing need of securities businesses to permit – and encourage – alternative working arrangements for their associated persons. Though this effort has produced exclusions that are limited by substantial constraints, the emergence of exclusions, and of a willingness by regulatory authorities to consider further interpretive relief, is also a welcome addition to the regulatory landscape in respect of broker-dealers’ office infrastructure.

Substantial challenges remain for broker-dealers. Three examples pointed out by this note include:

1. multiple constraints on the use of personal residences by associated persons of a broker-dealer;
2. strict limitations on the number of transactions that can be conducted at offices of convenience; and
3. recognition of an increasingly international securities industry.

Notes

1. The SEC’s Order relating to the NASD definition, “Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment Nos. 1, 2, 3, 4, 5 and 6 thereto Relating to Proposed Uniform Definition of ‘Branch Office’ under NASD Rule 3010(g)(2),” SEC Release 34-52403 (September 9, 2005), is currently available on the SEC’s Internet web site at www.sec.gov/rules/sro/nasd/34-52403.pdf (the “NASD Approval Order”); the SEC’s Order relating to the NYSE definition, “Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 2 and 3 to the Proposed Rule Change Relating to the Amendment of Rule 342 (Offices Approval, Supervision and Control) to Provide for a Uniform Definition of ‘Branch Office,’ ” SEC Release 34-52402 (September 9, 2005), is currently available at www.sec.gov/rules/sro/nyse/34-52402.pdf (the “NYSE Approval Order,” and together with the NASD Approval Order, the “Approval Orders”).
2. See the NYSE Approval Order at text accompanying Footnote 1.

3. See the NASD Approval Order at text accompanying Footnote 1.

4. See the NASD Approval Order at Footnote 6 thereto.

5. In this regard, the Approved Rules are closely linked to recent initiatives by the NASD and the NYSE to ensure that all member firms have substantial supervisory controls, and that policies and procedures that are designed to comply with securities regulation are regularly tested and certified by member firms. For more information on these initiatives, see “SEC Approves NASD Rule Requiring Brokers and Dealers to Appoint a Chief Compliance Officer, and Requiring Annual Certification of Firm Policies” (December 2004), currently available at www.shearman.com/documents/SD_1204.pdf. As well, the Approved Rules are closely linked to recent initiatives by the SEC relating to the books and records that are required to be kept by branch offices and other satellite locations of broker-dealers. For more information relating to the books and records requirements of US broker-dealers, please see “SEC Amendments to Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934 Take Effect” (April/May 2003), currently available at www.shearman.com/documents/CM_04_05_03.pdf

6. See the NASD Approval Order at page 6, and the NYSE Approval Order at page 4.

7. Note, however, that NASD and the NYSE have placed substantial additional limitations on the exclusion of private residences from the definition of “branch office”; those limitations are described at Section 3.2.

8. Other conditions also apply to this exclusion; please see Section 3.2 below.

9. It is noteworthy that the Adopted Rules were adopted by the SEC following the consultation of NASD and the NYSE with the North American Securities Administrators Association.

10. For example, in its general discussion of the exclusions to the uniform definition, the SEC states in the NASD Approval Order that “the Commission believes that the seven proposed exceptions to registering as a branch office will recognize current business, lifestyle, and surveillance practices and provide associated persons with additional flexibility. For instance, because associated persons may have to work from home due to illness, or to provide childcare or eldercare for certain family members, the Commission believes it is appropriate to except primary residences from the definition of branch office while providing certain safeguards and limitations to protect investors.” See the NASD Approval Order, at text accompanying Footnote 97.

11. It is noteworthy that the Adopted Rules exclude only a person’s “primary” residence, rather than any personal residence meeting the enumerated criteria.

12. The NYSE Approval Order states that “the term ‘associated person of a member or member organization’ would be defined in proposed NYSE Rule 342.10 as a member, allied member, or employee associated with a member or member organization.” See the NYSE Approval Order at Footnote 15. While the NASD does not provide a definition for this term, it is reasonable to assume that for purposes of Rule 3010, NASD will use the definition of “associated person” found at Article I of its By-Laws, and incorporated into the Conduct Rules by NASD Rule 0121. A similar definition of “associated person” exists for purposes of the NASD’s Membership Proceedings (“1010” Series) Rules at NASD Rule 1011(b).

13. This criterion underscores the importance of supervision and supervisory controls in the Adopted Rules. It is noteworthy that both NASD and the NYSE have issued guidance highlighting the need for adequate supervision of primary residence locations. For a description, please see the NASD Approval Order at pages 9-10, and the NYSE Approval Order at pages 14-15.

14. See the NASD Approval Order at pages 15-16.

15. See the NASD Approval Order at pages 15-16.

16. See the NASD Approval Order at page 16.

17. The Adopted Rules require each office of limited use to meet each of the criteria found at NASD Conduct Rule 3010(g)(2)(A)(2)(ii)(a) through (h), which correspond to the criteria enumerated (a) through (h) at Section 3.2.1 above.

18. See NASD Approval Order at page 8, and the NYSE Approval Order at Footnote 25 thereto.

19. See the NASD Approval Order at page 8.
20. See the NASD Approval Order at pages 8-9. For example, NASD Conduct Rule 2350 and NYSE Rule 343 provide guidance and create requirements in circumstances where broker-dealers share space with other financial institutions.

21. In describing what constitutes “non-securities” activities, the NASD Approval Order contains a sole parenthetical remark, stating that non-securities activities include activities “[such as] insurance.” See the NASD Approval Order at page 9.

22. See the NASD Approval Order at page 9, and the NYSE Approval Order at page 7; substantial comment was received by NASD on this transactional limitation. Please see the NASD Approval Order at pages 17-20.

23. See the NASD Approval Order at page 9, and the NYSE Approval Order at page 7.

24. NASD Membership Rules 1021 and 1031 expressly permit the registration of principals and representatives, respectively, who are “engaged in the investment banking or securities business of a foreign securities affiliate or subsidiary of the member.”

25. See NASD Membership Rule 1100.


27. NASD and the NYSE have been unambiguous that all locations, whether they are branch offices or non-branch locations, must be adequately supervised; the issue here relates solely to increased costs associated with required inspection and supervision of those offices designated as branch offices.