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A PRIMER ON BROKER-DEALER REGISTRATION*

David A. Lipton**

Broker-dealers play a pivotal role in maintaining the integrity and efficiency of the American securities markets. By serving public investors, they effect securities transactions, provide investment advice, take custody of securities and funds, extend credit, and even exercise investment discretion. Broker nonfeasance or misfeasance can result in harm to investors who rely upon brokers as fiduciaries. Injury to investors can threaten the welfare of our capital formation markets, as well as our secondary trading markets. Because of the sensitive role that broker-dealers play in our economy, federal securities laws have imposed a comprehensive regulatory scheme upon broker-dealers. This system establishes duties, prohibitions, surveillance mechanisms, disclosure requirements, reporting, financial responsibility and record retention obligations, in addition to sanctions for performance failures. This regulatory system is imposed only upon those businesses or persons that are required to register as broker-dealers under the federal securities laws. In order for the regulatory system to function effectively, those who are subject to registration, and thus the regulatory system, must be those persons who perform the financially sensitive functions as broker-dealers which necessitate investor protection. This Article will explore the question of who is a broker-dealer and, consequently, who is required to register as a broker-dealer and comply with the regulatory structure.

Initially, the answer to that question appears relatively simple. There is a generally accepted understanding by the public that a broker-dealer is someone who effects securities transactions for customers either on a commission or mark-up/mark-down basis. Unfortunately, this common understanding of the broker-dealer does not provide guidance for determining broker status.

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* Extensive portions of this Article have been excerpted from the first chapter of a treatise on broker-dealer regulation, scheduled for publication in late 1987 by Clark Boardman Co., Ltd. The publisher retains the copyright on that material. Portions of the chapter to appear in the treatise have not been included in this article for reasons of economy of space. The excluded sections deal with municipal securities brokers, government securities broker-dealers and banks and brokers.

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in other than the customary securities industry situation. Common understanding of the term "broker-dealer" is not useful in determining, for example, whether the vice president of an oil and gas mining company whose duties include distributing investment interests in the business to the public is a broker-dealer. Other noncustomary candidates for the classification of broker-dealer may include finders, who on a commission basis, secure investors for promoters who seek to develop a specific business idea, or companies that perform back-office services for brokerage firms when such services require possession by the company of customer securities. The necessary analysis for situations involving noncustomary broker-dealers is whether the potential broker-dealer is performing functions that create risks comparable to those arising from the activities of customary broker-dealers. An extensive body of case law, Securities and Exchange Commission rules, and no-action letters have evolved in response to these issues. This Article will explore that body of law and, in addition, will focus upon issues subsidiary to the question of who is a broker-dealer. These issues include the operation of intrastate as well as other exemptions from broker-dealer registration, the need for registration of foreign broker-dealers, the definition of a security upon which the definition of broker-dealer is dependent, and the need for broker-dealer registration by banks engaged in securities activities.

I. HISTORICAL DEVELOPMENT

The present federal system for the regulation of brokers and dealers did not spring fully armored from the head of Congress. The Seventy-third Congress, which enacted the Securities Exchange Act of 1934 (the Exchange Act or the 1934 Act), knew how to be quite specific when responding to many of the securities trading abuses identified in the highly regarded investigation of the securities industry conducted by the Senate Committee on Banking and Currency. However, when Congress first adopted legislation


2. Senate Comm. on Banking and Currency, Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. 1 (1934). The name of this report is traditionally identified with Ferdinand Pecora, the last of a series of four attorneys who served as counsel to this subcommittee in its investigation. Id. at 2.

In describing the work of the Senate Committee, James Landis, one of the draftsmen of the 1933 Act, said:

That Committee spread on the record more than the peccadillos of groups of men involved in the issuance and marketing of securities. It indicted a system as a whole that had failed miserably in imposing those essential fiduciary standards that should govern persons whose function it was to handle other people’s money.

Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev. 29, 30 (1959). Another extensive study of the practices of the securities industry was conducted
relating to the registration of brokers and dealers, it seemed to hesitate.

The initial congressional approach to broker-dealer registration was to provide the nascent Securities and Exchange Commission (the Commission or the SEC) with largely unspecified rulemaking discretion regarding trading activities of brokers and dealers.³ Pursuant to this broad authorization, the Commission was empowered to provide for (1) the regulation of broker-dealer transactions, (2) the registration with the Commission of brokers and dealers, and (3) the registration of securities in which brokers and dealers trade.⁴ Excluded from the Commission's authority was the regulation of broker-dealer activities on national securities exchanges and the registration of securities traded on those exchanges. Brokers and dealers would trigger the Commission's authority only if they (1) used the mails or instrumentalities of interstate commerce to make or create an over-the-counter market, (2) allowed another to make or create an over-the-counter market for the purchase and/or sale of any security, or (3) used any facility of such a market.⁵

Regulation of broker-dealer activities on national securities exchanges was to be conducted by the exchanges themselves. As in the current version of the 1934 Act, registration of these exchanges with the Commission was required in order for securities transactions to be lawfully effected on them, or

³. For instance, original § 15 of the Exchange Act reads in relevant portion:
It shall be unlawful, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest and to insure to investors protection comparable to that provided by and under authority of this title in the case of national securities exchanges, (1) for any broker or dealer, . . . to make use of the mails or any means or instrumentality of interstate commerce for the purpose of making or creating, or enabling another to make or create, a market, otherwise than on a national securities exchange, for both the purchase and sale of any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills, or unregistered securities the market in which is predominantly intrastate and which have not previously been registered or listed), or (2) for any broker or dealer to use any facility of any such market. Such rules and regulations may provide for the regulation of all transactions by brokers and dealers on any such market, for the registration with the Commission of dealers and/or brokers making or creating such a market, and for the registration of the securities for which they make or create a market and may make special provision with respect to securities or specified classes thereof listed, or entitled to unlisted trading privileges, upon any exchange on the date of the enactment of this title, which securities are not registered under the provisions of section 12 of this title.

for securities transactions to be lawfully reported by the exchange or by any broker or dealer. Registration for exchanges would only be granted or remain in force if the exchanges had rules for "expulsion, suspension, or disciplining" a member for violating "just and equitable principles of trade." Registration of over-the-counter brokers and dealers was not mandated by the original section 15 of the 1934 Act. Instead, registration of over-the-counter brokers was one of a number of ways by which the Commission was authorized to regulate over-the-counter markets generally, which was intended to supplement the regulation of trading on exchanges. Thus, the current system of broker-dealer registration began as nothing more than a legislative suggestion as to how the Commission might exercise the broad authority it had been granted to supplement regulation of trading by exchanges.

Shortly after the enactment of the 1934 Act, the Commission heeded Congress' suggestion and began to require the registration of all brokers and dealers who used the mails or other instrumentalities of interstate commerce for the purpose of making a market over-the-counter or who used any facility of the over-the-counter market. The registration of 5,088 brokers and dealers became effective on January 1, 1936.

Two years after enacting the 1934 Act, Congress codified the rules and

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6. Section 78e of the Exchange Act states in relevant portion:
   It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange . . . to effect any transaction in a security, or to report any such transaction, unless such exchange (1) is registered as a national securities exchange under section 78f of this title, or (2) is exempted from such registration upon application by the exchange because, in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration.

Id.

7. Original § 6(b) of the Exchange Act stated:
   No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.


8. The Commission's authority to regulate trading in general on the over-the-counter market was perceived as a necessity to "forestall widespread evasion of stock exchange regulation by the withdrawal of securities from listing on exchanges, and by transferring trading therein to 'over-the-counter' markets where manipulative evils could continue to flourish, unchecked by any regulatory authority." S. REP. No. 792, 73d Cong., 2d Sess. 6 (1934) (report to accompany the Senate bill which was to become the Exchange Act).

9. SEC, REPORT ON TRADING IN UNLISTED SECURITIES UPON EXCHANGES 17 (1936).
Broker-Dealer Registration

This report was prepared in compliance with the original § 12(f) of the Exchange Act directing the Commission to conduct a study of trading in unlisted securities upon exchanges. 10 Exchange Act, §§ 15(a), (b), & (c), enacted by Pub. L. No. 621, 49 Stat. 1375, 1377-78 (1936). In the legislative hearings that resulted in the 1936 amendments, then SEC Chairman James M. Landis expressed his thoughts: "[I]t was about time actually to put into legislation [the Commission's system for registration of brokers and dealers] rather than making it rest simply upon the regulations of the commission." Unlisted Securities: Hearings on S. 4023 Before the House Comm. on Interstate and Foreign Commerce, 74th Cong., 2d Sess. 10 (1936) (statement of James M. Landis, Chairman, SEC).


12 See supra note 3.

13 Exchange Act § 15(a). Although the registration of exchange brokers per se remained outside of the Commission's authority, as a practical matter, most stock exchange member firms engaged in some over-the-counter trading and market making. The Commission interpreted § 15(a) as authority to require registration of any broker or dealer who engaged in any over-the-counter transaction, whether or not that broker or dealer was an exchange member. In a number of instances, the Commission had made clear that effecting any over-the-counter transactions in nonexempted securities triggered the registration requirement. Adoption of rule X-15A-3, Exchange Act Release No. 5790, [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,615 (Oct. 10, 1958) (specialists were required to have an exemption from registration if they effected any transactions over the counter even if those transactions were effected in order to maintain a fair and orderly market in the exchange trading of that security); F.W. Horne & Co., 38 S.E.C. 104, 108-09 (1957); Burley & Co., 28 S.E.C. 126, 128 (1948) (any transactions in nonexempt, over-the-counter securities trigger registration even if the broker's business was primarily in exempt securities). Thus, the Commission believed that most exchange brokers were covered by § 15.
virtue of the definition of "exempted securities" in the then-existing section 3(a)(12).

The Securities Reform Act of 1975\(^\text{15}\) eliminated both of these gaps in the scheme of broker-dealer registration. Today, the Securities Exchange Act no longer limits registration to brokers effecting transactions or inducing the purchase or sale of securities "otherwise than on a national securities exchange."\(^\text{16}\) Even specialists and floor brokers, who trade exclusively on an exchange, are now required to register. In 1975, the 1934 Act also was revised to amend section 3(a)(12),\(^\text{17}\) thereby eliminating the exemption from regulation provided brokers who traded exclusively in municipal securities. Under the amended Act, even brokers and dealers engaging exclusively in transactions in municipal securities need to register.\(^\text{18}\) The somewhat tentative start Congress had made forty-one years earlier in initiating a registration program for broker-dealers had come full cycle, and now constitutes a comprehensive, mandatory registration system for all brokers and dealers.

II. TODAY

The result of the evolutionary development of section 15(a)(1) of the 1934 Act is that today it is unlawful for any broker or dealer to make use of the mails or means of instrumentalities of interstate commerce to effect transactions in any security, or to induce or attempt to induce purchase or sale of any security unless that broker or dealer is registered pursuant to the Act.\(^\text{19}\) Brokers and dealers whose business is exclusively intrastate and who do not

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14. Prior to 1975, § 3(a)(12) of the 1934 Act defined exempted securities to include municipal securities. 48 Stat. 881, 884 (1934). As remains true today under § 15(a)(1), broker-dealers effecting transactions exclusively in exempted securities need not register. Thus, prior to 1975, brokers effecting transactions exclusively in municipal securities did not need to register.


19. Exchange Act § 15(a)(1), states:

It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentalities of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial
use any facility of a national securities exchange are exempt from the registration requirement. Also, transactions that are exclusively conducted in exempted securities, commercial paper, bankers' acceptances, or commercial bills still do not trigger the registration requirements.\textsuperscript{20}

Brokers and dealers whose trading activities are solely limited to the floor of a national securities exchange are no longer exempt from registration. Similarly, brokers and dealers who trade only in municipal securities are no longer viewed as trading in exempted securities for purposes of section 15 and, consequently, must register.\textsuperscript{21}

The section 15(a)(1) proscriptions barring transactions by nonregistered brokers and dealers only apply to a broker or dealer who is not a "natural person" or a natural person who is "not associated with a broker or dealer which is a person other than a natural person."\textsuperscript{22} In essence, section 15(a)(1) only requires the registration of brokerage firms or of individual brokers who are not associated with a brokerage firm. The broker or "registered representative" who is employed by a brokerage house does not need to register under section 15(a)(1) because the broker is associated with a broker or dealer which is other than a natural person and the brokerage house itself would need to be registered.\textsuperscript{23} The registered representative would have to register with the National Association of Securities Dealers (NASD). The NASD's bylaws require registration by all persons associated with a NASD member.\textsuperscript{24} Since all brokers who register with the SEC must become members of the NASD,\textsuperscript{25} any registered representative employed by a registered brokerage firm is associated with a NASD member.

Pursuant to section 15(a)(2), the Commission is authorized to exempt specific brokers and dealers or classes of brokers and dealers from the registration requirements of section 15(a)(1).\textsuperscript{26} These exemptions must be granted

\begin{itemize}
\item paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.
\item \textit{Id.}
\item \textsuperscript{20} See supra note 14.
\item \textsuperscript{21} See supra note 18 and accompanying text.
\item \textsuperscript{22} Exchange Act § 15(a)(1). The phrase "person associated with a broker or dealer" is defined in § 3(a)(18) of the 1934 Act to include a "partner, officer, director, or branch manager of such broker or dealer...[a person] controlling, controlled by, or under common control with such broker or dealer or any employee of such broker or dealer" whose functions are other than clerical or ministerial. \textit{Id.} § 3(a)(18).
\item \textsuperscript{23} \textit{Id.} § 15(a)(1).
\item \textsuperscript{24} NASD, By-Laws (CCH) schedule C, §§ II, III, ¶ 1753 (May 1985).
\item \textsuperscript{25} See infra note 41 and accompanying text.
\item \textsuperscript{26} Exchange Act § 15(a)(2) states: "Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraph (1) of this subsection any broker or dealer or class of brokers or dealers specified in such rule or order." \textit{Id.}
in a manner consistent with "the public interest and the protection of investors." 27

Nearly one dozen terms employed in section 15(a) are defined in section 3 of the 1934 Act. 28 Nonetheless, numerous definitive questions have been raised regarding these defined terms, as well as other terms employed in section 15(a) and not defined elsewhere in the 1934 Act. Much case law, as well as administrative activity regarding the registration requirement, has centered on these definitional uncertainties.

The significance of the registration process can best be understood in light of the requirements placed upon brokers and dealers once they register.

III. CONSEQUENCES OF REGISTRATION

Because of the tentative manner in which the current scheme for broker-dealer registration evolved, Congress has never fully articulated its goals in requiring broker-dealer registration. To the extent that the purpose of requiring broker-dealer registration was analyzed, Congress perceived the registration requirement as an element of the overall mechanics of regulation of trading in over-the-counter securities. 29 In turn, regulation of the over-the-counter market was perceived as necessary in order to discourage listed issuers and traders of listed securities from the temptation of avoiding the discipline of the exchanges. 30

27. Id.

28. In Exchange Act § 3, the following terms used within § 15(a) are defined: "exchange" (§ 3(a)(1)); "facility" (§ 3(a)(2)); "broker" (§ 3(a)(4)); "dealer" (§ 3(a)(5)); "person" (§ 3(a)(9)); "security" (§ 3(a)(10)); "exempted security" (§ 3(a)(12)); "purchase" (§ 3(a)(13)); "sale" (§ 3(a)(14)); "interstate commerce" (§ 3(a)(17)); "person associated with a broker or dealer" (§ 3(a)(18)).


30. Id. at 16. The House Report said:

[The over-the-counter markets] are of vast proportions and they would serve as a refuge for any business that might seek to escape the discipline of the exchanges; and the more exacting that discipline, the greater the temptation to escape from it . . . . This constitutes the sanction for Federal regulation of over-the-counter dealers and brokers. To leave the over-the-counter markets out of a regulatory system would be to destroy the effects of regulating the organized exchanges." 31

Id. (quoting the report of the Twentieth Century Fund on "Stock Market Control").

In recent years, the Commission has evaluated Congress' purpose in requiring broker-dealer registration by referring to a statement made in the SEC's Special Study nearly 30 years after the passage of the 1934 Act. Exchange Act Release No. 20,943, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,621, at 86,822 (May 9, 1984). The statement suggests that "no amount of disclosure in a prospectus can be effective to protect investors unless the securities are sold by a salesman who understands and appreciates both the nature of the securities he sells and his responsibilities to the investor to whom he sells." SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 95, 88th Cong., 1st Sess., pt. 1, at 588 (1963).
In order to evaluate the intended role of registration in the absence of a definitive congressional statement, it is necessary to analyze the consequences of registration. Registration as a broker or dealer under section 15 of the 1934 Act triggers numerous other sections of that Act, as well as rules promulgated pursuant to those sections. In summary, these consequences generally serve to (1) insure basic competency of registered broker-dealers, (2) provide the public with information regarding the business and integrity of broker-dealers, (3) promote financial solvency of broker-dealers, and (4) subject broker-dealers to the jurisdiction, rules, and oversight of the NASD.

Initially, registration with the Commission requires filing an application on a standardized form, Form BD.\textsuperscript{31} Contemporaneous with the filing of an application for registration, the broker-dealer must file a statement of financial condition.\textsuperscript{32} Registering broker-dealers and all natural persons associated with such broker-dealers must meet basic standards of competency and training.\textsuperscript{33} Broker-dealers may demonstrate satisfaction of these standards by the performance of registrants and associated persons on examinations administered by self-regulatory organizations.

Once registered, a broker-dealer is required to comply with specific record keeping, financial compliance, and financial reporting requirements.\textsuperscript{34} The record keeping provisions require maintenance of numerous records regarding, among other matters, securities transactions, positions held in securities, orders received and given, as well as the receipt and disbursement of various funds.\textsuperscript{35} In addition, there are rules specifying the period of time for which the specific records must be retained.\textsuperscript{36} Further, registrants must prepare and file quarterly financial reports with the Commission (for clearing brokers, the filing period is monthly), as well as certified annual reports.\textsuperscript{37} The certified annual reports also must be sent to the registrant's customers.

