**To**: ABC Bank CEO

**From**: Lisa LeFever

**Date**: December 15, 2017

**RE**: B/D and I/A Registration and Compliance Programs

**ISSUE**

ABC Bank would like to establish a U.S. registered broker-dealer (B/D) to engage in fixed income sales and trading, equity sales and trading, and investment banking activities, consisting of underwriting in fixed-income and equity securities as well as certain public finance activities, to serve solely institutional clients. ABC Bank would also like to establish a U.S. registered investment adviser (I/A) to provide investment advice and portfolio management services to institutional customers and high net worth individuals.

**SUMMARY**

The processes described below in Part I and II detail the steps that ABC must take in order to register B/D and I/A affiliates in the United States. B/D registration is governed by the Securities Exchange Act of 1934 (Exchange Act), whereas I/A registration is governed primarily by the Investment Advisers Act of 1940 (Advisers Act). The B/D affiliate must register with the Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA), the Securities Investor Protection Corporation (SIPC), and state regulators. ABC B/D could provide advisory services without necessitating I/A registration if those services were “solely incidental” to its B/D activities.[[1]](#footnote-1) However, since ABC I/A will serve high net worth individuals, customers not served by ABC B/D, the I/A entity cannot use the B/D exemption and it must register with either the SEC or state regulators, but not both.

Part III discusses the role of compliance in B/D and I/A entities and the development compliance programs within each entity to ensure conformity with the applicable laws and regulations. While the compliance goals of each will be similar, each entity will face distinct business, compliance, and legal and risks such that each will necessitate separate compliance programs that address the intricacies of each business. ABC B/D will contend with the prescriptive, rules-based regime of the Exchange Act, while ABC I/A will operate under broader, principles-based framework of the Advisers Act.

**DISCUSSION**

1. **BROKER-DEALER REGISTRATION**

Pursuant to the Exchange Act, assuming that ABC B/D will engage in multi-state business, it must register with the SEC in order to engage in market making activities in securities for its institutional customers and on its own account.[[2]](#footnote-2) Specifically, Section 15(a) of the Exchange Act requires that B/Ds register with the SEC in order to conduct their business, unless an exemption applies. While banks enjoy specific exemptions from registration as a B/D, the exemptions are limited and not available for bank subsidiaries or affiliates who engage in B/D activities.[[3]](#footnote-3) By establishing ABC B/D, ABC will effectively protect its banking enterprise by “pushing out” its securities activities to ABC B/D.

* 1. *Form BD*

Section 15(b) of the Exchange Act provides the formal requirements for B/D registration, which will be effectuated through the filing of Form BD with the SEC.[[4]](#footnote-4) ABC B/D will complete an initial Form BD filing, which will include information about ABC B/D’s operations, finances, compliance mechanisms, its directors, board, owners, control persons and affiliates, as well as past legal, regulatory, and criminal proceedings. The form specifically defines the necessary terms, including what constitutes control, an affiliate, applicant, etc.

Form BD includes various schedules. ABC B/D will complete Schedule A and Schedule B of Form BD. Schedule C will be used in the future to update the form. Information regarding ABC B/D’s direct owners and executive officers will be included in Schedule A. Information about indirect owners will be included in Schedule B. ABC B/D will also complete Form BD’s disclosure reporting pages (DRPs) that is required of it determined by the answers to the yes or no questions provided on the form. These questions include specifics about the criminal background of control persons and affiliates, regulatory enforcement proceedings, civil actions, and past bankruptcies. If ABC B/D plans to establish branch offices, information about such branches will be disclosed on Schedule E.

ABC B/D will file Form BD through the Central Registration Depository (CRD), which is operated by FINRA, the self-regulatory organization (SRO) that B/Ds are required to be members of. Since it is an initial Form DB filing, it is required to be submitted in full paper format. Within 45 days, the SEC will grant the application or institute proceedings to determine if it should be denied. Membership approval from FINRA could take longer than 45 days.

* 1. *FINRA*

The Exchange Act also requires B/D to become a member of an SRO like FINRA.[[5]](#footnote-5) Form BD will also be used by ABC B/D to register as a member of FINRA. In addition, FINRA oversees the registration of those persons affiliated with B/Ds, known as “affiliated persons” (APs), and administers certain qualifying exams for such individuals.[[6]](#footnote-6) Generally, employees, registered representatives, will qualify as “associated persons” (APs) of the B/D who must be registered on Form U–4.[[7]](#footnote-7) Form U–4 provides disclosure regarding employees’ employment and disciplinary history. Some employees of ABC B/D will further need to qualify under the Series 7 examination. Other supervisory personnel will need to qualify beyond the Series 7 examination. The owner of a B/D must qualify and register as a principal. The Chief Compliance Officer will also need to register as a principal.