Registered broker-dealers, as well as nonregistered broker-dealers, are subject to rigorous net worth and capital requirements.\textsuperscript{38} The net capital rule requires brokers to maintain at least a minimum net worth in addition to a minimum ratio of net capital to total indebtedness.\textsuperscript{39} Further protection

\begin{itemize}
\item \textsuperscript{31} Rule 15b-1-1, 17 C.F.R. § 240.15b-1-1 (1987). Form BD requires the disclosure of basic business information as well as information about any previous securities acts violations by the registrant or persons associated with the registrant. \textit{Id}.
\item \textsuperscript{32} Rule 15b-1-2, 17 C.F.R. § 240.15b-1-2 (1987).
\item \textsuperscript{33} Exchange Act § 15(b)(7).
\item \textsuperscript{34} Rule 17a-3, 17 C.F.R. § 140.17a-3 (1987).
\item \textsuperscript{35} \textit{Id}.
\item \textsuperscript{36} Rule 17a-4, 17 C.F.R. § 240.17a-4 (1987).
\item \textsuperscript{37} Rule 17a-5, 17 C.F.R. § 240.17a-5 (1987); see also Exchange Act §§ 17(e)(1)(A)-(C).
\item \textsuperscript{38} Exchange Act § 15(c)(3); Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1987).
\item \textsuperscript{39} Exchange Act § 15(c)(3).
\end{itemize}
is provided investors by the Securities Investor Protection Act, which requires all registered brokers to join an insurance program to cover customer losses in instances of brokerage house failure.

Additionally, if a broker is required to register under the 1934 Act, that broker must also join the NASD unless he either (1) is an exchange member, (2) carries no accounts, and (3) conducts only a de minimis business in over-the-counter securities.

Furthermore, registration with the Commission subjects the registrant to Commission discipline and inspections. The Commission has a range of disciplinary actions it may take against brokers for a variety of wrongful acts such as securities acts violations, felony and misdemeanor convictions which reflect upon integrity and financial competence, and willfully providing misinformation on registration applications. Registered brokers, as well as unregistered brokers, are subject to the broker antifraud provisions of the 1934 Act and the rules promulgated thereunder. Registered brokers are also subject to the general antifraud provisions of the 1933 Act, which prohibit fraud in the issuance and trading of securities. Unlike other individuals who trade in securities, however, registered brokers and dealers can violate the prohibitions of the 1934 Act without utilizing the mails or other means of interstate communication. Mere registration as a broker satisfies the jurisdictional requirements of these prohibitions.

IV. WHO MUST REGISTER

A. General

Brokers and dealers are required to register with the Commission if they use "the mails or any means or instrumentality of interstate commerce" either to effect transactions or to attempt to induce the purchase or sale of any security other than exempted securities or commercial paper, bankers' acceptances, or commercial bills. To determine which persons are included under the registration requirements, it is necessary to assess who is a

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42. Exchange Act § 15(b)(4)-(6).
44. Exchange Act § 15(c)(1)-(2).
45. 15 U.S.C. §§ 77a-77aa.
47. Id.
48. Id. § 15(a)(1).
broker or a dealer. As discussed, registration requirements only apply to
the brokerage firm itself or brokers not associated with a brokerage firm. The "registered representative" employed by a brokerage firm need not register with the Commission, but should register with the NASD.

The term "broker" is defined by the 1934 Act to mean "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." The term "dealer" is defined to mean "any person engaged in the business of buying and selling securities for his own account but does not include any person in so far as he buys or sells securities not as a part of a regular business." The definition again excludes from its coverage "a bank," as well as any person whose purchase and sale of securities are not effected "as a part of a regular business." Both definitions refer to the term "person" and to the phrase "engaged in the business." The term "person" is conveniently defined by the 1934 Act as "a natural person" as well as a "company, government, or political subdivision, agency, or instrumentality of a government." The phrase "engaged in the business," however, is not defined in the 1934 Act.

The distinction between the definitions of broker and dealer often becomes blurred when evaluating which persons must register pursuant to section 15. Frequently, in judicial or administrative analysis, both definitions are discussed, and the person in question is characterized as being a "broker and a dealer" or a "broker-dealer" without further clarification as to which definition has been satisfied by the person's activities. At other times, a person is

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49. See supra notes 3-6 and accompanying text.
51. Id.
52. Id. § 3(a)(4).
53. Id. § 3(a)(5).
54. Exchange Act § 3(a)(5) reads:
The term "dealer" means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person in so far as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.
55. Id. § 3(a)(9).

This blurring of the distinction between brokers and dealers is consistent with the treatment afforded these definitions in other contexts. At an early point in the history of the 1934 Act, the courts began to ignore the distinction between brokers and dealers for purposes of determining liability under § 12(2) of the 1934 Act. See, e.g., Murphy v. Cady, 30 F. Supp. 466 (D. Me. 1939), aff'd, 113 F.2d 988 (1st Cir.), cert. denied, 311 U.S. 705 (1940); see also Lawler v.
shown to satisfy only the definition of a broker or only the definition of a dealer, but is nonetheless referred to as a broker-dealer.\footnote{Eastside Church of Christ v. National Plan, Inc., 391 F.2d 357 (5th Cir.), \textit{cert. denied}, 393 U.S. 913 (1968). The court argued that the defendant satisfied the definitions of both broker and dealer but only provided evidence demonstrating the defendant to be dealer. \textit{Id.} at 361-62.} In some instances, a distinction is drawn between the two definitions and a person is referred to only as a broker or only as a dealer, as appropriate.\footnote{Castlemen \& Co., SEC No-Action Letter, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. CCH \# 80,260 (June 15, 1975); Thomas R. Vorbeck, SEC No-Action Letter (Mar. 24, 1974) (LEXIS, Federal Securities Library, No-Action File); Ballard \& Cordell Corp., SEC No-Action Letter (Sept. 30 \& Oct. 14, 1973) (LEXIS, Federal Securities Library, No-Action File).}

\textbf{B. Engaged in the Business}

Central to the definitions of both broker and dealer is the phrase “engaged in the business” of securities transactions. Unfortunately, the 1934 Act does not define this term. However, a general understanding of this phrase has evolved through case law and administrative action, primarily in the form of no-action letters. Critical to the concept of being engaged in the business of securities transactions is “regularity of participation.”\footnote{In determining who was a broker or dealer for purposes of membership in the federally established Securities Investor Protection Corporation, it was noted that the definition of both broker and dealer “connotes a certain regularity of participation in securities transactions at key points in the chain of distribution.” Massachusetts Fin. Servs., Inc. v. Securities Investor Protection Corp., 411 F. Supp. 411, 415 (D. Mass.), \textit{aff'd}, 545 F.2d 754 (1st Cir. 1976), \textit{cert. denied}, 431 U.S. 904 (1977); \textit{see also Eastside Church of Christ, 391 F.2d at 360-62; SEC v. Hansen, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) \# 91,426, at 98,119 (S.D.N.Y. 1984).} The definition of dealer qualifies engaged in the business by requiring that a person’s securities activities must be a “part of a regular business,” while the definition of a broker is not so qualified. However, attention is not typically paid to this distinction.\footnote{Professor Loss suggests that the qualifying phrase “regular business” in the dealer definition does not alter the need to show regularity of participation in proving the existence of a dealer or a broker. \textit{Id.} Another commentator has suggested that “arguably less activity is required to make one a broker than a dealer.” Rice, \textit{The Expanding Requirement for Registration As "Broker-Dealer" Under the Securities Exchange Act of 1934}, 50 \textit{Notre Dame L. Rev.} 201, 202 (1974). However, Rice cites no cases or administrative action under federal securities laws in support of his hypothesis.}

\footnote{Professor Loss suggests that the phrase “engaged in the business” which is common to the definition of broker and dealer “connotes a certain regularity of participation in purchasing and selling activities rather than a few isolated transactions.” L. Loss, \textit{SECURITIES REGULATION} 1295 (1961).}

\footnote{Professor Loss suggests that the qualifying phrase “regular business” in the dealer definition does not alter the need to show regularity of participation in proving the existence of a dealer or a broker. \textit{Id.}} In both instances, regularity is required to be shown for a person to be deemed to be engaged in a securities business.
In determining what constitutes regularity of participation, it has been held that a broker-dealer that solicited investors over a four-year period violated section 15(a)(1) for failing to register since the broker "had a certain regularity of participation in securities transactions."\(^{61}\) In another instance, the purchase of several million dollars’ worth of securities provided sufficient regularity of purchase to satisfy the phrase "engaged in the business."\(^{62}\)

The Commission staff has found that an individual might not be acting as a broker or a dealer if, "on a single, isolated basis," the individual advertised an interest to engage in securities transactions for his own account.\(^{63}\) However, if the advertising were "engaged in more often than on a single isolated basis,"\(^{64}\) broker-dealer registration would be required. The staff’s position is of further interest here since it demonstrates that merely holding oneself out as willing to engage in securities transactions will satisfy the need for regularity.\(^{65}\) Even when an individual anticipated selling securities only once per year, the staff was unable to conclude that the individual would not be required to register as a broker.\(^{66}\)

Regularity is analyzed frequently in terms of past and future experiences. Officers and directors of a corporate general partner of an oil and gas exploration limited partnership were advised by the staff that they would not be engaged in the business of effecting transactions in securities if they sold units in the limited partnership since in the past they had not engaged in the offer and sale of other securities. Also, these officers and directors did not ever intend to sell securities of any other issuer.\(^{67}\) On the contrary, a real estate investment company, whose employees were to sell units in a limited partnership, was required to register under section 15(a)(1).\(^{68}\) The company previously had made a similar offering of comparable securities and its employees perhaps were going to be involved in future offerings of similar securities. The staff concluded that the company appeared to be selling

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64. Id.
securities on a "recurring basis." 69

In order to be engaged in the business of securities transactions, that business does not have to be the sole business, nor even the primary business, of the broker-dealer. The staff found that a real estate developer who proposed to accept and sell securities in partial payment for real estate lots "as a part of his regular business activities" would be required to register with the Commission. 70 Similarly, a Swiss banking corporation whose American security business represented less than three or four percent of its lending business was found to be a broker or dealer. 71

C. Badges of Broker-Dealer Activities

1. Generally

Establishing regularity of business activity satisfies the phrase "engaged in the business." However, the specific business in which a person is engaged must satisfy the remainder of the definition of either broker or dealer in order for registration to be required. Thus, the business engaged in must be interpreted as constituting either "effecting transactions in securities for the account of others" or "buying and selling securities" for a person's own account. 72

An analysis of the cases and administrative actions in this area leads to a distillation of a number of factors, or "badges," 73 of business activities that would identify a person as a broker-dealer. A distinction is only infrequently drawn between activities identifiable as broker activities as opposed to dealer activities, or vice versa. 74 Consequently, it is not always necessary to segregate the badges of broker-dealer activities into broker activities and dealer activities.

Because they are derived from the specific language of the definitions of broker or dealer, some of the badges are relatively predictable. Other badges

69. Id.
73. The author would like to credit the use of the term "badge" to Professor Ronald J. Coffey who creatively employs that term to analyse when a person may be deemed an underwriter.
74. See supra note 56.
are not as obvious because they are interpretations of the connotations of the terms broker and dealer.

Buying and selling securities for one's own account is a badge of broker-dealer business activity derived from the specific language of the definition. For instance, when a defendant in the business of assisting churches in raising money through the issuance and sale of bonds both purchased and sold these bonds for its account, it was found to have satisfied the definition of section 3(a)(5). The defendant therefore was in violation of section 15(a)(1) of the 1934 Act for failing to register as a broker and a dealer.75

However, merely purchasing or selling for one's own account does not appear to create a need to register. The Commission staff advised an individual who sought to advertise his interest in purchasing or selling securities for his own account that this activity, on other than an isolated basis, would require broker-dealer registration. However, in order to trigger registration the advertisements needed to "encompass offers to buy as well as to sell."76

Another badge of broker-dealer business activity derived from the specific language of the definition is effecting transactions for others. Thus, a company that sold securities "of various issuers on a recurring basis" was found by the Commission staff to be required to register as a broker or dealer.77 Similarly, when an officer of the corporate general partner of a limited partnership proposed to offer and sell interests in the limited partnership, had sold securities in the past, and proposed to sell securities in the future, the staff found that the officer was "engaged in the business of effecting transactions in securities."78

On the contrary, the staff concluded that a business need not register as a broker-dealer when it assists churches in organizing bond sales programs but

78. Wainoco 73 Co. (John B. Ashmun & Thomas B. Grootemaat), SEC No-Action Letter (July 19, 1973) (LEXIS, Federal Securities Library, No-Action File). Cf. Sears Roebuck Acceptance Corp., SEC No-Action Letter (April 15, 1973) (LEXIS, Federal Securities Library, No-Action File). Two corporate officers participating in a distribution at Sears were not required to register as broker-dealers, even though they had been involved in other offerings within the previous two years. The employees, however, intended to avoid other badges of broker-dealer activity. For example, they were not going to receive compensation that was in any way based upon sales volume. Id.
takes no part in selling efforts. Similarly, when consultants provide registered brokers who sell annuity plans with demographic information about public employers, insurance policies and pension plans, but do not represent the brokers "in the effectuation of sales of securities to public employers or their employees," registration is not required.

One badge of broker-dealer activity that is derived from an interpretation of the connotations in the broker definition is the earning of a commission. Commission compensation is a hallmark of a broker-customer relationship and demonstrates success in effecting transactions for the account of others. Hence, a realty company that proposed selling units of a limited partnership through employees whose compensation would be "directly related to the success of the sale of the subject securities" consequently was found by the Commission staff to be required to register as a broker or dealer under section 15(a)(1) of the 1934 Act. On the contrary, when employees of a company selling interests in a limited partnership, of which the company was a general partner, only assisted that company in developing and maintaining relationships with broker-dealers and received "no commission or other variable compensation based upon the volume of sales," the Commission staff advised that it would not recommend action for nonregistration.

Solicitation of business is considered a badge of securities activity within the definition of broker. The staff advised an employee who solicited a sale of stock purchased through an employee stock purchase plan in order to take advantage of lower commission rates on larger quantity sales that he would be considered a broker. The staff's advice was in part based upon "solicitation of business" by the employee on his own behalf. Solicitations in the form of newspaper advertisements may also trigger the need to register. For instance, in a proceeding for an injunction, the Commission demonstrated that a person was a broker-dealer by submitting evidence that he placed advertisements in a New York City daily newspaper offering savings

84. Id.
In determining whether a person had to register as a broker or a dealer, the Commission staff has examined both past and intended employment in the securities business. The staff has taken the position that individuals employed to sell securities who previously were registered representatives indeed would be broker-dealers even though their compensation did not appear to be linked to sales. Likewise, in determining that a company intending to distribute units in a limited partnership of which it was the general partner must register as a broker-dealer for its current distribution, the staff noted that the company intended to register as a broker-dealer in the near future.

The staff also has employed a number of apparently ad hoc badges in determining whether a person needs to register as a broker-dealer. These badges frequently are classifications of overall broker-dealer behavior, rather than specific broker-dealer activity, and are not used often enough to be considered customary standards. For instance, the staff has advised that a person selling securities for fellow employees would have to register because the person's "participation in the transactions may be viewed as a necessary link in the periodic sale of the securities."

2. Special Situations

In regard to a number of specific fact patterns, the no-action letters issued by the Commission staff have developed guidelines or badges as to what constitutes broker or dealer activities. These fact patterns and guidelines are sufficiently unique to warrant separate discussions, and are not inconsistent with the general badges of broker-dealer activity. Rather, they apply the general guidelines to specific relationships.

a. Issuers and Issuers' Employees as Broker-Dealers—The Self-Sale Approach

In frequent instances, issuers sell their own securities through their officers and employees. Reasons for this practice include economic concerns and an inability to secure an investment banker's services. At times, these concerns are a result of uncertainties associated with the offering. Historically, a self-sale approach by an issuer for distribution of its securities was a common method for financing a broad range of corporate and financial activities. Today, the self-sale approach is most closely identified with limited partnerships, frequently having corporate general partners, seeking to finance oil and gas exploration, agriculture, real estate development, or similar activities that often might serve as tax shelters.

Regardless of the nature of the venture financed by the self-sale approach, the issues relevant to broker-dealer registration remain constant: (1) whether the issuer is a broker or a dealer, and (2) whether the employees are brokers or dealers.

The first issue would appear to be relatively simple to resolve. An issuer cannot be a dealer since it is not both buying and selling its securities. Furthermore, the issuer should not be considered a broker because the securities are not sold for the "account of others"; rather, they are being sold by the issuer for its own account. In fact, the Commission historically has adopted this analysis in regard to the question of whether the issuer needs to register.

Notwithstanding the Commission's long standing recognition of an "issuer exemption" for self-selling issuers, no-action requests regarding broker-dealer registration continue to be made to the Commission staff when issuers do self-sell and the Commission staff continues to assume a no-action pos-

89. Professor Loss explains that under the 1934 Act, an issuer cannot be a dealer because "even if it is considered to be engaged in the 'business' of selling securities, [it] does not do any buying as required by the definition." II L. Loss, supra note 59, at 1298 (emphasis in original).

90. In the release originally proposing rule 3a4-1, the Commission stated: "[T]he Act has customarily been interpreted not to require the issuer [which self-sells] itself to register as either a broker or a dealer; the issuer would not be effecting transactions for the account of others nor, generally, would it be engaged in the business of both buying and selling securities for its own account."

Broker-Dealer Registration

...ture in regard to these inquiries. Generally, the question is raised as an additional inquiry in the context of a no-action request for nonregistration of employees of an issuer. Registration of employees of an issuer, as opposed to registration of the issuer itself, usually warrants a case-by-case analysis. However, the staff's discussion of the need for registration of an issuer's employees generally is interwoven with its discussion of the need for registration of the issuer itself. Therefore, the factors generating the response in regard to the employees are not distinguished from the factors generating the response in regard to the issuer. As a consequence, it is not always possible to discern the basis of the staff's exemption from registration for the

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93. Generally, the staff examines the factors that are discussed below regarding the need for registration of employees of the issuer.

94. One staff no-action letter advising an issuer that the staff would not recommend Commission action if the issuer did not register (with no mention of employee registration) recited facts in the letter that appeared to be primarily relevant to registration of the issuer's employees. Argonaut Energy Corp., SEC No-Action Letter, [Jan.-June 1973] Sec. Reg. & L. Rep. (BNA) No. 198 at C-6 (Feb. 28, 1973). This letter could suggest that criteria relevant to employee registration indeed are relevant to registration of the issuer. An examination of the corresponding letter of inquiry provides a more plausible explanation. The request letter specifically asked for a no-action response in reference to two officers of the issuer, as well as the issuer itself. Letter of inquiry from Edward H. Hill (attorney for Argonaut Energy Corp.) (Feb. 28, 1973). The staff's no-action response appropriately analyzed the request in terms of factors that would impact on the registration of the employees. However, the staff appears to have partially misidentified the subject of the no-action request in limiting the subject to the issuer, as opposed to the employees and the issuer.

In another instance in which it advised an issuer that it did not have to register, the staff also analyzed the issue in terms of factors that appeared relevant primarily to the issuer's employees. DeMatteis Dev. Corp., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,415, at 80,915 (Sep. 2, 1971). There, the letter of inquiry did ask for a no-action response just in terms of the issuer. The selling practices described were ascribed to the corporate general partner of the issuer. In fact, the selling practices clearly were those of employees of the issuer. Thus, the letter of inquiry misidentified the real focus of concern for broker-dealer registration and the no-action letter adopted the misidentifications. However, the misidentification was not consequential. The practices described would not have mandated registration for the employees and the issuer had available the issuer exemption.
issuer. Readers of no-action letters are left to speculate whether the historical "issuer's exemption" is the actual basis of the staff's no-action posture toward the registration of a specific issuer. Alternatively, the no-action being assumed may be in response to behavior by an issuer's employees when that behavior is compatible with nonregistration.

In one instance, the staff has made clear that the criteria it utilizes to determine whether employees are broker-dealers are not relevant in determining whether an issuer is a broker-dealer. In *Corporate Investment Company* (CIC), the staff indicated that the officers and directors of CIC might be brokers because they were indeed selling CIC's securities. Although the activities of the officers and directors possibly warranted their registration, the staff concluded that CIC itself did not appear to be a broker-dealer. Thus, factors suggesting the need for registration of officers and directors do not necessarily suggest the need for registration of the issuer-employer.

i. Typical Factors

In determining whether employees of an issuer must register when employees sell an issuer's securities, the Commission staff has established a set of factors to examine. At times, these factors are clearly identified in no-action letters as guidelines existing independently of any fact pattern. At other times, they are only discoverable by a distillation of the staff's recitation of facts in no-action letters. In the latter instance, the staff does not appear to consistently place the same emphasis on the same factors.

The following factors have specifically been identified by the staff as relevant to a determination of whether an employee of an issuer needs to register:

1. Whether the employee is under the issuer's supervision (i.e., whether he is an employee or an independent contractor). Actual employees are less likely to be required to register.

2. Whether the employee's compensation will be linked to the amount of securities sold or whether it is a fixed compensation. Employees receiving a fixed compensation are less likely to be required to register.

3. Whether the employee devotes a substantial portion of his time to rendering services for the issuer that are not related to the sale of securities. Employees providing nonsecurities selling services are less likely to be required to register.

4. Whether the employee intends to remain with the issuer after com-

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96. Id.
pletion of the offering. Employees intending to remain are less likely to be required to register.

(5) Whether the employee participated in the past, or whether the employee will in the future participate, in other securities offerings by this or other issuers. Employees participating in other offerings are more likely to be required to register. 97

In examining these considerations, the staff is exploring whether the employee has to register because he is either (1) an independent salesperson temporarily calling himself an employee, but is essentially in the business of effecting transactions for the account of others, or (2) a full-time employee who, because his selling efforts are of such magnitude or because his compensation is so related to his success in sales, will be considered to be in the business of effecting transactions for the account of others.

Numerous no-action letters issued by the staff of the Commission have relied upon many or all of these factors in determining whether to require broker-dealer registration. 98 No single factor appears to be dispositive of the


registration issue in any particular instance. Rather, the staff appears to focus upon the total mix of factors. Additionally, not all factors are discussed in all no-action letters.

**ii. Compensation Based Upon Sales**

The most frequently considered factor is the degree to which compensation reflects success in sales. The Commission has stated that commission payment “not only raises questions as to whether the recipient is engaged in the business of effecting [securities] transactions,” but that payment also increases the likelihood of “high pressure sales tactics” and “engender[s] other problems of investor protection.”

Virtually every no-action letter issued by the staff dealing with selling efforts by employees of the issuer makes some reference to the fact that the employees either are or are not compensated on a basis of sales volume. When analyzing employee compensation, the staff has examined not merely whether salary reflects the specific amount of securities sold, but also whether salary beyond the normal amount is paid to the employee for merely assuming the additional burdens of selling.

The staff’s applications of the compensation factor do not appear to be consistent. In one instance, a proposed compensation scheme pursuant to which an employee would be paid a percentage of the underwriting commission for the sale of limited partnership units prevented the staff from taking a no-action position regarding the employee’s nonregistration. This posi-


100. Of the 22 no-action letters cited supra note 98, in only one instance, The Woodmoor Corp., was no specific mention made as to whether the employees were being compensated on the basis of sales volume. The no-action letter referred to the salesmen as “salaried” and the staff did not believe registration was necessary. The letter of inquiry suggested that commissions indeed would be paid to the employees.


102. Maurice S. Holcomb, SEC No-Action Letter (July 19, 1973) (LEXIS, Federal Securities Library, No-Action File); see Corporate Inv. Co., SEC No-Action Letter (Apr. 20, 1974) (LEXIS, Federal Securities Library, No-Action File) (in which the staff indicated that there was a question as to the need for officers, directors, and employees to register when offering their employer’s securities. The employees were to be compensated on a commission basis); Ballard & Cordell Corp., SEC No-Action Letter (Sept. 30 & Oct. 14, 1973) (LEXIS, Federal Securities Library, No-Action File). In this instance, assuring the staff in a follow-up letter that employees would not receive commission compensation was a factor, inter alia, considered by the staff in reversing an earlier decision requiring registration.
tion was taken even though the employee was to remain with the issuer "long after" the current distribution. Two years earlier, the staff indicated that it would "not raise any objection" because two officers were to participate in a distribution of securities by their employer, even though they were to receive a "10% commission" on sales.

iii. Duties in Addition to Sales

Demonstrating that employees have duties other than the sale of securities and/or that the employee is fulltime and permanent is a critical aspect to proving that the employee is other than a broker temporarily serving on an issuer's payroll. If an employee's sales activities are a small or incidental aspect of his overall duties or if the employee is a permanent, full-time member of the issuer's staff, then the employee is not in the "business" of effecting transactions in securities for the account of others. In some instances when determining whether an employee need register, the staff has focused upon the percentage of an employee's time that will be devoted to securities sales. In other instances when making this determination, the staff has identified the nature of the nonselling and/or selling activities in which an employee will engage. Occasionally, when examining whether employees need to register, the staff has noted that an issuer is paying social security and unemployment taxes for an employee as well as paying withholding


106. Wilson & Sons Energy, SEC No-Action Letter (Sept. 24, 1982) (LEXIS, Federal Securities Library, No-Action File) (employee responsible for "coordinating and supervising the offer and sale of Unit's"; "interacting" with assisting broker-dealers; arranging bank financing; seeking participants in the issuer's oil and gas activities); Arizona-Colorado Land & Cattle Co., SEC No-Action Letter (June 30, 1973) (LEXIS, Federal Securities Library, No-Action File) (employee "will devote a 'significant' portion of his time to the Cattle Feeding Program when the registration statement becomes effective").
state and federal income tax. These payments and withholdings evidently suggest to the staff that employees are being regarded by an issuer as full-time personnel and not as part-time independent contractors. Additionally, the staff occasionally has repeated in no-action letters information provided in letters of inquiry asserting that an employee was not hired expressly to participate in a sales program and/or that no other new personnel will be hired by an issuer for the express purpose of assisting in the sale of securities. This information appeared to be provided in the letter of inquiry and then reiterated by the staff to further demonstrate that the selling effort is not being conducted by temporary employees who might be independent salespersons effecting transactions for the accounts of others, but rather by full-time employees who, in light of existing duties, would not be viewed as being in the business of effecting transactions for others.

iv. Noninvolvement in Other Securities Activities

Lack of employee participation in selling other securities is mentioned in staff no-action letters concerning the necessity of broker-dealer registration. Other participation would presumably increase the possibility that the employee, because of his regularity of participation in securities transactions, would be viewed as being engaged in the “business of effecting transactions in securities for the account of others.” The staff has focused upon (1) specific sales of securities by an employee and (2) specific associations of


an employee in the securities industry\textsuperscript{111} in determining whether there was sufficient regularity of participation in securities transactions to necessitate registration.

Although the fact that an employee has not previously sold securities has been identified as a consideration in staff determinations not to require registration, the fact that an employee has made sales of securities other than during the current issuance does not necessarily mean that the employee will be advised to register.\textsuperscript{112} After 1977, inquiry letters concerning broker-dealer registration frequently viewed the two years prior to a current issuance as the relevant time period in which to demonstrate that an employee has been uninvolved in the sale of securities.\textsuperscript{113}

Although this is not always true, prior employment as a registered representative frequently appears to compel the staff to require an employee to register regardless of whether there was compliance with other guidelines which would otherwise permit nonregistration.\textsuperscript{114} However, current employment of a person as president of an investment advisory company who was also serving as the corporate general partner of the issuer-limited partnership did not compel a determination that the employee must register.\textsuperscript{115}

\textbf{v. Other Factors}

At times, participation or nonparticipation in a sales situation of registered broker-dealers, who are not employees of an issuer, is a factor examined by the staff in determining the need for registration of the issuer’s employees. If employees of an issuer are to supervise broker-dealers, the employees need to register as broker-dealers.\textsuperscript{116} On one occasion, in advis-

\begin{enumerate}
\item\textsuperscript{112} Sears Roebuck Acceptance Corp., SEC No-Action Letter (June 3, 1979) (LEXIS, Federal Securities Library, No-Action File). Here, the employees complied with the other relevant staff guidelines enabling the staff to determine what was not necessary.
\item\textsuperscript{113} Id.; ITT Fin. Corp., SEC No-Action Letter (July 17, 1978) (LEXIS, Federal Securities Library, No-Action File). The two year time period was suggested as a guideline by the Commission in its 1977 release originally proposing rule 3a4-1. In the 1984 re-proposed version of rule 3a4-1, this time period was reduced to one year. When rule 3a4-1 was adopted in 1985, the time period remained at one year. \textit{See infra} text accompanying notes 121-42.
\end{enumerate}
ing employees that registration was not required, the staff observed that sales would be made without the participation of any brokers or dealers, which suggests that absence of that participation is relevant to the staff’s no-action position.\(^{117}\) In several other instances, however, participation of nonemployee brokers or dealers in selling efforts along with issuer-employees has not prevented the staff from taking a no-action position regarding the need for employee registration.\(^{118}\)

Since 1977, some no-action letters\(^{119}\) have indicated whether employees for whom exemptions from registration were sought were subject to the statutory disqualifications enumerated in section 3(a)(39) of the 1934 Act. The implication of the notation was that an exemption would be denied if the employee were subject to a statutory disqualification. This standard was derived from rule 3a4-1\(^{120}\) which, in its proposed form, contained a provision excluding from its exemption persons subject to a statutory disqualification. This standard is intended to discourage exemption from registration for persons who have shown a potential for certain abuses of the securities acts.

\(\text{vi. Rule 3a4-1}\)

In 1977, in an effort to provide guidance regarding the need for broker-dealer registration for officers and employees of issuers who distribute their employer’s securities, the Commission proposed rule 3a4-1.\(^{121}\) The proposed rule was not intended as an exclusive safe harbor; however, “only unusual circumstances” would support a conclusion that persons falling outside of the rule need not register as brokers.\(^{122}\) Even prior to the adoption of the rule, the criteria established in the proposed forms of the rule had been cited by the Commission staff as a basis for positions taken in various no-action


\(^{118}\) Midland-Guardian Co., SEC No-Action Letter, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,947 (Nov. 27, 1978) (the staff did not even mention participation in sales by broker-dealers—that participation was only discussed in the letter of inquiry); China Trade Corp., SEC No-Action Letter, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,939 (July 24, 1978); Ballard & Cordell Corp., SEC No-Action Letter (Sept. 30 & Oct. 14, 1973) (LEXIS, Federal Securities Library, No-Action File) (employees were not to be involved in actual selling efforts, but were to serve as intermediaries between brokers and the issuer).


\(^{120}\) See infra text accompanying notes 121-42.


\(^{122}\) Id.
letters. In 1984, a revised version of rule 3a4-1 was reproposed, and, in 1985, the rule was adopted substantially as proposed in the 1984 version. The Rule 3a4-1 Adopting Release advised that while the rule "does provide legal certainty to those persons whose activities meet the conditions of the rule," compliance with the safe harbor of the rule is not the exclusive means by which persons associated with an issuer may sell the issuer's securities without registration as a broker-dealer. The Commission further indicated that the staff would continue to provide interpretive guidance to those whose activities do not fall clearly within the rule.

The safe harbor of rule 3a4-1 only provides protection for "associated persons" of the issuer. Initially, in order to be eligible for the safe harbor, associated persons must satisfy three preliminary conditions. The associated person cannot be (1) subject to a statutory disqualification as defined in section 3(a)(39) of the 1934 Act, which is based upon filing misrepresentations and various securities acts abuses; (2) paid commissions based upon sales; or (3) associated with a broker-dealer. In regard to the first of the conditions, the Commission believes that there is added potential for abuse in the sale of an issuer's securities if persons who are subject to a statutory disqualification are permitted to "participate without assurance of adequate supervision or regulatory oversight."

If the preliminary tests are met, the associated person must comply with one of three alternative restrictions on his activities in order to satisfy the safe harbor. First, the associated person satisfies the safe harbor if he limits his sales efforts to certain specified activities which do not appear to require

123. See supra note 98.
126. Rule 3a4-1 Adopting Release, supra note 125, at 654.
127. Id. at 653.
128. The definition of associated persons includes natural persons who are either partners, officers, directors, or employees of an issuer, or a corporate general partner of a limited partnership that is the issuer, or of a company or partnership that controls, is controlled by, or is under common control of the issuer. 17 C.F.R. § 240.3a4-1(c)(1) (1987). Also, partners, officers, directors, and employees of a registered investment adviser for an investment company issuer are considered associated persons of the issuer. Id. Financial consultants, attorneys, accountants, and insurance brokers who assist in the distribution of securities for a fee are not considered associated persons of the issuer for purposes of the rule; however, the staff may consider the need for those persons to register on a case-by-case basis. Rule 3a4-1 Adopting Release, supra note 125, at 654 n.9.
131. Rule 3a4-1 Adopting Release, supra note 125, at 655.
the protection that broker-dealer registration would provide. The specified activities are sales (1) made only to financial institutions and intermediaries; (2) of exempted securities, under sections 3(a)(7), 3(a)(9), or 3(a)(10) of the 1933 Act from registration under that Act (securities of issuers in bankruptcy, securities exchanged by the issuer exclusively with its existing shareholders, or securities issued in an exchange approved after a hearing, by a court, a government official, or an agency); (3) made in connection with reorganizations; and (4) pursuant to an employee benefit plan.

One of the assumptions underlying the first alternative is that institutions and financial intermediaries are sufficiently sophisticated to protect themselves. Under this alternative, the Commission did not choose to include all securities exempt under section 3(a) of the 1933 Act, but instead it chose only those exemptions insuring that transactions therein would be sufficiently restricted so that the protections of the broker-dealer regulatory scheme would not be necessary.

Under the second alternative, the associated person may sell the issuer’s securities, but he must (1) perform substantial duties for the issuer other than selling securities; (2) not be or have been within the past twelve months a broker, a dealer, or an associated person of a broker or dealer investment advisor; and (3) not participate in the sale of securities for any issuer more than once every twelve months.

The third alternative permits the associated person to make sales for an issuer, but requires that the associated person’s involvement in the sales be passive. A seller can only communicate in writing with prospective purchasers when responding to inquiries initiated by potential purchasers and the written communication must be approved by a partner, an officer, or a director of the issuer. Communication in the form of “cold calls” are not permitted. When responding to inquiries of potential purchasers, the response must be limited to information contained in a registration statement or other offering document. In addition, the associated person can perform

134. Id. § 77c(a)(9).
135. Id. § 77c(a)(10).
136. Rule 3a4-1 Adopting Release, supra note 125.
137. Rule 3a4-1(a)(4)(ii), 17 C.F.R. § 240.3a4-1(a)(4)(ii) (1987). In essence, the second alternative requires that the associated person be a bona fide employee, and not a broker or dealer who is employed by the issuer. Additionally, the relevant time period for nonparticipation in the securities industry or in securities transactions has been abbreviated to 12 months from the two years found in the original proposed rule.
140. Id.; Rule 3a4-1 Adopting Release, supra note 125, at 660.
ministerial and clerical work, such as bookkeeping entries and arranging for the delivery of securities. Under these restrictions, the risks typically associated with sales activities are limited.

The impact of the rule is to exclude from the safe harbor agents specifically hired to sell securities and promoters regularly engaged in actively marketing securities. The safe harbor provided by the rule does not extend to situations in which an issuer's employees assist buyers and sellers of the issuer's securities with secondary market transactions.

b. Finders

A second instance in which requests are frequently made for exclusion from the broker-dealer registration requirements arises out of the activities of independent businesspeople whose role is to find buyers and sellers of securities, and who do not themselves actually engage in the purchase and sale of securities. These "finders" are frequently in the business of identifying suitable companies for acquisition or merger in deals that might be structured through the sale of securities. Other finders or "channelers" may be in the business of merely directing customers to brokers and dealers, or businesspersons who are engaged in locating investors for a business seeking to raise capital.

In these instances, the rationale for a finder's exemptions is that he does not satisfy the section 3(a)(4) definition of a broker because he is not "effecting" transactions for others. Rather, the finder argues that his activities are limited to identifying potential purchasers or sellers of securities and that the negotiation and execution of the actual transaction is left to others.

i. Typical Factors

Requests for no-action letters for the benefit of finders are frequently addressed to the Commission staff. Here, the staff has developed a series of factors, or badges, of broker-dealer activity that are taken into consideration in evaluating whether a particular finder needs to register as a broker-dealer. These factors or badges include:

(1) Whether the finder was involved in negotiations for the sale of the securities. Finders involved in negotiations would more likely be required to register as a broker-dealer than finders not involved in negotiations.

142. Rule 3a4-1 Adopting Release, supra note 125, at 655.
143. See infra notes 146-57 and accompanying text (operative factors in triggering registration requirement).
144. II L. Loss, supra note 59, at 1299.
(2) Whether the finder discussed details of the nature of the securities sold or whether he made any recommendations. Discussions of details and making recommendations increase the likelihood that registration would be required.

(3) Whether the finder was compensated on a commission basis linked to sales. Sales volume linked commissions would increase the likelihood that registration would be required.

(4) Whether the finder previously was involved in sales of securities. Previous involvement increases the likelihood that registration would be required.  

Essentially, the first three factors are guidelines to determine whether the finder is in the sort of relationship with a customer that would allow the customer to be exposed to potential abusive sales practices. The fourth factor seeks to determine whether there is sufficient reoccurrence of sales of securities to suggest that the finder is in the “business” of effecting transactions.

ii. Involvement in Negotiations, Discussing Details, or Making Recommendations

No single factor appears to be dispositive of the question of whether registration is required. However, a finder’s involvement in negotiations and providing detailed information or advice appears to be an influential factor. Broker involvement in negotiations with a customer will virtually always trigger registration.  