* 1. *Other B/D Registration Requirements*

ABC B/D will further need to register with the Securities Investor Protection Corporation (SIPC) and be cognizant of the various state regulatory frameworks that apply to B/Ds. B/Ds must become SIPC members unless their business is exclusively intrastate or their principal place of business is outside the United States.[[8]](#footnote-8) SIPC membership requires an annual fee, which allows the organization to provide for member’s customers in the event of a member’s liquidation. The North American Securities Administrators Association (NASAA) provides information about the varying states regulation of B/Ds.[[9]](#footnote-9)

1. **INVESTMENT ADVISER REGISTRATION**

ABC I/A will engage in the business of providing investment advice for its institutional customers and high net worth individuals. An I/A is any person or firm engaged in the business (i.e. for compensation) of advising customers on investment decisions or issuing reports and analyses regarding securities.[[10]](#footnote-10) The Advisers Act, and the rules and regulations promulgated thereunder by the SEC, governs the business of I/As and focuses on the special fiduciary nature of the advisory relationship. The Act aims to prevent fraud and manipulation in the advisory business and requires advisers to disclose certain information to the investing public. Among other things, it contains specific rules implemented in order to eliminate, or mitigate, conflicts of interests that may exist in investment advice rendered to customers.

Under the Advisers Act, I/As must register with the SEC pursuant to the Advisers Act or with state regulators. The Act provides that entities which have less than $100 million in assets under management (AUM) are prohibited from registering with the SEC and must solely register at the state level. However, this prohibition does not apply to entities that will be advising investment companies.[[11]](#footnote-11) Since ABC I/A will be advising institutional entities, which presumably include investment companies, it is required to register with the SEC regardless of its AUM. By registering this separate entity, ABC Bank will avoid being classified as an “investment adviser” itself.[[12]](#footnote-12) Registration at the firm level will cover ABC I/A employees and others under the firm’s control who participate in advisory activities on the firm’s behalf.

* 1. *Form ADV*

Form ADV includes two parts. Part 1 is subdivided into Part 1A and 1B. Part 1A will require information about the firm, controlling persons of the firm, and persons associated with the firm. The firm will need to fill out items 1, 2, 3, 6, 7, 10, and 11 of Part 1A. There are also corresponding schedules that will need to be filled out. These include Schedules A, B, C, D, R, and Disclosure Reporting Pages (DRPs). Part 1B will not be required of the firm because it is only for those registering with state regulators. Part 2 includes Part 2A and 2B. Part 2A requires the firm to create a narrative brochure about its advisory business. Part 2B will include brochure supplements that contain information about the firm’s supervised persons.

ABC I/A will complete Form ADV and file it electronically with the SEC through the Investment Advisers Registration Depository (IARD).[[13]](#footnote-13) After Form ADV is submitted, the SEC will respond within 45 days by either approving the registration or submitting the application for further administrative review.

1. **BROKER-DEALER AND INVESTMENT ADVISER COMPLIANCE**
   1. *Role of Compliance*

Compliance will be an essential component of both ABC B/D and ABC I/A at the registration stage and continuing for the life of the businesses. It is important to have compliance personnel to advise on various issues that arise in the real-time, monitor activities, transactions, and communications within each entity in order to identify improper conduct or weaknesses in procedures, and support the business unit and management through education and support.

Compliance serves important roles in mitigating legal and regulatory risks, as well as business risks.[[14]](#footnote-14) Registration as either a B/D or I/A will impose specific ongoing compliance obligations on the entities. To meet the standards of compliance required of these registered entities, they will need to establish well-functioning compliance programs administered by the Compliance Department and a CCO, annual review of the programs, and specified disclosures. Failure to meet the applicable requirements will subject them to the regulatory risk of enforcement or litigation proceedings brought by FINRA or the SEC.[[15]](#footnote-15) Further, as federally-regulated entities, they will be subject to the broad anti-fraud provisions of the Exchange Act and this poses the legal risk of criminal liability for bad actors.[[16]](#footnote-16) Either of these events contribute to the risk of business failure due to enforcement or suspension or revocation of registration. By managing issues before they result in costly problems, a working compliance group effectively minimizes a broad range of these risks.