146. Mike Bantuveris, SEC No-Action Letter (Sept. 23, 1975) (LEXIS, Federal Securities
sion of details regarding investments or the making of recommendations usually permits the staff to conclude that a finder does not have to register. In addition, channelers who select investors in order to introduce them to brokers may be required to register. For example, a market consultant who invited potential customers to a dinner seminar with a broker was told that the staff could not sanction the consultant's solicitations in the absence of registration. The consultant guaranteed the broker the attendance of thirty-five couples at each dinner, trained the telephone personnel, counseled brokers in seminar "protocol," and counseled mutual fund speakers "to insure maximum results." The consultant was paid for each couple in attendance at the seminar. The consultant was also considering a fee based upon the number of couples who opened accounts with the broker. In light of these facts, the staff was unable to take a no-action position on nonregistration. In addition, the staff was concerned with the use of devices by the consultant that might "whet the appetite" of prospective investors in a manner inconsistent with the consultant's fiduciary duties.

### iii. Commission Fee in Proportion to Sale Amount

The Commission staff has taken the position that receipt by a finder of fees that are paid in proportion to the amount of the sale is a factor that suggests

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149. Id.

150. Id.
that the finder would be required to register as a broker-dealer. In a
number of instances, however, the staff has found that there was no need for
registration even if a finder was compensated in proportion to the amount of
the sale. In one instance, the finder was in the business of locating insurance
agencies and evaluating them for acquisition. The finder was paid a fee
linked to the consideration paid if a subsequent purchase or sale occurred.
However, the acquisition of a specific agency was not necessarily structured
by the sale of securities and the finder played no role in organizing the actual
acquisition. The staff perceived the finder as just a consultant “retained to
bring to bear its knowledge and expertise to the task of identifying an acqui-
sition prospect,” and not as a broker. Thus, where a finder merely locates
a business and does not serve to effect the transaction, registration is not
required.

In another instance, the staff found that registration was not required even
though the finder was to receive “a commission of about [five] percent,” was
locating investors, and was not limiting its activities to identifying business
acquisition prospects. In an initial response to a first letter of inquiry, the
staff determined that registration was required. A second letter of inquiry
provided further information regarding the finder in question and indicated
that the finder had not previously “been engaged in other private placements
wherein he received commissions as a finder or broker.” Thus, the absence
of prior involvement in effecting a securities transaction allowed the staff to
ignore the receipt of commissions in a current finder arrangement.

Library No-Action file) (registration required because commission was to be paid); Mike Bantuveris,
File) (payment of commission as well as participation in negotiations necessitated
registration); Financial Charters & Acquisitions Inc. and Hirshen & Assocs., SEC No-Action
Letter (Nov. 25, 1984) (LEXIS, Federal Securities Library, No-Action File) (registration was
not required for a finder who was to be paid a fee derived in part from the commissions gener-
ated from the transactions the finder facilitated; however, the transactions were to be only in
Sec. L. Rep. (CCH) ¶ 79,186 (Dec. 20, 1972) (payment of commission as well as conducting
negotiations necessitated registration); Ruth H. Quigley, SEC No-Action Letter, [1972-1973
necessitated registration; issue of registration was raised in the context of seeking a determina-
tion regarding the need to become a member in the Securities Investor Protection Corp.).


153. Id.

iv. Other Experience Selling Securities

The Commission staff has been strongly influenced by a finder's involvement or noninvolvement in other securities sales, as well as by disciplinary actions arising out of other securities sales, in determining whether a finder would need to register. For instance, a finder who was to locate investors for a private offering and who was to be compensated on a commission basis was initially advised by the staff that he would need to register. After the staff was informed that the finder had "not previously been engaged in any private or public offerings of securities," however, it determined that registration would not be necessary. But a finder who was to locate brokers and dealers as potential underwriters or participants in private offerings, but was neither to be involved in actual selling efforts nor to receive any commission compensation was required to register. In this instance, the finder had previously been a broker and had been disciplined by the Commission and the NASD for securities act violations. A history of abusive securities practices would appear to override compliance with guidelines that are normally satisfactory in demonstrating a lack of need to register.

v. Trading Information Systems

On a number of occasions, the staff has responded to inquiries regarding the need to register certain trading information systems as broker-dealers. Such trading information systems include a computerized system operated by a nonprofit corporation to match venture capital investors with entrepreneurs. Another system was a computerized listing of buying and selling interests in the secondary mortgage market, designed to facilitate mortgage


trading between financial institutions. A third inquiry to which the staff responded concerned a "mailing list" containing the names of interested buyers and sellers of shares in a mutual fund. The staff concluded that registration would be required for the trading information systems in mortgages and mutual funds, but not for the information system linking venture capitalists with entrepreneurs. The staff's reasoning was not completely explicit but the following distinctions can be made. Both the trading systems in mortgages and mutual fund shares involved trading in established securities. The trading system matching investors with entrepreneurs did not assist the purchase or sale of specific securities because the investment vehicle was not yet created. Further, the investor-entrepreneur matching system was run by a nonprofit corporation which did not charge a fee for its services. The nonprofit corporation did require that a $100 donation, designed to discourage frivolous use of the system, be made by listed entrepreneurs to other nonprofit corporations assisting area business people. On the other hand, the mortgage trading system did require a subscription fee as well as a use fee. Although the proposed mutual fund trading interest list did not require a listing fee, the list would have promoted secondary market liquidity for the mutual fund.

In addition to not charging a fee for its service, the non-profit investor-entrepreneur matching system was not to be in any way involved in the transactions between the investor and the entrepreneur after the names were matched. As the Commission staff emphasized, the matching service did not advise either the investors or the entrepreneurs on the merits of a particular opportunity, participate in the negotiation of an investment, advise either participant on how the transaction between the parties might be completed.

162. Id.
163. When a buyer-seller locating service that was to publish a monthly report containing a list of stocks available for purchase or sale also proposed to provide "instructions on completing the transactions," the staff concluded that the service must register as a broker. Public Sec. Locating Serv., SEC No-Action Letter, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,528 (Sept. 8, 1973).
or handle funds or securities regarding the completion of the transaction.\textsuperscript{167} On the other hand, the mortgage trading system's employees were expected to discuss offers to trade with both parties. The employees would assist the making of a match by suggesting adjustments to offers. The matching service also planned to "make available to subscribers information as to the current status of the secondary mortgage market."\textsuperscript{168} The mutual fund trading interest list proposal required the fund's business manager to follow up agreements to trade by handling the transfer of shares and payments from buyers to sellers.\textsuperscript{169} These additional services involving negotiations, advice, and handling of investors' funds or shares were factors that the staff considered in concluding that registration would be required for the mutual fund and the secondary mortgage information trading systems.\textsuperscript{170}

Questions may also be raised in regard to trading information systems as to whether the system constitutes an "exchange," as defined by section 3(a)(1) of the 1934 Act,\textsuperscript{171} a "securities information processor" or an "exclusive processor" as defined by section 3(a)(22),\textsuperscript{172} or an "investment adviser" under section 202(a)(11) of the Investment Adviser's Act of 1940.\textsuperscript{173} Satisfying any of these definitions would invoke additional registration concerns.

c. Investment Advisers and Financial Consultants

Investment advisers and providers of financial services frequently seek no-action positions from the Commission staff regarding their need to register as broker-dealers. Registration of investment advisers under the provisions of the Investment Advisers Act of 1940 does not resolve the issue whether registration is also required pursuant to section 15(a) of the 1934 Act. Registration under the 1934 Act has been required if the investment adviser: (1) executes transactions for its clients; (2) charges fees based upon the amount of securities transactions effected by its clients; or (3) takes posses-


\textsuperscript{172} \textit{Id.} § 78c(a)(22)(A)-(B).

\textsuperscript{173} \textit{Id.} § 80b-2(a)(11).
sion of its clients' funds or securities. These factors demonstrate the existence of a potential for customer abuse by the adviser.

The payment of advisory fees based upon the amount of securities bought or sold is, by itself, a basis for requiring broker-dealer registration. In *Fundamental Advisors, Inc.*, an investment adviser proposed to charge an advisory fee equal to three percent of the purchase price of any securities purchased by its customers as a result of any recommendation made by the adviser. The advisory contract was to provide that a confirmation of every securities transaction effected by a customer would be sent by the customer's broker to the adviser, thereby allowing the adviser to compute his fee. Based upon the advisory fee arrangement, the staff indicated that in its view, the adviser would be required to register as a broker-dealer.

Also, when advisers maintain possession of customer funds or securities, concerns over misuse of these funds trigger the need for broker-dealer registration. For example, an adviser who proposed to publish a monthly list of new issues and who was to solicit subscriber deposits that were to be deposited in the adviser's account from which monies would be taken to place orders, was required to register as a broker-dealer. Even though the transaction would not be executed by the adviser and the securities purchased would be registered in the name of the subscriber and delivered to the subscriber, the adviser, who would be in possession of customer funds, would be required to register as a broker-dealer.

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176. Id.


was required to register. On the other hand, the staff found that an adviser that managed client assets on a discretionary basis was not required to register when the uninvested funds of the clients were to be held in separate trust accounts in a third-party bank. Individual records were to be kept of each account showing the name and address of the bank, the dates and amounts of deposits and withdrawals, and the exact amount of the client's beneficial interest in the account. These safeguards appear to lessen the concerns arising from an adviser's access to customer funds.

Pooling of customer orders with one another and with an adviser's own orders under the adviser's name can lead to problems of identification and segregation of client assets, as well as problems associated with allocation of aliquot commissions. Thus, when an investment adviser proposed executing all transactions for its advisory clients in the adviser's name in order to obtain a discount on brokerage commissions, the staff opined that the adviser would be required to register. The adviser also planned to effect transactions for himself at the same time as he effected transactions for his clients.

In order to mitigate the potential problems associated with the pooling of client orders, advisers institute compensating safeguards designed to segregate client accounts from pooled accounts and to assist in identification of the client accounts. These safeguards include: (1) advising the executing broker that specific transactions are being effected for various advisory clients; (2) providing the executing broker with a list of the adviser's clients; (3) notifying clients and obtaining their agreement in advance for aggregated transactions; (4) maintaining completely separate client accounts for all purposes other than executing orders; and (5) avoiding effecting any transactions for the adviser contemporaneously with the client transactions. The staff has been willing to take a no-action position in regard to an adviser's need to register as a broker-dealer even when the adviser pools customer orders, so long as safeguards similar to these are implemented.

The question of the need to register as a broker-dealer also has arisen in the context of a purchaser representative as defined in rule 501(h) under regulation D promulgated pursuant to the 1933 Act. Where a purchaser

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182. 17 C.F.R. §§ 240.501-506 (1987). Under rule 506 of regulation D, sales may be made to purchasers who are inexperienced and unknowledgeable in financial and business matters if the purchaser is advised by a purchaser representative as defined in rule 501(h). Note 1 to rule.
representative proposed to advise investors in a regulation D private offering, the Commission staff advised that it would not recommend enforcement action if the representative advised potential investors without registering as a broker or dealer. The advice was based upon assurances that the purchaser representative's fees (1) would be payable irrespective of whether the representative's offerees purchased securities, and (2) would not be based upon any securities transaction. Furthermore, assurances were provided that the purchaser representative assured the staff that it would comply with the requirements of rule 501.

Financial service consultants frequently seek no-action positions from the staff. Financial service consultants provide issuers with advice and assistance in preparing offerings of securities, and historically, broker-dealer registration has not been necessary for financial consultants so long as their activities do not include certain identifying badges of broker-dealer status.

Activities that have been found by the staff not to trigger broker-dealer registration are (1) determining and giving advice on applicable law, (2) advising upon antifraud concerns, (3) advising an issuer on its financial potential and recommending methods of financing, (4) advising upon and preparing appropriate disclosure documents and clearing them with appropriate government agencies, (5) providing appropriate debt instruments, (6) advising the issuer as to necessary charter amendments, (7) making arrangements with a bank for retiring debt instruments and payment of principal and interest, (8) advising an issuer about clerical work involved in selling bonds, (9) suggesting to an issuer procedures for selling bonds, (10) suggesting a date of sale, and (11) suggesting investment opportunities for temporarily idle proceeds of an offering. On the other hand, sales of securities, receipt of commission fees based upon securities sold, and holding funds on securities have been specifically identified as activities in which financial service consultants frequently seek no-action positions from the staff. Financial service consultants provide issuers with advice and assistance in preparing offerings of securities, and historically, broker-dealer registration has not been necessary for financial consultants so long as their activities do not include certain identifying badges of broker-dealer status.

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501(h) (the rule which defines a "purchaser representative") cautions that a "person acting as a purchaser representative should consider the applicability of the registration . . . provisions relating to brokers and dealers under the Securities Exchange Act of 1934."

184. Id.
185. Id.
Financial consultants cannot engage and still maintain an exemption from broker-dealer registration.\(^\text{187}\)

Registration is not required if one only acts as a "consultant" to an issuer in negotiations with issuer-selected purchasers. However, if the consultant acts as an "agent" for the issuer in soliciting purchasers for a negotiated sale, registration would be required.\(^\text{188}\) In one instance, the consultant was permitted to "explain" a capital raising program to volunteer sales persons and still obtained an exemption from registration.\(^\text{189}\) In other instances of providing a no-action position on registration, however, the Commission staff indicated that the consultant could neither "train" nor "direct" sales personnel.\(^\text{190}\)

Commission fees as compensation for financial service consultants have been permitted when the fees are based upon the total amount of securities offered, as opposed to the amount actually sold.\(^\text{191}\)

Similar to investment advisers, a consultant's representations that it would not hold a client's funds or securities was deemed significant by the staff in its decision to assume a no-action position.\(^\text{192}\) Avoiding the potential for abuse lessens the need to register as a broker-dealer.

d. **Back Office and Ministerial Services**

Effecting transactions is an essential requirement of broker activities. Numerous activities, integrally related to the purchase and sale of securities and the execution of orders, may be subsumed within the term "effecting transactions." These activities, which are frequently performed in the back office of a brokerage firm, include accounting, data processing, record keeping, and custodial transfer.\(^\text{193}\) However, they also can be performed by independent businesses that provide these back office and ministerial services

\(^{187}\) See No-Action Letters, supra note 186.


\(^{191}\) ELJA Group-Evangelical Consultants, SEC No-Action Letter (Oct. 25, 1984) (LEXIS, Federal Securities Library, No-Action File). There, the staff apparently believed that the Commission payment would not result in abusive sale techniques because the fees were not linked to success in sales, but were viewed by the staff as a "flat fee." See Christian Bonds, Inc., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,407 (Aug. 27, 1971) (fee was described as a percentage of the total offering).


\(^{193}\) See infra notes 195-208 and accompanying text.
to brokerage firms choosing not to maintain their own support staff.\footnote{194}

When a business provides back office or ministerial services, questions arise as to whether the business acts as a broker requiring registration under the 1934 Act. The staff typically employs a number of tests to determine whether registration is necessary, two of which are general and one specific in nature. Registration will not be required if the services performed are "of a purely clerical or ministerial nature."\footnote{195} Registration is necessary, however, if the provider of services "acts as agent for an issuer or investor in connection with the purchase or sale of securities."\footnote{196} More objectively, if the provider of services "maintains custody or possession of funds or securities at any stage of a securities transaction,"\footnote{197} it must then register as a broker-dealer.

Consequently, a business that provides services normally performed by the back office of a brokerage firm was required to register.\footnote{198} In Clearing Services, Inc.,\footnote{199} the business performed complete accounting and record-keeping services from the time that it received initial trade information to the time stock was delivered or checks deposited. It held "for safekeeping" all of the broker-dealer's securities and the securities of its customers, and transferred and delivered securities in accordance with instructions.\footnote{200} In addition, it maintained trust accounts for each client-broker in which all funds received from the broker-dealer, the broker's customers, or other broker-dealers were deposited. The staff found that these services were of a character that were more than purely clerical or ministerial and required registration.\footnote{201}

A corporate subsidiary of a major national brokerage firm that cleared securities transactions on behalf of various brokers, dealers, and banks was required to register.\footnote{202} The subsidiary was involved in the delivery and re-

\footnote{194. Id.}


199. Id. at 81,508.

200. Id.

201. Id. at 81,509.

cept of municipal securities for its customers and exchanged funds received for securities delivered. At times, the subsidiary advanced to its customer the sale price of securities it received for clearance. To insure its financial security, the subsidiary required its customers to deposit $25,000 in escrow with it. Based on these facts, the staff required registration because the subsidiary received public customers' funds or securities, and also because "it [was] a significant participant in effecting the securities transactions of its customers."204

The possession of customer funds and/or securities is also critical in determining whether a provider of ministerial services needs to register. In NARE Life Service Co.,205 the business provided regulatory, actuarial, marketing consulting, and administrative services to assist life insurance companies in selling variable life insurance and variable annuities. As part of its services, NARE administered variable life insurance policies, including billing individual policy holders in the name of the client company, accounting for premium dollars received, calculating benefits and reserves, and providing required information on a policy to a policyholder.206 The staff found that "[b]y having supervisory and physical control over funds used in customers' securities transactions, NARE would be a broker" and, thus, would be required to register with the Commission.207 On the other hand, if custody of funds or securities is only temporary and if there is no control over the funds because they are made payable to the account of others, the staff will not require registration.208

D. Caveat Regarding No-Action Letters

The law that has developed in determining who is a broker-dealer is singularly dependent upon opinions of the Commission staff as expressed in no-action letters. Perhaps because of the expense of litigation or the expediency of no-action letters, there are relatively few court cases in this area. In addition, there are very few Commission releases. The domination of this area by no-action letter opinions compels a brief discussion regarding the relevance of and difficulties with the advice obtained from these letters.

No-action letters provide the view of the responding staff on whether cer-

203. Id.
204. Id.
206. Id.
207. Id.
tain conduct described in request letters is in compliance with specified rules or statutes. All no-action letters have been made publicly available since the early 1970's. The regulatory description of the administrative significance of no-action letters indicates that the letters "do not constitute an official expression of the Commission's views;" rather, they are the views of the staff of the division that prepares the letter. The Commission has sought to remind the public that no-action letters "are subject to reconsideration and should not be regarded as precedents binding on the Commission." At one time, the Commission publicly stated its disagreement with an evaluation of no-action letters that "interpretations" found in no-action letters "are law."

Nonetheless, as a practical matter, practitioners place significant reliance on no-action letters. A former chairperson of the American Bar Association's section on Corporation, Banking and Business Law described the weight that securities lawyers place upon the advice found in no-action letters:

Normally a no-action letter is requested when the Rule is not clear, and both client and counsel want the comfort. In such a case, counsel is not really sure whether the staff is correct when the letter is received. Nevertheless, I think most counsel will advise clients to proceed in these situations. This decision is often based in large measure on the fact that most courts, when presented with a no-action letter, will agree with the letter's position.

A respected authority on administrative law, Professor Kenneth Culp Davis, commented that "some of the most important law of the SEC is embodied in this big batch of no-action letters. This is law." Even the Commission has acknowledged that "practitioners might find [no-action] letters helpful." Further, it has recognized that no-action letters are

214. See Davis, supra note 212, at 29.
monitored closely by many issuers, members of the bar and the public." Of course, since no-action letters represent the view of the division issuing the letters, they provide a reliable indication as to whether the particular division will recommend Commission action in response to behavior specified in the request letters.

Whether or not no-action letters are law, they clearly influence judicial decisions. Courts have cited staff no-action letters, as well as interpretive releases, as a basis for judicial opinions. For example, in ADM Corp. v. Thomson, a district court held that a good faith pledgee of restricted securities was not an underwriter when he sold the collateral in a foreclosure sale. The United States Court of Appeals for the First Circuit agreed, stating that "[t]he Securities and Exchange Commission . . . would not recommend enforcement proceedings in the circumstances [of the case]." In this decision, evidence supporting the SEC's position was limited to a series of staff no-action letters written over a nine-year period. The staff's interpretation actually was in conflict with other circuit court dicta cited by the court. The Thomson court did not need to decide the underwriter status of the pledgee, and therefore, it is unclear whether it would accord greater weight to staff no-action letters than to circuit court dicta. However, the court clearly considered no-action positions to be influential.

In other instances, courts have found that no-action letters provide parties with a valid basis for otherwise questionable securities activities. For example, a broker who had accepted securities pursuant to an option after the SEC had issued a suspension order for the securities was held not to be in violation of the suspension order. The court found that the broker had relied upon an interpretive release issued by the SEC, in addition to a letter issued by the staff indicating that objections would not be raised to conduct similar to that of the brokers. The court held that the staff's letter was "drafted in the knowledge that the industry would place heavy reliance on it." The court determined that the broker's reliance was justified, apparently because it was written with such knowledge. In Colema Realty Corporation v. Bibow, a district court stated that "the confusion and ambiguity

216. Id.
219. A.D.M. Corp. v. Thomson, No. 82-1618, slip op. (1st Cir. May 24, 1983).
220. Id.
222. Id. at 95-96.
223. Id. at 98.
surrounding the SEC interpretation" of its own rule, as evidenced by staff no-action letters, contributed to the court's refusal to follow the Commission's own interpretation.225

Because no-action and interpretive letters are relevant to securities issues, in general and particularly to issues in the area of broker-dealer registration, it is worthwhile to focus upon the problems involved in seeking guidance from no-action letters. Although no-action letters today are readily available, the position expounded by any particular no-action letter, or perhaps even several letters, is often open to debate.

In no-action letters, the staff typically does not provide a rationale for its position. Frequently, a no-action letter is merely "the expression of a judgment with respect to enforcement policy."226 The reader is compelled to speculate which of numerous facts recited in the response and/or letter of inquiry triggered the staff reaction. Because the staff has placed different emphasis on the same factors at varying times, comparing the facts cited in one no-action letter with those in numerous other letters does not necessarily indicate which factors were most persuasive.227 A situation in which two different request letters are written regarding the same matter, and the second letter adds a single bit of information beyond the facts described in the first, is helpful in analyzing the rationale behind specific no-action letters.228 Should the staff reverse its position in the second response from the one it assumed in its first response, it would appear to be reasonable to conclude that the factor raised in the second letter influenced the staff's evaluations.

Another problem is that no-action letters do not appear to be uniformly or carefully prepared. Facts cited in these response letters are sometimes at variance with those given in the inquiry letters.229 These inconsistencies heighten the difficulties of interpretation because the reader is not certain whether the staff's position is in response to the facts as stated in the response or in the request. At times, conclusions drawn in no-action responses appear to flatly contradict conclusions drawn in other no-action responses.230

Finally, because no-action letters do not refer to other no-action letters or

225. Id. at 1038 n.9.
227. See, e.g., supra notes 138, 142, 212, and accompanying text.
228. See, e.g., supra note 138.
229. See, e.g., supra note 131, 142.
230. For example, in the area of brokerage sales pursuant to rule 144, the staff has taken an inconsistent view as to whether a broker can employ itself to sell its own rule 144 securities. On occasion, the staff has advised that a broker would not be in compliance with rule 144 if it sold its own securities. National Envtl. Controls, SEC No-Action Letter, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,183 (Dec. 26, 1972). The staff has also advised that a
to case law for precedent, a reader cannot discern the relevant criteria in one letter through an appreciation of relevant criteria in other letters. This avoidance of precedence is consistent with the stated freedom of the staff to reconsider its position at any time. However, certain factors appear to retain their relevance over time and the staff repeatedly relies on them. Yet, these factors can only be verified by examining an extensive number of letters because no-action letters do not cross-reference to others that support a common position.

The difficulties involved in analyzing no-action letters in the area of broker-dealer registration would be greatly diminished if the staff more frequently sought to distill its recent letters and publish interpretive releases. When the staff’s position remains constant, it might further ease the burdens of lawyers in the field of broker-dealer regulation if the Commission would codify these positions in its own releases or rules.

V. INTRASTATE EXEMPTION FROM REGISTRATION

A broker who has a business that is “exclusively intrastate and who does not make use of any facility of a national securities exchange” does not need to register pursuant to section 15(a) of the 1934 Act. This exemption from registration is restrictively applied.

The term “intrastate” has been narrowly interpreted within the language of the 1934 Act itself. Intrastate use of a facility of a national securities exchange, a telephone, another means of communication, or any other interstate instrumentality is included within the section 3(a)(17) definition of “interstate commerce.” Furthermore, not only is intrastate interpreted narrowly, all aspects of a transaction must occur intrastate for a transaction to be included within the category of intrastate. Thus, the intrastate requirement was not satisfied when a broker negotiated and agreed upon a sale of securities within one state, but received payment for the securities from a second state.

The requirement of exclusivity is also strictly construed. Thus, a transaction must be entirely intrastate, and all of a broker’s transactions must be


231. See supra note 211 and accompanying text.


233. Id. § 78c(a)(17). Section 3(a)(17) was amended by the Securities Reform Act of 1975 to include the intrastate use of these facilities of interstate communication within the definition of interstate commerce. Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 97 [hereinafter 1975 Act].

in order to be eligible for the exemption. The Commission has denied the intrastate exemption when the record showed sales to as few as two out-of-state residents in one state and one out-of-state resident in another state. Furthermore, even interstate sale of exempted securities, which would not require registration, would make the intrastate exemption unavailable to a broker whose activities otherwise satisfied the intrastate requirements.

When dealing with a solely-owned brokerage firm, the Commission will examine the securities sales of both the brokerage firm and the sole proprietor in determining whether an interstate securities business has been conducted. For instance, when the sole proprietor of an unregistered brokerage firm sold securities in a "personal" capacity in interstate transactions, the Commission aggregated these personal sales with the brokerage firm's intrastate sales and concluded that there was a willful violation of section 15(a) of the Exchange Act.

If a broker limits its activities to intrastate transactions, but has interstate business affiliations, it appears that the Commission is unwilling to find that registration is not required. In In re Capital Funds, a broker asserted that it had discontinued securities transactions in State A before opening its then sole office in State B. The Commission viewed the fact that the broker was still qualified as a securities dealer in both States A and B as a factor to be considered in concluding that the broker's business was not exclusively intrastate. In another instance, the staff was disinclined to find that registration would not be required when a broker, which sold limited partnership interests only on an intrastate basis, proposed to form, as a general partner, other limited partnerships that would be interstate in nature and would be sold exclusively by other registered brokers. In addition, selling intrastate for an out-of-state issuer is a factor the Commission has considered in deciding that a broker-dealer's intrastate exemption from registration was

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237. In re Chester Richard Koza, 39 S.E.C. 950 (1960). The Commission "rejected the contention that a person engaged in the securities business as a sole proprietor may treat certain of his securities transactions as 'individual' transactions not a part of his securities business." Id. at 952 (citing In re Lawrence R. Leeby, 32 S.E.C. 307 (1951)).


Prior interstate business activities could also present problems for brokers seeking an intrastate exemption. In *Winchester Securities,* a broker was to discontinue its interstate transactions and also withdraw its registration. The staff felt that serious questions would be raised if the broker continued what was formerly an interstate business on an intrastate basis.

For purposes of determining whether an intrastate exemption is available for a broker, the staff is willing to focus on the location of the broker's sales activities, rather than on the actual residence of the purchasers. Professor Loss has asserted that in the instance of the intrastate exemption from broker-dealer registration, unlike the intrastate exemption under section 3(a)(11) of the Securities Act, the emphasis is upon the physical location of the broker-dealer's customers, rather than on their legal residence. The staff therefore was willing to grant a no-action position regarding a broker's nonregistration when the broker indicated in its letter of inquiry that although its sales activities would be "exclusively intrastate," it could not guarantee that it would not "inadvertently" sell to an out-of-state resident. In regard to residence of purchasers, the intrastate exemption for broker registration is not interpreted as strictly as is the exemption for 1933 Act registration.

VI. REGISTRATION OF FOREIGN BROKER-DEALERS

The literal language of section 15(a)(1) encompasses within the registration requirements of the Act foreign broker-dealers who utilize the mails or other means of interstate commerce to effect transactions in nonexempt securities. The 1933 Act definition of "interstate commerce" includes com-

merce between a foreign country and any state. Section 30(b) of the 1934 Act does not protect foreign brokers from the registration requirements of section 15 unless the foreign broker is operating outside of the jurisdiction of the United States.

The Commission has indicated that it will not exercise the limits of its authority under section 15(a)(1). In a 1964 release, the Commission stated that it would not require registration of a foreign broker-dealer participating as an underwriter in a distribution of American securities being made abroad, who limits himself to the following activities:

1. taking down securities which he sells outside the jurisdiction of the United States to persons other than American nationals, and
2. participating solely through his membership in the underwriting syndicate in activities of the syndicate in the United States such as, sales to selling group members, stabilizing, overallotment, and group sales, which activities are carried out for the syndicate by a managing underwriter or underwriters who are registered with the Commission.

However, the Commission has stated that registration would be required of a foreign broker who engaged in selling securities in the United States or who purchased securities in the United States for sale to American investors abroad. The negative implication of the Commission’s statement is that it would not require registration of brokers who sold securities purchased in the United States to foreign investors abroad, although it would technically have the authority to do so. Thus, the emphasis of the Commission’s broker-dealer registration requirements is to protect American investors.

248. 1933 Act § 3(a)(17).
249. Section 30(b) of the 1934 Act reads:

The provisions of this chapter [title 15] or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this chapter.

Id. at 1363.

The 1934 Act generally, and specifically § 10(b), has been found to apply to transactions in securities that occur outside of the United States between foreign buyers and sellers when the subject securities were registered on an American exchange and there was concern about the welfare of either domestic markets or domestic investors. Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (2d Cir.), aff’d in relevant part, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969); see Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir.), cert. denied, 423 U.S. 1018 (1975).

251. Id. at ¶ 1363.
252. There is also a negative implication that the Commission would not require registration of foreign broker-dealers who sell foreign purchased securities to Americans abroad. But,
Selling securities abroad that are bought in the United States does not trigger registration so long as the sales are to non-American investors.\textsuperscript{253} The Commission staff has indicated that it would not recommend enforcement action against a Canadian broker that sold Canadian securities to American investors solely through registered American brokers or investment advisers.\textsuperscript{254} The transactions would be exclusively unsolicited. All accounts with the Canadian broker would be in the name of the American broker, and the Canadian broker would not deal directly with the individual customer of the American broker.\textsuperscript{255} In promulgating its no-action stance, the Commission's staff apparently accepted the Canadian broker's argument that the imposition of a broker-dealer registration requirement on the Canadian broker would not contribute to the protection of American citizens, who would all be customers of registered American securities professionals.\textsuperscript{256}

The Commission also has chosen to limit its registration authority of foreign brokers in regard to mutual funds. Although, the Commission technically could have insisted upon the registration of foreign brokers who use the mails or interstate commerce to buy shares in mutual funds in the United States for sale abroad,\textsuperscript{257} it has chosen not to do so. The Commission has advised that registration would not be required in this instance so long as: (1) the shares are only sold to foreign nationals outside the United States, its territories, and possessions, and (2) the foreign broker-dealer "is not directly or indirectly selling such shares to or acting for the account of an unregistered investment company whose portfolio contains shares issued by open-end investment companies [mutual funds] registered under the Investment Company Act."\textsuperscript{258} Again, the Commission made clear that its concern was with the protection of American investors. It cautioned that registration

\textsuperscript{253} However, selling foreign securities (or certificates of deposit) within the United States does trigger the registration requirements since there would be a concern with the protection of American investors. \textit{See} R. Allan Neblett, SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,327 (June 19, 1971).


\textsuperscript{255} Id.

\textsuperscript{256} Id.

\textsuperscript{257} No exemption from regulation under § 15(a) is provided for transactions in mutual fund shares or for non-domestic broker-dealers. If the mails or interstate instrumentalities are utilized by a broker or a dealer, then § 15(a)(1) requires registration.

would be required of a foreign broker-dealer who solicits and sells mutual fund shares to United States nationals, "no matter where located."\textsuperscript{259}

\section*{VII. Brokers Exempted From Registration}

Pursuant to section 15(a)(2) of the Exchange Act,\textsuperscript{260} the Commission is authorized to exempt by rule or order any broker or dealer, or class of brokers or dealers, from the broker-dealer registration requirements. The Commission's authority to grant exemptions is limited only to the extent that it must \textit{deem} the exemption to be consistent with the public interest and the protection of investors.

\subsection*{A. Exemption by Rulemaking}

The Commission has chosen to exercise sparingly its rulemaking authority to exempt brokers from registration. Although the Commission has promulgated exemption rules pursuant to its authority under section 15(a)(2), some of its rules do not specifically exempt brokers from registration, but instead exempt certain securities from the operation of section 15(a)(1) of the Exchange Act.\textsuperscript{261} Because section 15(a) does not require registration of brokers and dealers who effect transactions only in exempted securities, providing a securities exemption also provides an exemption from registration for brokers and dealers whose business is conducted exclusively in these exempted securities.\textsuperscript{262} Other rules promulgated by the Commission under section 15(a)(2) specifically provide an exemption from registration for a broker-dealer.\textsuperscript{263}

Rule 15a-2\textsuperscript{264} provides an exemption from the operation of section 15(a)(1) for shares in a corporation representing ownership in cooperative apartments. To be exempt, shares must be sold by or through a real estate broker licensed under the laws of the jurisdiction in which the cooperative is located. Again, brokers who transact business only in shares exempted under section 15(a)(1) are exempted from registration under section 15(a)(2).

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\item[259.] \textit{Id.}
\item[260.] Exchange Act § 15(a)(2) reads: "The Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraph (1) of this subsection [requiring registration] any broker or dealer or class of brokers or dealers specified in such rule or order." Congress restricted the Commission's authority to promulgate any exemption or order by requiring that they be "consistent with the public interest and the protection of investors."
\item[261.] For a discussion of exempted securities and their impact on broker-dealer regulation, see \textit{infra} text accompanying notes 347-94.
\item[262.] 15 U.S.C. § 78o(a).
\item[263.] Rule 15a-2, 17 C.F.R. § 240.15a-2 (1987).
\item[264.] \textit{Id.}
\end{enumerate}
\end{footnotesize}
Securities bought or sold off the floor of a national securities exchange in a block by a specialist registered in that security are also exempted from the operation of section 15(a)(1) pursuant to rule 15a-3. Pursuant to rule 15a-4, "a natural person who is a member of a national securities exchange" and whose association with a registered broker-dealer has terminated is exempt from registration as a broker-dealer for a period of forty-five days after termination for the sole purpose of effecting transactions on the floor of the exchange. The person seeking this exemption must have filed with the Commission an application for registration on form BD as a broker-dealer and he must be in compliance with Commission rules applicable to broker-dealers.

Rule 15a-4 permits brokers who are employed by registered brokerage firms to continue effecting transactions on an exchange, even though the broker's employment has been terminated, so long as the broker-employee promptly seeks his individual registration with the Commission. During the time a broker-employee is associated with a brokerage house, the broker-employee need not register with the Commission because section 15(a)(1), by negative implication, does not require the individual registration of natural persons associated with registered brokers. If the broker-employee's association with the brokerage house is terminated, however, section 15(a)(1), in the absence of rule 15a-4, would dictate that the unregistered broker-employee no longer effect transactions in securities on or off an exchange. Rule 15a-4, however, allows the broker-employee to continue effecting transactions on an exchange of which he is a member for forty-five days while he pursues his application for registration. Within that time, the Commission must either grant registration or, if denial is contemplated, institute proceedings to determine whether the application should be denied. Thus, if a broker-employee files an application for registration under section 15(a)(1) immediately upon termination of employment with a registered brokerage firm, the

265. Id. § 240.15a-3. The transaction must be approved by the exchange pursuant to its rules for assisting specialists in maintaining a fair and orderly market in that security on the specialist's exchange.


267. Additional requirements are that the exchange of which the person is a member must file with the Commission a statement indicating that it has reviewed the application for registration and there do not appear to be grounds for the denial of the person's application. 17 C.F.R. § 240.15a-4(a)(2) (1987). Further, the person seeking the exemption cannot be involved in any proceeding pending before the Commission to consider denial of an application for registration pursuant to § 15(b)(1)(B). 17 C.F.R. § 240.15a-4(b) (1987).


employee should be able to continue service as a broker on an exchange through the time that his registration is approved.

Rule 15a-5 provides an exemption from registration for certain lenders who participate in the Small Business Administration’s guaranteed loan program. To obtain an exemption, a lender must not engage in the business of buying and selling securities for its own account except to the extent that the lender receives notes evidencing loans to small business concerns and sells the portion of the notes that is guaranteed by the Small Business Administration. The sale must be made either through or to a broker or dealer registered with the Commission or to certain institutional customers. This rule was intended to encourage participation by qualified lending institutions in the Small Business Administration’s loan program and thus increase the supply of capital available to eligible small businesses.