While management will be subject to the duty to supervise,[[17]](#footnote-17) the Compliance Department will function separately from the business units to instill a firm-wide “culture of compliance,” engaging in broad interactions among units of the firm, including legal, risk, audit, and management. The Department will coordinate with legal with respect to regulatory inquiries, filings, investigations, and potential violations. The Compliance Department will engage in open and direct communication with senior executives in order to promptly recognize, escalate or remedy potential issues. While serving many cross-unit functions within the firms, the Compliance Department will maintain substantial independence in order to serve important “control room” functions, such as creating informational barriers between the B/D and I/A units, conducting unit evaluations, and maintaining restricted lists and personnel. It will also operate externally to foster relationships with regulators and keep informed of regulatory developments and changes.

The extent of compliance efforts at the entities will be dictated by the size and resources available to them.[[18]](#footnote-18) At the onset, it is possible that one Compliance Department with a single Chief Compliance Officer (COO) will effectively serve the needs of both. However, as the entities grow and their compliance needs diverge, their compliance efforts will need to scale accordingly. Within the Compliance Department, the COO will be cognizant of the separate issues and risks faced by each entity in implementing the compliance programs, paying special attention to possible conflicts of interest that may arise.

* 1. *Broker-Dealer Compliance Program*

ABC B/D’s Compliance Program will address the applicable rules and regulations of the Exchange Act and FINRA and provide for the necessary procedures to meet those regulatory goals. The Compliance Program will focus on the financial, operational, reporting, and suitability requirements, as well as promoting anti-fraud efforts. Specific obligations will include recordkeeping, the net capital and reserve requirements, rules regarding the segregation of customer’s funds, and margin and extensions of credit rules. Further, ABC B/D must ensure that its employees and persons conducting B/D activities on its behalf are appropriately certified and apprised of their duties and responsibilities.

ABC B/D will operate under the duty of best execution of customer’s orders,[[19]](#footnote-19) the duty of fair dealing,[[20]](#footnote-20) and the duty to ensure the securities are “suitable” for their customers.[[21]](#footnote-21) Disclosure must also be made to customers regarding terms of credit.[[22]](#footnote-22) ABC B/D will be subject to specific rules regarding the protection of customer funds and information–it must have policies and procedures in place to ensure the protection of customer funds and information.[[23]](#footnote-23) After effectuating transaction, the B/D must have the necessary policies that provide for customer confirmation of orders.[[24]](#footnote-24)

ABC B/D’s compliance program must also address issues that arise during its underwriting activities. Its policies and procedures that prevent the dissemination of material non-public information it will acquire. Policies must appropriately address restrictions on trading during underwriting in accord with Regulation M of the Exchange Act. In addition, if ABC B/D and ABC I/A share research reports or analyses, special attention will need to be paid to the disclosures provided to customers regarding such reports and any potential conflicts of interest.[[25]](#footnote-25) All reports and information it disseminates will need to be “fair and balanced.”[[26]](#footnote-26)

ABC B/D’s compliance program will be subject to annual review by an executive officer who will ensure that the firm “has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance” with the applicable rules and regulations.[[27]](#footnote-27) The executive officer will meet with the CCO to discuss such policies as needed, but no less than annually.

* 1. *Investment Adviser Compliance Program*

Registration as an I/A obligates the firm to a linty of ongoing compliance requirements under the Advisers Act. ABC I/A’s compliance program will focus on potential conflicts of interest that may arise, disclosure and management of such conflicts, recordkeeping requirements,[[28]](#footnote-28) the development of a “code of ethics,” policies and procedures to prevent fraud and manipulative conduct, accuracy of information shared with customers, and mechanisms to meet the various duties I/As are subject to. Similar to B/Ds, I/As must ensure their personnel understand the requirements of the compliance program and the responsibility to guard against violations of violations of the Advisers Act and also federal securities laws.

ABC I/A will be operating under a more onerous standard when conducting its advisory activities–I/As are subject to the duty to act in the best interest of its customers, a duty of loyalty to expose conflicts of interest, and a duty of care in executing transactions when the I/A selects the broker.[[29]](#footnote-29) ABC I/A must establish a “code of ethics” which will address employee conduct and prohibit fraudulent and manipulative activity in association with the advisory business.[[30]](#footnote-30) To ensure these requirements are met, ABC I/A’s compliance program will entail an annual review of its policies to ensure efficiency under the law.[[31]](#footnote-31)