B. Individual Grants of Exemption

Beyond its rulemaking activity, the Commission infrequently exercises its authority under section 15(a)(2) by granting an exemption from registration for individual brokers. In addition, the Commission staff occasionally has used the format of the no-action letter to opine upon whether an exemption, which can only be granted by the Commission, would be granted in a specific instance. The basis for the grant or denial of an exemption from registration is not always made clear, neither in Commission responses to requests for exemptions nor in staff no-action letters. However, it is clear that exemptions are only infrequently granted and that there is a heavy burden on the applicant to show the Commission that the grant of an exemption would be in the public interest or for the protection of investors.

The Commission did grant an exemption in one instance when the applicant proposed to establish numerous safeguards to protect the investors whom it would serve. The net impact of these safeguards was to provide protection comparable to the protection provided if the applicant was required to register. In the fact pattern underlying the exemption, the National Association of Investment Clubs (NAIC), a not-for-profit corporation,

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271. Id.
proposed to assist its members in purchasing securities through corporate dividend reinvestment plans in order to avoid commission payments which would be high in relation to the small amount of dollars invested by most of the Association's members.\(^{276}\) In order to protect its investing members, NAIC provided an escrow account for members' investment funds. Shares purchased by NAIC were to be issued in the names of the individual members. NAIC proposed to provide the Commission staff with quarterly reports including information regarding shares purchased by members, any complaint letters received concerning the program, and copies of solicitation letters used by NAIC. NAIC would preserve for six years extensive records regarding purchases made, monies received, membership applications, and copies of correspondence and complaints, among other matters.\(^{277}\) NAIC offered to permit the Commission to conduct periodic inspections of its books, records, and the operations of the proposed program. Finally, NAIC employees were to be bonded and no person associated with NAIC was to be subject to a statutory disqualification.\(^{278}\) On the basis of these representations, the Commission concluded that although NAIC would be a broker, it would be in the public interest to grant NAIC a conditional exemption from registrations as a broker or dealer.

In another instance when alternative investor protection safeguards were not provided by an applicant which intended to solicit investor purchases of stock in large utility companies, the Commission staff advised the applicant that the staff would not be in a position to recommend that an exemption from broker-dealer registration be granted.\(^{279}\) Cash, Inc., a nonprofit Florida corporation, sought to inject consumer influence into the decision making process of utility companies. It solicited consumers to purchase a share of stock in a Florida utility company where the purchasers would not be required to pay a commission but would be required to pledge dividend income to the applicant, Cash, Inc. The letter of inquiry from Cash did not indicate that any specific investor protections would be implemented. Based upon the information provided, the staff was not able to conclude that Cash would not have to register as a broker-dealer.

In evaluating whether to grant an exemption from registration as a broker-dealer for the Federal Home Loan Mortgage Corporation (FHLMC), the Commission again focused upon the availability of alternative means of

\(^{276}\) Id.

\(^{277}\) Id.

\(^{278}\) Id.

The Commission determined that in selling mortgages and participation interests in mortgages, the FHLMC was acting both as a broker and a dealer. However, the Commission noted that the FHLMC's financial stability was insured by its status as a government instrumentality and its being subject to an annual government audit. In addition, oversight by the Federal Home Loan Bank Board, an independent governmental agency, was considered to be "an adequate substitute for the training and experience requirements" contemplated under the broker registration provisions. Beyond its concern with investor protection, the Commission also noted that the FHLMC's enabling legislation did not reflect a congressional intent to require broker-dealer registration. Based upon these considerations, the Commission granted an exemption from registration under section 15(a)(1) of the Act.

Members of exchanges, even if they only serve other brokers or engage in just a limited amount of securities business, are not eligible for exemptions from broker-dealer registration. In reference to a request for an exemption from a floor trader on a regional exchange who effected approximately twenty-four to thirty-six transactions per year on the exchange, the Commission noted that the Securities Acts Amendments of 1975 specifically required the registration of exchange members such as specialists, floor traders, and two-dollar brokers who conducted their securities business exclusively on an exchange. The staff took an identical position when it was asked whether an exchange member that intended to effect executions only for other brokers would be required to register. The staff indicated that it would not recommend to the Commission an exemption from registration for the broker.

Occasionally, in response to a request for an exemption from registration, the staff will indicate that it will not recommend enforcement action to the Commission if the requesting party fails to register as a broker-dealer.

281. Id.
282. Id.
283. Id.
284. Id.
285. Id.
288. ETIW Syndication Agreement, SEC No-Action Letter (Nov. 2, 1984) (LEXIS, Federal Securities Library, No-Action File) (the applicant requested an exemption from registration under § 15(a)(2), arguing that the offer and sale of fractional interests in an Arabian
Because the staff cannot provide an exemption pursuant to section 15(a)(2), the staff’s no-action letters cannot be viewed as providing technical exemptions from registration. However, the net effect of the staff’s no-action response is to permit the inquiring party to conduct the proposed securities activity without requiring broker-dealer registration.

VIII. BROKER-DEALER REGISTRATION AND DEFINITION OF A SECURITY

Registration of broker-dealers is required under section 15(a)(1) only if there is any business being conducted in securities. If the interests involved in a business are not securities, registration is not required. Each of the definitions of the terms “broker” and “dealer” require that transactions occur in securities. The term “security” is thus doubly important to the registration of brokers and dealers. It is critical both in defining a broker and dealer as well as in defining the activity requiring registration of brokers and dealers.

Even though the term “security” is central to broker-dealer registration requirements, questions of broker-dealer registration do not often turn upon whether the instruments involved in a transaction are indeed securities. Rather, the question of whether a specific instrument is a security typically is relevant to broker-dealers only in determining whether there have been violations of the proscriptions against selling unregistered securities or violations of antifraud provisions. Because the term “securities” plays an integral role in the definitions of both broker and dealer, and because that term is examined at times by courts to determine if broker-dealer registration is required, the definition of securities warrants a brief discussion.

289. Pursuant to § 15(a)(2), the Commission is authorized to grant exemptions. 15 U.S.C. § 78o.


292. The issue of what constitutes a security is essentially peripheral to the focus of this chapter, which is the regulation of broker-dealers. It is a subject matter better addressed in the context of the regulation of the issuance and sale of securities. For a more complete analysis of the definition of securities, see 3 Sec. & Fed. Corp. L. Rep. (Clark Boardman) 19 (1977).
Section 3(a)(10) of the 1934 Act provides a broad definition of the term “security.” This definition includes traditional securities such as “stocks, bonds, and debentures,” as well as more exotic instruments, such as “collateral-trust certificates” and participations in mineral royalties. The definition also includes catchall phrases such as “investment contracts” and “profit sharing agreements.” The 1934 Act definition of security is substantially the same as the definition of security found in section 2(1) of the 1933 Act. Indeed, the United States Supreme Court has incorporated into the interpretation of the 1934 Act definition of securities, those cases that define securities, under the 1933 Act. Both definitions are preceded by the phrase “unless the context otherwise requires.” This phrase provides additional flexibility in interpreting definitions that are already drafted as multi-purposed vehicles.

The judicial attitude to the term “security” historically has recognized the need to avoid rigidity in interpretation. In an early decision dealing with the definition of security, the Supreme Court noted that the term “security” “embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”

293. Section 3(a)(10) reads:
   (10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

295. 15 U.S.C. § 78c(10). The 1934 Act definition does not include the term “evidence of indebtedness” found in the 1933 Act. The 1934 Act excludes any note, draft, bill of exchange, or banker's acceptance with an initial maturity of nine months or less. Also, the 1934 Act employs a different wording for its definition of securities that are mineral interests.
296. Tcherepnin v. Knight, 389 U.S. 332 (1967). The Senate, in adopting the 1934 Act, indicated that the 1934 Act definition of security was intended to be “substantially the same as [that contained] in the Securities Act of 1933.” S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934).
A. Investment Contracts

In determining what constitutes a security, courts have focused primarily on the phrase "investment contract." In the watershed case on this matter, SEC v. W.J. Howey Co., the Supreme Court defined an investment contract as "a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and is led [3] to expect profits [4] solely from the efforts of the promoter or a third party." This four-part definition established a test for a profit-seeking business venture managed and controlled by those other than the investors. The Howey test has become the key definition of a security.

Utilizing this test in Howey, the Supreme Court found that the sale of portions of a citrus tree grove when coupled with a service contract to cultivate, harvest, and market the fruit constituted a security. The sellers of the citrus tree units were found to be offering investors "an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents [sellers]." The purchasers were perceived as being "attracted solely by the prospects of a return on their investment." They had "no desire to occupy the land or to develop it themselves." Accordingly, the Court concluded that they were purchasing securities.

Since Howey, the four part investment contract test has been applied to find securities in offerings to participate in enterprises the focus of which are as diverse as chinchillas, earthworms, scotch whiskey and managed customer accounts at brokerage firms. In each instance, there was a common enterprise in which investors were seeking profits from a business managed by others.

Several of the elements of the Howey test have been modified or refined since first enunciated by the Supreme Court. The requirement that the ef-

300. Id. at 298-99 (bracketed numbers added).
301. Id. at 299-300.
302. Id. at 299.
303. Id. at 300.
305. Smith v. Gross, 604 F.2d 639 (9th Cir. 1979).
306. Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974).
307. SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974). The question of whether a managed account is indeed a security is of particular relevance to brokers; it generally arises in the context of attempts by customers to find anti-fraud violations by the brokerage firm managing the account. Those circuits that are opposed to viewing these accounts as securities often base their opposition on the absence of a common enterprise among investors. Milnarik v. M-S Commodities, Inc., 320 F. Supp. 1149 (N.D. Ill. 1970), aff'd, 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972).
forts leading to profits come solely from the efforts of others has been lessened so that the efforts now need only be "significant."  Without this modification, it was perceived that the *Howey* test might be evaded merely "by adding a requirement that the buyer contribute a modicum of effort." Pursuant to this more pragmatic approach, the sale of interests in a pyramidal promotion enterprise was considered a sale of securities, even though the investors performed perfunctory roles in the promotion enterprise pursuant to a script.

The element of the *Howey* test requiring an investment of money has also been refined by later decisions. In *International Brotherhood of Teamsters v. Daniel*, the Supreme Court held that an employer contribution toward a pension fund could not be equated with an investment by the employee. The Court found that the contributions could not be viewed as being made "on behalf" of any employee because there was not a one-for-one relationship between contributions made by the employer and benefits to be received by the employee. Furthermore, the employee's contribution was too negligible to constitute an investment of money. The contribution made on the employee's behalf pursuant to his employment contract was viewed as "a relatively insignificant part of an employee's total and indivisible compensation package." Thus, after *Daniel*, in order to satisfy the *Howey* test, the money invested in securities must be significant and must be capable of being segregated out as a distinct sum.

A final element of the *Howey* test to be refined in later cases is the requirement that there be an expectation of profits. Profits have been defined to include "income yielded by an investment as well as . . . capital appreciation." In determining whether the sale of cooperative apartment units constitutes the sale of securities, however, the Supreme Court specifically excluded from the definition of profit tax savings to the owner of a cooperative apartment that resulted from the deductibility for tax purposes of the interest paid on the mortgage. These benefits were characterized as "nothing more than that which is available to any homeowner who pays interest on his mortgage."

Additionally, the Court found that the savings realized by cooperative

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309. Id.
312. Id. at 560.
314. Id. at 855.
owners in obtaining housing at below-market rental costs were not acceptable as "profits." Because the low rent was derived from financial subsidies provided by the New York State government, it could neither be liquidated into cash nor result from the managerial efforts of others.\textsuperscript{315} Finally, the income to be derived from leasing by the cooperative of certain commercial facilities, professional offices, and parking spaces and from its operation of community washing machines was considered as "far too speculative and insubstantial" to allow the entire transaction to be viewed as the sale of securities.\textsuperscript{316}

The Daniel opinion also considered the question of what type of profits would satisfy the Howey test. In Daniel, the pension fund income was derived to a far larger extent from continued employer contributions than from earnings on its assets.\textsuperscript{317} The Supreme Court concluded that the benefits received by the employees from the pension fund could not be considered profits because they were not derived from the managerial efforts of others.\textsuperscript{318} In addition, an employee's eligibility for benefits was contingent on meeting a number of vesting requirements. Receiving "profits" thus depended primarily on the employee's efforts to meet the vesting requirements. As a consequence, the employee's participation in the pension plan, and thus his receipt of profits, was found to be "too speculative and insubstantial" to warrant considering the pension plan as involving the sale of securities.\textsuperscript{319} Thus, after Daniel and Forman, to satisfy the Howey test, profits must be derived from the efforts of others. They must not be too speculative or insubstantial. They cannot result from government subsidies nor can they constitute merely tax savings.

There had been some uncertainty as to whether the Howey test was intended to determine whether a particular investment instrument fits into any of the categories listed in the statutory definition of security or whether it was a means solely intended for evaluating whether an instrument is an investment contract. The question is significant because if the Howey test is not a universal test for what constitutes a security, then, should an instrument not satisfy this test, it still might be found to be a security that is other than an investment contract.

In the Daniel case, the Court hinted that the Howey test was indeed universal when it stated that the test "embodies the essential attributes that run

\textsuperscript{315} Id.
\textsuperscript{316} Id. at 855-56.
\textsuperscript{318} Id. at 562.
\textsuperscript{319} Id.
However, in a later case, the Court squarely asserted that the Howey test "was designed to determine whether a particular instrument is an 'investment contract,' not whether it fits within any of the examples listed in the statutory definition of 'security.' "321 The Court explained what appeared to be an inconsistency with its earlier statement by explaining that the Forman statement quoted in Daniel was made only in response to an argument which asserted that if the investment instruments were not "stock" or "investment contracts," they at least were "instrument[s] commonly known as a 'security.' "322 In hindsight, the Court observed that all it held in Forman was that once the label "stock" did not apply, the Howey test would have been appropriate whether the instrument in question was perceived as an "investment contract" or as an "instrument commonly known as a 'security.' " Thus, the Court concluded, the Howey test was not universal, but rather designed to determine the existence of an investment contract or an instrument commonly known as a security.323

B. Economic Realities

A second frequently utilized mode of analysis for determining the existence of a security is the "economic realities" test refined by the Supreme Court in United Housing Foundation, Inc. v. Forman324 as a supplement to the Howey test. Addressing congressional intentions in adopting the securities acts, the Court opined that the application of these acts "turn[s] on the economic realities underlying a transaction, and not on the name appended thereto."325 Noting that the purchasers of cooperative apartments were sold shares called "stock," the Court concluded that "common sense" suggested that the purchasers were not misled into believing that they were purchasing investment securities simply because of the name used to represent an ownership interest.326 The shares sold did not possess the characteristics of a security. They provided no right to receive dividends, and they were neither negotiable nor capable of being hypothecated. Voting was not in proportion to share ownership. Additionally, because of a resale restriction requiring

320. Id. at 558 n.11 (quoting United Housing Found., Inc. v. Forman, 421 U.S. 837, 852 (1975)).
322. Id. at 691 n.5.
323. Id. at 691-92 & n.5.
325. Id. at 849.
326. Id. at 851.
that upon termination of occupancy tenants must resell to the cooperative at cost, the shares could not appreciate in value.\textsuperscript{327}

The Howey test was reconfirmed by the Forman Court to be an integral element of the economic reality analysis.\textsuperscript{328} The Howey test determines whether an instrument is an investment contract by examining whether it possesses the essential attributes that run through the various Supreme Court decisions defining a security.\textsuperscript{329} Thus, the Howey test looks to the substance of an instrument, rather than to the name employed.\textsuperscript{330} Because the parties in Forman, in purchasing shares in a cooperative, were seeking "living quarters for personal use" and not "profits from the efforts of others," the instrument acquired did not possess the characteristics of a security.\textsuperscript{331}

The Forman case provided little guidance as to when the economic realities test might or must be applied. After the enunciation of the test in Forman, it was unclear whether an economic realities analysis would have to be employed each time the issue of the existence of a security was raised. If an instrument clearly has the characteristics of a security, would a court have to conduct an economic realities analysis to determine whether the substance of the transaction suggests that a security is involved?\textsuperscript{332}

In 1985, the Supreme Court resolved this matter in Landreth Timber Co. v. Landreth.\textsuperscript{333} In Landreth, the Court confirmed that previous cases\textsuperscript{334} had not been "entirely clear" regarding the issue. The Court indicated that in the past it had only applied the economic realities analysis when transactions involved "unusual instruments not easily characterized as 'securities.'"\textsuperscript{335}

\textsuperscript{327} Id.
\textsuperscript{328} Id. at 851-52.
\textsuperscript{329} Id. at 852.
\textsuperscript{330} Id. at 851-52.
\textsuperscript{331} Id. at 858.

\textsuperscript{332} Respondents in Landreth Timber Co. v. Landreth, 471 U.S. 681, 684 (1985), urged the Supreme Court to utilize an economic realities test even when the interests in question possessed all the traditional characteristics of a security. Landreth involved the sale of a business by respondents to a purchaser who intended to run the company. Respondents argued that the economic realities of the transaction demonstrated that the shares sold were not securities because the purchaser had not "entered into the transaction with the anticipation of earning profits derived from the efforts of others." Id. at 684-85.

\textsuperscript{333} Id. at 681.

\textsuperscript{334} The economic realities test has been employed by the Supreme Court on several occasions other than in Forman: SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), predated Howey. The Howey Court also stated that it was placing emphasis on the economic reality of a situation. 328 U.S. at 298, 299. The economic realities test was also employed at times closer to Forman. See Tcherepnin v. Knight, 389 U.S. 332 (1967); Marine Bank v. Weaver, 455 U.S. 551 (1982).

\textsuperscript{335} Landreth Timber Co., 471 U.S. at 690.
Thus, when the instrument involved is "traditional stock," there is no need "to look beyond the characteristics of the instrument to determine whether the Acts apply." On the contrary, when, as in *Forman*, an instrument has none of the traditional characteristics of a security, even if labelled "stock," the economic realities test should be applied.

At first glance, the Court's explanation of when to apply the economic realities analysis does not entirely clarify an uncertain situation. Advising the use of an economic analysis only when the subject instruments are not "traditional" securities sounds potentially like circular logic. In essence, the Court might be advising use of the economic realities analysis only upon a determination, assumedly through economic reality analysis, that one does not have a traditional security. If this indeed is the Court's advice, situations in which the economic realities analysis should be employed are essentially outcome determinative. An instrument that fails the test of traditional security because of the economic realities test should similarly fail the test of being a security because the economic realities test again would be employed.

More likely, the Court had in mind two different economic realities tests. The first test would be the one employed in *Forman* to determine whether the instrument has the characteristics of a security: negotiability, issuance of dividends, and proportional voting power. Only if that stock characteristics, economic realities test is failed would the Court then apply the *Howey* economic realities test, which is an investment of money in a common enterprise with the expectation of profits from the efforts of others.

If one interprets the Court's advice in *Landreth* as referring to two different economic realities tests, it makes sense. The *Howey* economic realities test need only be employed if a stock fails the stock characteristics, economic realities test of *Forman*.

C. Risk Capital

A number of state courts and a few federal courts have employed a risk capital test for determining the existence of a security. Under this test, a security is found to be present whenever an investor places his money at risk in an enterprise over which he has no managerial control. Perhaps the most complete articulation of the risk capital test was provided by the Supreme Court of Hawaii, which held that an investment contract is created when:

1. an offeree furnishes initial value to an offeror, and
2. a portion of this initial value is subjected to the risks of the enterprise, and
3. the furnishing of the initial value is induced by the offeror's

336. *Id.*
promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.\textsuperscript{337}

The test permits the possibility of the existence of a security even if there is no expectation of profits and even if there is some participation by the investor in the enterprise.\textsuperscript{338}

Among those courts applying the risk capital test, a consensus is lacking as to exactly what the test entails. Some jurisdictions only apply the test in situations involving "start up" capital, as opposed to an infusion of capital to an ongoing enterprise.\textsuperscript{339} In addition, a number of decisions required that an enterprise involve speculative risk in order for the test to give an affirmative result.\textsuperscript{340} The Supreme Court has declined to apply the risk capital test.\textsuperscript{341}

\textbf{D. Variations in the Applications of Definitional Tests for Securities}

In determining whether a security exists, courts do not always restrict themselves to formal application of the above-described tests, but will occasionally apply variations. The tests have been applied both singly and jointly. Courts also employ unique tests which are distinguishable from the above-described tests and are applicable only to specific investment vehicles or to specific fact patterns.

An example of an application of a unique test for the existence of a security can be found in the Supreme Court's decision in \textit{Marine Bank v. Weaver}.\textsuperscript{342} In that case, the Court found that a certificate of deposit of a federally regulated bank was not a security because (1) the bank issuing the certificate was subject to a "comprehensive set of regulations governing the banking industry," and (2) the deposits in the bank were insured by the Fed-

\textsuperscript{338} Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961) (the risk capital test was employed to determine whether sale of country club memberships constituted the sale of securities under the California Corporation Code). Mr. Steak, Inc. v. River City Steak, Inc., 324 F. Supp. 640 (D. Colo. 1970), modified on other grounds, 460 F.2d 666 (10th Cir. 1972) (the court acknowledged the utility of a risk capital test in determining whether a franchise constitutes a security).
\textsuperscript{341} United Housing Found., Inc. v. Forman, 421 U.S. 837, 857 n.24 (1975).
\textsuperscript{342} 455 U.S. 551 (1982).
eral Deposit Insurance Corporation. The focus of the Court's analysis in Marine Bank was protection of the investor. Finding that the purchaser of the certificate was "virtually guaranteed payment in full," the Court determined that the protection of the antifraud provisions of the 1934 Act was unnecessary.

In regard to a separate loan agreement involved in the Marine case, negotiated "one-on-one" between the parties to the agreement, the Court again concluded that no security was present. In this instance, the Court found that there was no intent to publicly trade the instrument in question. The lending party was given privileges, personal only to the lenders, to use the borrower's farming facilities. Again, the Court's focus was on unique characteristics of the investment fact pattern in which the transaction arose.

There, the Court focused its concern on the nature of the distribution of the investment instruments. The Court concluded that, since the instrument was not publicly traded, it was not a security. The Court's analysis was relatively unorthodox since the question of whether or not an instrument is publicly traded typically is considered in conjunction with a determination of the need to register, not in conjunction with a determination of whether a security exists.

The Supreme Court in Weaver acknowledged the unique aspects of its analysis. It cautioned that in other situations a certificate of deposit might be deemed to be a security. The Court advised that "[e]ach transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole." Thus, in some instances, tests are employed for determining the existence of a security that are not universal in applicability.

IX. EXEMPTED AND OTHER "EXCLUDED" SECURITIES AFFECTING BROKER-DEALER REGISTRATION

Not all securities transactions trigger the broker-dealer registration requirements of section 15(a)(1). Transactions in certain securities are excluded from the category of security transactions in which it is unlawful for a broker or dealer to engage without registration. Securities in which transactions do not require broker-dealer registration include securities specifically identified as "exempted securities" as well as other securities not so identified but which function as exempted securities. Collectively, we can

343. Id. at 558.
344. Id. at 558-59.
345. Id. at 559-60.
346. Id. at 560 n.11.
347. Id.
refer to these exempted and functionally exempted securities as "excluded securities."

Securities are subject to exclusion by operation of both statute and rule. Excluded securities are characterized as:

(1) Securities that are defined as "exempted securities" in section 3(a)(12) of the 1934 Act and are deemed "exempted" for purposes of section 15.349

(2) Securities that are specifically exempted from the section 3(a)(10) definition of security. The section 3(a)(10) definition of security specifically


The term "exempted security" or "exempted securities" includes securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States; such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors; municipal securities, as defined in section 3(a)(29) of this title: Provided, however, That municipal securities shall not be deemed to be "exempted securities" for purposes of sections 15, 15A (except subsections (b)(6), (b)(11), and (g)(2) thereof), and 17A of this title; any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian; any interest or participation in a single trust fund, or a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, which interest, participation, or security is issued in connection with (A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, (B) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of such Code, or (C) a governmental plan as defined in section 414(d) of such code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described in clause (A), (B), or (C) of this paragraph (i) which covers employees some or all of whom are employees within the meaning of section 401(c) of such Code, or (ii) which is a plan funded by an annuity contract described in section 403(b) of such Code; and such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this title which by their terms do not apply to an "exempted security" or to "exempted securities."

Id. (emphasis in original).

349. Municipal securities are defined as "exempted securities," but not for purposes of §§ 15, 15A, and 17A of the 1934 Act.

excludes "currency or any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance of not exceeding nine months."

(3) Securities that are not defined as exempted by section 3(a)(12), but are nonetheless excluded from the operation of section 15(a)(1) by its language. Specifically, section 15(a)(1) does not require registration for brokers and dealers who transact business solely in "commercial paper, bankers' acceptances, or commercial bills." 351

(4) Securities that are exempted for purposes of section 15(a)(1) pursuant to the Commission's rulemaking authority. The Commission has exercised its authority under section 3(a)(12) to exempt certain securities as it deems "consistent with the public interest and the protection of investors." 352 Pursuant to section 15(a)(2), the Commission also has authority to exempt a specified class of broker-dealers from the registration requirement of section 15(a)(1). 353 In exercising its latter authority, the Commission has at times essentially established a class of exempted securities.

A. Exempted Securities

The section 3(a)(12) definition of securities exempted for purposes of section 15(a) is complex, and it includes a number of categories of securities:

(1) United States government securities, including any direct obligations of the government or obligations guaranteed by the government as to principal or interest. Securities issued or guaranteed by corporations in which the government has an interest and that are designated for exemption by the Secretary of the Treasury are also exempted. 354

(2) Interests in common trust funds maintained by banks exclusively for collective investment and reinvestment of assets maintained therein by the bank as trustee, administrator, executor, or guardian. Also exempted are interests in single or collective trust funds maintained by a bank. 355

(3) Securities arising out of contracts issued by an insurance company in connection with stock bonus, pension, or profit sharing plans which meet the qualification requirements of section 401 of the Internal Revenue Code, annuity plans for which employer contributions are deductible under section 404(a)(2) of the Code, or governmental plans as defined in section 414(d) of the Code, established for the exclusive benefit of employees. 356

352. Id. § 3(a)(12).
353. Id. § 15(a)(1).
355. Id.
356. Id.
(4) Securities that the Commission designates as exempted securities.\(^{357}\) That designation can be unconditional or upon specified terms or for stated periods. These exemptions may be from one or more provisions of the 1934 Act.

(5) Although municipal securities are included within the section 3(a)(12) definition of exempted securities, since the 1975 Securities Reform Act,\(^{358}\) municipal securities are no longer exempted for purposes of sections 15 and 15A of the 1934 Act. Municipal securities are defined by section 3(a)(29)\(^{359}\) to include direct obligations of a state, political subdivision, or any agency of a state or political subdivision as well as obligations guaranteed as to principal or interest by a state, political subdivision, or agency of a state or political subdivision. Also included in municipal securities are industrial development bonds.

Brokers and dealers who confine their transactions solely to exempted securities do not need to register under section 15(a)(1).\(^{360}\) Transactions in securities exempted from registration under the 1933 Act because of a transaction exemption do not exempt brokers or dealers from registration under section 15 of the 1934 Act. Thus, a broker who proposed to engage exclusively in transactions with respect to securities which were the subject of a private placement was advised by the Commission staff that he would be required to register as a broker or dealer.\(^{361}\)

**B. Commercial Paper**

Section 15(a)(1) specifically does not require registration for brokers or dealers whose business is limited to transactions in commercial paper, bankers' acceptances, or commercial bills. In addition, the term "security" is defined in section 3(a)(10) to exclude notes, drafts, bills of exchange, or bankers' acceptances with a maturity not exceeding nine months.\(^{362}\) Thus, brokers and dealers whose transactions involve exclusively short-term instruments, as opposed to long-term instruments with a maturity of greater than nine months, are also absolved from the registration requirements. These short-term instruments include commercial paper.\(^{363}\) The character-
istics of the short-term commercial paper exclusion found in the 1934 Act definition of a security have been construed as coextensive\textsuperscript{364} with the characteristics of the short-term commercial paper exemption from registration found in section 3(a)(3)\textsuperscript{365} of the 1933 Act.

The term "commercial paper" is not defined in either the 1933 or the 1934 Act. However, the Commission described what it considers to be the characteristics of exempted commercial paper in the discussion of section 3(a)(3) of the 1933 Act:

"The legislative history of the Act makes clear that section 3(a)(3) applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks.\textsuperscript{366}

Thus, the Commission perceives commercial paper to be only those instruments which are: (1) prime quality; (2) not ordinarily purchased by the public; (3) used to finance operations rather than as start-up capital; and (4) eligible for discounting by Federal Reserve banks.\textsuperscript{367}

The Commission's characterization of commercial paper has been adopted by the Seventh Circuit. In \textit{Sanders v. John Nuveen & Co.,}\textsuperscript{368} short-term notes were held not to be exempt from the section 3(a)(10) definition of security because the notes, issued by an insolvent finance company, were not of prime quality. Furthermore, because of the issuer's insolvency, the \textit{Sanders} court found it unlikely that the notes were used to facilitate current transactions or were eligible for discounting by Federal Reserve banks. In addition, the notes were found to be of a kind bought by the general public. Indeed, the notes were offered and sold to forty-two members of the public.\textsuperscript{369}


\textsuperscript{367} It should be noted that the Supreme Court has found that under the Glass-Steagall Act, commercial paper is to be construed as a security. Securities Indus. Ass'n v. Board of Governors of Federal Reserve System, 468 U.S. 207 (1984).

\textsuperscript{368} 463 F.2d 1075 (7th Cir.), cert. denied, 409 U.S. 1009 (1972).

\textsuperscript{369} \textit{Id.} at 1079.
C. Mortgage Securities and Other Securities Exempted by Commission Rule

In a limited number of instances, the Commission has exercised its rulemaking authority under sections 3(a)(12) and 15(a)(2) of the 1934 Act to exempt certain securities from the registration requirements of section 15(a) of the Act.

1. Mortgage Securities

Under rule 3a12-1, brokers who deal solely in mortgages or interests in mortgages sold by the Federal Home Loan Mortgage Corporation (FHLMC) are exempt from broker-dealer registration requirements and from the net capital provisions applying to broker-dealers. The mortgages and mortgage interest sold by the FHLMC are originated by financial institutions whose deposits or accounts are insured by an agency of the United States. The FHLMC purchases these mortgages from the financial institutions in an effort to improve the liquidity of the market in residential mortgages. In adopting rule 3a12-1, the Commission noted that the FHLMC contemplated requiring investors in its mortgage and mortgage interest programs to effect minimum purchases of at least $100,000. Thus, buyers would tend to be institutions. The Commission's rule, adopted in 1972, was intended to facilitate the FHLMC's goal of establishing a liquid market in residential mortgages. The Commission's willingness to abstain from regulation in this area was prompted in part by the FHLMC's ability and desire to regulate this field of securities and by the Commission's perception of a "probable lack of small investor participation" in the area.

In 1974, the Commission demonstrated an increased willingness to provide exemptions for brokers who deal in mortgage securities with the adoption of rule 3a12-4. This rule identifies mortgage securities as "exempted securities" for purposes of broker-dealer registration and the net capital requirement. The term mortgage security includes: "whole loan mortgages," e.g., an actual debt instrument secured by a mortgage; "aggregated whole loan mortgages," e.g., two or more whole loan mortgages grouped together and sold to one person; "participation interests," e.g., one of only two such interests in either a whole loan or an aggregated whole loan mortgage with the other interest retained by the originator of such participation interest; as

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371. Id. at 82,365.
372. Id.
well as "commitments," e.g., a contract to purchase a whole loan or aggregated whole loan mortgage or a participation interest which contract requires full execution within two years. 374

Unlike rule 3a12-1, the securities exempted under rule 3a12-4 are not limited to those sold by the FHLMC. The Commission recognized that FHLMC had devised financial standards to be maintained by all participants in its then-proposed automated trading system. 375 Not all mortgage brokers and dealers, however, would participate in the FHLMC automated system and thus might not be subject to financial responsibility oversight of the FHLMC. Therefore, the Commission required that in order for the rule 3a12-4 exemption to apply to specific mortgage securities, the instrument must have an unpaid balance of at least $50,000 and the security must not be in default. 376 The Commission believed that these limitations would insure the sophistication of the sellers of exempted mortgage securities.

Rule 3a12-4 exempts not merely whole loan mortgages but participation interests and advance commitments in exempted securities as well. In its release adopting rule 3a12-4, the Commission indicated that trading in commitments then comprised half of the mortgage sales in secondary mortgages. 377 Commitments serve to shift the long-term market risks, such as those resulting from interest rate fluctuation. Trading in participation interests then amounted to over $10 billion annually. 378

The adopting release noted that the rule 3a12-4 exemption might be inapplicable if the mortgage security was sold as part of an investment contract. 379 Thus, if the seller of the contract or someone other than the buyer provides certain services specified in the promulgating release, 380 the mort-

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374. Id. at 84,176-77.
375. Id. at 84,177.
376. 17 C.F.R. § 240.3a12-4(b) (1987).
378. Id.
379. Id.
380. The list of services which would suggest the existence of a service contract is:
   1. Complete investigation and placing service.
   2. Servicing collection, payments, foreclosures, etc.
   3. Implied or express guarantee against loss at any time or providing a market for the underlying security.
   4. Making advances of funds to protect the security of the investment.
   5. Acceptance of small uniform or continuous investments.
   6. Implied or actual guarantee of specified yield or return.
   7. Continual reinvestment of funds.
   8. Payment of interest prior to actual purchase of the mortgage or trust note.
   9. Providing for fractional interests in mortgages or deeds of trust (other than as provided for by the rule).
   10. Circumstances which necessitate complete reliance upon the seller.
gage security might not be exempt because it would be viewed as an investment contract in which significant efforts were provided by someone other than the investor. Merely providing collection, payment and foreclosure services would not transform an otherwise exempt mortgage into an investment contract. This qualification of the no-externally-provided-services rule is significant because these particular services are indeed often provided to investors in mortgage securities.

Rule 3a12-4 was promulgated pursuant to the Commission's rulemaking authority to exempt securities under section 3(a)(12), as well as its authority to exempt brokers under section 15(a)(2).

2. Other Securities Exempted by Commission Rulemaking Authority Under Section 3(a)(12)

The Commission has also chosen to exercise its rulemaking authority to exempt securities in a limited number of other instances involving government securities or government backed securities. In these instances, the Commission has generally expressed its satisfaction in the alternate protection that will be afforded the trading market in these securities as a result of the nature of the issuer of the subject security or of the trading market in these securities, e.g., an institutionalized market, or as a result of protective limitations written into the exempting rule.

Thus, the Commission has designated as exempted securities certain securities, the income of which is guaranteed by a state or a political subdivision of a state. To qualify for exemption under rule 3a12-2, not only must the issuer's income be guaranteed to the extent necessary to pay interest or dividends, but the business of the issuer must be managed by the state or political subdivision or by a board appointed by the state or subdivision.

Also exempted pursuant to the Commission's rulemaking authority are puts, options, straddles, or privileges which relate to United States government securities, government guaranteed securities or securities issued by a corporation in which the United States has a direct or an indirect interest. In order to be exempt under rule 3a12-7, these derivative securities cannot be traded on a national securities exchange, nor can quotations in these se-

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11. Seller's selection of the mortgage or deed of trust for the investor.

Id.


382. Id.


384. Id.
curities be available in an automated quotation system. This restriction makes it less likely that the derivative security will be traded by the public. Also, in order to be exempt, the underlying security involved must represent an obligation equal to or greater than $250,000. 385 This dollar size qualification was designed to insure that the investor in these over-the-counter options would continue to be the "professional/institutional type of business" that the Commission indicated characterized the trading in these options. 386 

Finally, under rule 3a12-8, the Commission has exempted futures in British and Canadian government securities. 387 To qualify for the exemption, the future contract cannot be settled in the United States, nor may the underlying debt instrument be traded in the United States. The requirement of foreign delivery was designed to hamper the development of a domestic market in the unregistered government bonds and to "deter utilization of future contracts as if they were simply deferred-delivery cash transactions." 388 The requirement that the underlying security not be traded in the United States was intended to prevent the growth of an unregulated market in futures which might impact upon a regulated market in the domestically traded underlying security.