1. Broker-dealers are exempt from registration as an I/A if their services are solely incidental to their business and they do not receive any special compensation for their advice. *See* Section 202(a)(11)(B). [↑](#footnote-ref-1)
2. A “broker” is defined as “any person engaged in the business of effecting transactions in securities for the account of others.” § 3(a)(4)(A). A “dealer” is defined as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.” § 3 (a)(5)(A). [↑](#footnote-ref-2)
3. *See* § 5(C). Regulation R dictates the specific activities banks can engage in without necessitating B/D registration. It describes the activities that must be “pushed out” to a separately registered entity. *See* 17 C.F.R. § 247 et seq.). [↑](#footnote-ref-3)
4. Form BD is available at: http://www.sec.gov/about/forms/formbd.pdf. [↑](#footnote-ref-4)
5. § 15(b)(8) and Rule 15b9-1. National securities exchanges are also SROs. In some instances, B/Ds may only be required to register as members with exchanges that they conduct business with; however, registration with FINRA provides the greatest coverage to B/D activities. *See* Rule 15b9-1. [↑](#footnote-ref-5)
6. The Exchange Act defines “APs” as: “any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer.” APs do not include those “whose functions are solely clerical or ministerial.” § 3(a)(18) and Rule 15b7-1. [↑](#footnote-ref-6)
7. 17 CFR 240.3a4-1 (APs are explicitly excluded from the B/D registration as long as their conduct is in relation to their employment with the B/D and not on their own behalf). [↑](#footnote-ref-7)
8. *See* Securities Investor Protection Act (SIPA), 15 U.S.C. § 78aaa, et seq. SIPA created the SIPC and governs liquidations of affiliates. *Id.* [↑](#footnote-ref-8)
9. More information is available at: http://www.nasaa.org/. [↑](#footnote-ref-9)
10. § 202(a)(11). [↑](#footnote-ref-10)
11. *See* Advisers Act Rule 203A­–1 and Rule 203A–2. [↑](#footnote-ref-11)
12. Section 202(a)(26). This section defines a “separately identifiable department or division” through which the bank can avoid being required to register as an “investment adviser.” *Id.* [↑](#footnote-ref-12)
13. IARD, a product of FINRA, is the portal through which the public accesses adviser information and disclosures. Form ADV is filed here: https://www.iard.com/filingonline. [↑](#footnote-ref-13)
14. *See generally* Securities Industry Association (SIA), White Paper on the Role of Compliance (2005). [↑](#footnote-ref-14)
15. FINRA provides that B/D customers disputes must be pursued through FINRA arbitration, whereas I/A disputes are subject to disputes brought by customers in federal court under the Advisers Act. [↑](#footnote-ref-15)
16. *See* Exchange Act § 10(b) and Rules 10b–5 (the broad anti-fraud provisions that apply to B/Ds). *See* Advisers Act Sections 206 (1)/(2)(prohibiting “any device, scheme or artifice to defraud any client or prospective client”). [↑](#footnote-ref-16)
17. The Exchange Act imposes a duty of supervision on B/Ds under which they must reasonably oversee their employees and persons under their control in order to prevent violations of securities laws. [↑](#footnote-ref-17)
18. *Id.* at 2. [↑](#footnote-ref-18)
19. A B/D must seek to obtain the most favorable terms available under the circumstances for its customer orders. [↑](#footnote-ref-19)
20. The “duty of fair dealing” includes the duty to execute orders promptly, disclose certain material information, charge prices reasonably related to the prevailing market, and fully disclose any conflict of interest. [↑](#footnote-ref-20)
21. The “suitability” requirement means that a B/D must have an "adequate and reasonable basis" for any recommendation that it makes. [↑](#footnote-ref-21)
22. “A B/D must establish procedures for disclosing this information before it extends credit to a customer for the purchase of securities. A B/D must give the customer this information at the time the account is opened, and must also provide credit customers with account statements at least quarterly.” *See* Exchange Act Rule 10b-16. [↑](#footnote-ref-22)
23. *See* Exchange Act § 15(g). [↑](#footnote-ref-23)
24. *See* Exchange Act Rule 10b-10. [↑](#footnote-ref-24)
25. *See* FINRA Rule 2241 and Rule 2242. [↑](#footnote-ref-25)
26. *See* FINRA Rules 2210; 2212–2216 [↑](#footnote-ref-26)
27. *See* FINRA Rule 3130. [↑](#footnote-ref-27)
28. I/As must maintain copies of their compliance program, as well as the annual assessment reports for 5 years from the date of their implementation. These records can be in electronic form. *See* Advisers Act Rule 38a–1. [↑](#footnote-ref-28)
29. *See* Advisers Act Section 206(3). [↑](#footnote-ref-29)
30. *See* Advisers Act Rule 204A-1. [↑](#footnote-ref-30)
31. *See* Rule 206(4)-7. [↑](#footnote-ref-31)