3. Securities Exempted by Commission Rulemaking Authority Under Section 15(a)(2)

The Commission has rulemaking authority under section 15(a)(2) of the 1934 Act to exempt brokers from registration. 389 The Commission has used its authority, however, under section 15(a)(2) to exempt securities as a means of indirectly exempting brokers. 390 The Commission has also used its section 15(a)(2) authority to directly exempt brokers. The distinction between the two rulemaking activities is not necessarily significant. Under section 15(a)(1), if a broker deals exclusively in exempted securities, the broker is exempt from registration. 391 Hence, by exempting a class of securities in which a broker exclusively deals, the Commission effectively exempts the broker from registration. The Commission's rulemaking authority under section 15(a)(2) of the Act, as well as section 3(a)(12) of the Act, is restricted

385. Id.
386. Id.
388. Id.
390. Id.
391. Id.
in requiring a finding by the Commission that the exemption is "consistent with the public interest and the protection of investors." [392] Also, under both sections, the exemption may be conditioned or unconditioned. [393]

As an example of the Commission using its broker exemption authority to exempt securities, rule 15a-2 exempts shares in cooperative housing when those shares are sold through a real estate broker licensed in the political subdivision in which the cooperative is located. [394] Also, rule 15a-3 exempts from the operation of section 15(a) securities registered on a national securities exchange, or exempted from registration thereon, when they are bought or sold off the floor of that exchange in a block by a specialist in order to assist the specialist in maintaining a fair and orderly market. [395]

X. BANKS AND BROKER REGISTRATION

A. Bank Exclusion

Banks are effectively excluded from broker-dealer requirements by the language of the 1934 Act. [396] The definitions of both broker and dealer specifically exclude banks from the respective meanings of those terms. [397] Since a bank is neither a broker nor a dealer, the registration requirements of section 15(a) do not apply to a bank. [398]

The term "bank" is defined by the 1934 Act:

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396. But see infra notes 439-79 (discussing Commission rule 3b-9 requirement of regulation of banks).
397. For the statutory definition of the terms broker and dealer, see supra notes 22, 28.
(A) a banking institution organized under the laws of the United States,
(B) a member bank of the Federal Reserve System,
(C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act, as amended, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title, and
(D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph. 399

While clauses (A) and (B) are quite specific in scope, clause (C) is a broad catchall definition that encompasses most banking institutions which either accept deposits or exercise fiduciary powers and are regulated by a state or federal authority. 400 The section 3(a)(6) definition of bank is qualified by the introductory phrase to section 3(a) which reads "unless the context otherwise requires." 401 In addition, section 3(b) 402 of the 1934 Act authorizes the Commission to define terms used in the Act. The Commission relied upon this qualifying phrase in sections 3(a) and its authority under 3(b) in the promulgation of rule 3b-9, requiring broker-dealer registration of banks conducting certain securities activities. 403

While the legislative history of the bank exclusion is not extensive, the Commission believes that in enacting the bank exclusion, Congress did not contemplate that banks would engage in the kind of activities that would typically subject them to broker-dealer registration. 404 The 1934 Act's stat-

400. In a request for a no-action position in regard to its nonregistration as a broker-dealer, an "international bank agency" argued that it was a bank and hence entitled to a bank exemption from registration since its American office was regulated and supervised in substantially the same manner as a domestic bank chartered under state law. The Commission staff did not challenge this position. Banque Sudamesis, SEC No-Action Letter (June 5, 1986) (LEXIS, Federal Securities Library, No-Action File).
401. Id. § 78(c)(a).
402. Id. § 78(c)(b).
403. See infra notes 439-79 and accompanying text.
404. The Commission believes that, in enacting the bank exclusion, the Congress did not contemplate that banks would publicly solicit brokerage business, receive transaction-related compensation for providing brokerage services for trust, managing agency or other accounts to which the bank provides advice, or deal in or underwrite . . . securities other than exempted securities or municipal securities.

utory definitions of broker and dealer containing the bank exclusions were enacted one year after Congress enacted the Glass-Steagall Act.\textsuperscript{405} The Glass-Steagall Act was designed, among other things, to separate commercial banking from investment banking. Sections 16 and 5(c) of that Act prohibit national banks and state banks that are members of the Federal Reserve System from underwriting or trading in corporate securities.\textsuperscript{406} In addition, section 20 prohibits national and state member banks from affiliating with any organization "engaged principally" in the distribution of securities.\textsuperscript{407} Further, under section 21 of that Act, individuals or businesses engaged in underwriting are barred from engaging in banking as broadly defined in that section.\textsuperscript{408} The Glass-Steagall Act does not bar banks from buying and selling securities for the accounts of customers upon the customer's order.\textsuperscript{409} While the Glass-Steagall Act did not totally bar banks from the securities business, it did impose significant restrictions.\textsuperscript{410} Either because of these restrictions or because of the lack of profitability of the activity, banks were not significantly engaged in securities transaction services for customers until the late 1970's. Bank brokerage activities were limited primarily to accommodation services for their customers or to transactions that were incidental to the trust accounts supervised by the banks. These transactions were conducted on a cost basis. In a 1977 report on banking activities submitted by the Commission to Congress,\textsuperscript{411} the Commission noted that banks handled relatively few customer securities orders and typically did not advertise transaction services nor draw profits from

\textsuperscript{406} 12 U.S.C. § 24, ¶ 7 (1982) (barring national banks); id. § 335 (barring state member banks).
\textsuperscript{408} Under § 21, organizations involved in underwriting are prohibited from engaging in the business "of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt or upon request of the depositor." 12 U.S.C. § 378a(1).
\textsuperscript{409} 12 U.S.C. § 24, ¶ 7; id. § 335.
\textsuperscript{410} In a 1935 interpretation of the limitations imposed by the Glass-Steagall Act on national banks, the Office of the Comptroller of the Currency indicated that national banks have the right to purchase and sell stocks "solely upon the order, and for the account of," customers. However, that did "not mean that national banks may do a brokerage business." 1 Bull. Comptroller Currency, No. 2, at 2-3 (Oct. 27, 1930), (portions reprinted in 4 Fed. Banking L. Rep. (CCH) ¶ 49,202 (1979)).
\textsuperscript{411} SEC, 95TH CONG., 1ST SESS. REPORT ON BANKS SECURITIES ACTIVITIES (Comm. Print 1977) [hereinafter BANK REPORT]. The Bank Report was prepared in response to a legislative directive adopted in the 1975 Securities Reform Act authorizing and directing the Commission to study the degree to which persons excluded from the definition of "broker" and "dealer" conduct a public customer securities business. 15 U.S.C. § 78k-1(e). Only banks were excluded from the definition of both "broker and dealer."
such services. As a consequence, the Commission refrained from seeking to require banks to register as broker-dealers, but noted that future changes in market conditions could result in a change in Commission position.

B. Expansion of Bank Brokerage Activities

The degree of bank involvement in customer securities transactions began to change significantly in the late 1970's. This trend continued into the 1980's. During this time, banks began to significantly increase their brokerage activities, primarily as discount brokers, and to solicit brokerage customers from the general public. In 1985, the Commission stated that it believed that "a thousand or more banks [were then] actively promoting brokerage services to the public." A representative study conducted by the Office of the Comptroller of the Currency and cited by the Commission found that fifty-five percent of the national banks surveyed were offering discount brokerage services.

The securities activities of banks are regulated by several governmental bodies. The jurisdiction of these regulatory bodies is largely dependent upon the nature of the banking institution to be regulated. State banks which are members of the Federal Reserve System have their securities activities regulated by the Board of Governors of the Federal Reserve Board. State banks which are not members of the Federal Reserve System are regulated by the Federal Deposit Insurance Corporation. The Comptroller of the Currency has jurisdiction over the securities activities of national banks. The Board of Governors of the Federal Reserve System regulates bank holding companies. Changes in the outlooks of these different regulatory boards, as well as supporting judicial decisions, have permitted bank brokerage activities to greatly expand. In January 1983, the Board of Governors of the Federal Reserve System approved the application of BankAmerica Corporation to acquire the parent company of the nation's largest discount brokerage firm, Charles Schwab & Co. The Board's action was challenged by the Securities Industry Association and the Board's approval was ultimately upheld by

412. Bank Report, supra note 411, at 86.
413. Id. at 305.
414. Id. at 343.
416. Id.
the Supreme Court. Consistent with its treatment of the BankAmerica application, the Board of Governors of the Federal Reserve System amended its regulations to permit discount securities brokerage as a permissible non-bank activity for bank holding companies.

Discount brokerage services provided by a bank subsidiary, as opposed to a bank holding company, also received approval by a governmental body in the early 1980's. In 1982, the Office of the Comptroller of the Currency, approved the creation of a registered brokerage subsidiary for the Security Pacific National Bank, holding that the discount brokerage activities of the subsidiary would not violate the Glass-Steagall Act. The Comptroller's decision was upheld by the District Court of the District of Columbia. However, the Court did find that bank brokerage offices were branches within the meaning of the McFadden Act. Therefore, bank brokerage offices would be subject to the same restrictions that the states impose on bank branches.

The decision was affirmed by the United States Court of Appeals for the District of Columbia Circuit. In 1987, a unanimous United States Supreme Court reversed the Court of Appeals and upheld the Comptroller of the Currency in its determination that national bank offices which offer only discount brokerage services are not branches pursuant to the McFadden Act. The majority opinion, written by Justice White, stated that "the operation of a discount brokerage service is not a core banking function" which would come under the restrictions of the McFadden Act. Thus, bank brokerage offices do not come under the branching restrictions of the McFadden Act.

In addition to the action taken by the Comptroller of the Currency, in 1982, the Federal Deposit Insurance Corporation issued a policy statement

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426. Id. at 762.
announcing that state nonmember banks are not prohibited by the Glass-Steagall Act from acquiring or establishing subsidiary corporations to engage in underwriting and brokerage activities.\footnote{427} The Federal Home Loan Bank Board, which has primary regulatory authority over federally chartered thrift institutions, in 1982 approved an application by several thrift institutions to establish a joint brokerage service corporation which would market its services in branch offices of the applicant savings and loan institutions.\footnote{428}

Inroads were also made by banks in the area of commercial paper. In the mid-1970's, Bankers Trust began selling commercial paper for several of its corporate clients. Bankers Trust's activities were described as that of "an advisor and agent to commercial paper issuers by advising each issuer of the interest rates and maturities that institutional investors are likely to accept, by soliciting prospective purchasers for commercial paper the client decides to issue, and by placing the issue with the purchasers."\footnote{429} In response to a petition filed by the Securities Industry Association and A.G. Becker, the Federal Reserve Board ruled that Bankers Trust was not violating the Glass-Steagall proscription barring the commercial banks from underwriting securities since commercial paper was not a security for purposes of the Glass-Steagall Act.\footnote{430} The district court disagreed with the Board\footnote{431} but was reversed by the appellate court.\footnote{432} The Supreme Court reinstated the district court's decision, determining that commercial paper is a security.\footnote{433} However, the case was remanded for a determination of whether the distribution of commercial paper constituted underwriting.\footnote{434} Upon remand, the Board of Governors found that Bankers Trust's placement of commercial paper did not violate the Glass-Steagall Act because it constituted the selling of a se-
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security without recourse solely upon the order of customers and for the account of customers. The federal district court reviewed the Board's decision and found Bankers Trust's efforts constituted "underwriting" and "distributing" and thus were in violation of section 21(a)(1) of the Glass-Steagall Act. The United States Court of Appeals for the District of Columbia Circuit found that Bankers Trust placements of commercial paper was consistent with the "literal requirements" of the Glass-Steagall Act and was consistent with the "panoply of the Act's purposes." The Supreme Court denied certiorari for this matter in 1987.

C. Rule 3b-9: A Checkered Career

1. Regulatory Background

By the mid-1980's, the Commission came to believe that brokerage activities and related promotional activities had changed substantially since the Commission had published its Bank Report in 1977. The Commission noted: "Members of the public are solicited through extensive and aggressive advertising campaigns to become 'brokerage' customers of the bank. Rather than merely providing accommodation services to existing customers, the services now promoted by banks...are functionally indistinguishable from those offered by registered broker-dealers." Propounding a functional (rather than institutional) approach to regulation, the Commission opined that "consistent with the statutory objective of ensuring fair competition among securities participants, all institutions providing brokerage services should be subject to the same regulatory scheme that the Congress set up for broker-dealers and charged the Commission with administering." Consistent with its new perceptions, in 1983 the Commission proposed rule 3b-9 for comment, which excluded from the bank exemption of sections 3(a)(4) and 3(a)(5) of the Act, those banks conducting

440. Functional regulation had been then recently endorsed by a task force headed by Vice President George Bush. SEC TASK GROUP ON REGULATION OF FINANCIAL SERVICES, BLUE PRINT FOR REFORM: REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 12, 91 (1984).
441. Rule 3b-9 Proposing Release, supra note 404.
specified brokerage activities. This rule was adopted in 1985. The rule reads as follows:

The term "bank" as used in the definition of "broker" and "dealer" in Sections 3(a)(4) and (5) of the Act does not include a bank that:

1. publicly solicits brokerage business for which it receives transaction-related compensation, unless the bank enters into a contractual or other arrangement with a broker-dealer registered under the Act pursuant to which the broker-dealer will offer brokerage services on or off the premises of the bank, provided that:
   (i) such broker-dealer is clearly identified as the person performing the brokerage services;
   (ii) bank employees perform only clerical and ministerial functions in connection with brokerage transactions unless such employees are qualified as registered representatives pursuant to the requirements of the self-regulatory organizations;
   (iii) bank employees do not receive, directly or indirectly, compensation for any brokerage activities unless such employees are qualified as registered representatives pursuant to the requirements of the self-regulatory organizations; and
   (iv) such services are provided by the broker-dealer on a basis in which all customers are fully disclosed.

2. directly or indirectly receives transaction-related compensation for providing brokerage services for trust, managing agency or other accounts to which the bank provides advice, provided, however, that this subsection shall not apply if the bank executes transactions through a registered broker-dealer and:
   (i) each account independently chooses the broker-dealer through which execution is effected;
   (ii) the bank's personnel do not receive, directly or indirectly, transaction-related compensation or compensation based upon the number of accounts choosing to use the registered broker-dealer; and
   (iii) the brokerage services are provided by the broker-dealer on a basis in which all customers are fully disclosed; or
3. deals in or underwrites securities. (b) This rule shall not apply to any bank that engages in one or more of the following activities only:

1. effects transactions in exempted or municipal securities as defined in the Act or in commercial paper, bankers' acceptances or commercial bills;
2. effects no more than 1,000 transactions each year in securities other than exempted or municipal securities as defined in the Act or in commercial paper, bankers' acceptances or commercial bills;
3. effects transactions for the investment portfolio of affiliated companies;
4. effects transactions as part of a program for the investment or reinvestment of bank deposit funds into any no-load open-end investment company registered pursuant to the Investment Company Act of 1940 that attempts to maintain a constant net asset value per share or has an investment policy calling for investment of at least 80% of its assets in debt securities maturing in thirteen months or less;
5. effects transactions as part of any bonus, profit-sharing, pension, retirement, thrift, savings, incentive, stock purchase, stock ownership, stock appreciation, stock option, dividend reinvestment or similar plan for employees or shareholders of an issuer or its subsidiaries;
6. effects transactions pursuant to Sections 3(b), 4(2) and 4(6) of the Securities Act of 1933 and the rules and regulations thereunder; or
7. is subject to Section 15(e) of the Act.

(c) The Commission, upon written request, or upon its own motion, may exempt a
was subsequently challenged in court and declared unlawful.\textsuperscript{443} In explaining its authority to adopt a rule which on its face denied an exclusion from registration for banks which exclusion was provided by statute, the Commission looked to section 3(b) of the Act as well as the introductory phrase of section 3(a). Section 3(b) provided the Commission with the “power by rules and regulations to define technical, trade, accounting and other terms used in [the 1934 Act]” insofar as such definitions are not inconsistent with the provision of [the Act].\textsuperscript{444} The introductory phrase of section 3(a) advises that the definitions of section 3 are controlling in interpreting the 1934 Act “unless the context otherwise requires.”\textsuperscript{445} The Commission argued that rule 3b-9 defines activities of banks which the Commission believes to be outside of the bank exclusion.\textsuperscript{446} The activities are beyond the bank exclusion because they were not the normal activities engaged in by banks at the time the 1934 Act was enacted.\textsuperscript{447} In other words, today’s operations of banks are not representative of the context in which the 1934 Act was enacted. As a consequence, the context in which banks operate today requires a definition of which bank activities are excludable from registration that is different from the definition provided by the broad exclusion of the 1934 Act. In support of its use of the context analysis to determine the scope of the bank exclusion, the Commission cited the Supreme Court’s decision in \textit{Marine Bank v. Weaver}.\textsuperscript{448} In \textit{Marine Bank}, the Supreme Court used the introductory language of section 3(a) as a basis for its analyzing the context of a securities transaction in determining whether a specific instrument falls within the definition of a security.\textsuperscript{449}

\begin{footnotesize}
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\item bank, either unconditionally or on specific terms and condition, where the Commission determines that the bank’s activities are not within the intended meaning and purpose of this rule.
\item For purposes of this section, the term “transaction-related compensation” shall mean monetary profit to the bank in excess of cost recovery for providing brokerage execution services.
\item See infra notes 450-79 and accompanying text.
\item 15 U.S.C. § 78(c)(b).
\item 15 U.S.C. § 78(c)(a).
\item Rule 3b-9 Adopting Release, supra note 415, at 817.
\item The Commission cited to hearings on the predecessor bills to the Exchange Act which contained “references to the limited nature of bank securities activities permitted at that time.” Id. at 817-18. The citations in the Adopting Release were to \textit{National Securities Exchange Act of 1934: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce}, 73d Cong., 2d Sess. 85-86, 686-87 (1934); \textit{Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency}, 73d Cong., 1st Sess. pts. 15-17, at 6470-71 (1933).
\item 455 U.S. 551 (1982), cited in Rule 3b-9 Adopting Release, supra note 415, at 819.
\item 455 U.S. at 555-59.
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2. Operation of the Rule

The rule, as adopted, excluded from the term "bank," as found in the definition of "broker" and "dealer," banks which engage in three identified activities: (1) public solicitation of brokerage business for transaction related compensation;\textsuperscript{450} (2) receipt of transaction related compensation for brokerage services provided to trust, managing agency, or other accounts to which the bank provides advice;\textsuperscript{451} and (3) dealing in or underwriting securities.\textsuperscript{452} Banks engaging in these activities, as significantly qualified by certain exceptions, had to register as broker-dealers or conduct these activities through a subsidiary or affiliate registered as a broker-dealer. Alternatively, these banks would be required to cease engaging in these activities.

In adopting rule 3b-9, the Commission expressed its hope that the rule would eliminate disparities in the regulation of equivalent activities conducted by banks and brokers. For example, registration of banks would subject bank personnel to the qualification examination procedures that all persons associated with broker-dealers must undergo.\textsuperscript{453} Furthermore, bank registration was expected to eliminate disparities in regulation concerning content and review of advertisements. In addition, registration of banks would result in oversight of the banks in order to insure compliance with sales practice and financial responsibility regulations. Finally, the rule was intended to bring banks within the structure of "rules and regulations designed by the Commission and self-regulatory organizations to assure investor protection."\textsuperscript{454} Upon the adoption of the rule, the Commission announced its intention to work closely with federal banking regulators in order to avoid duplicative regulation.\textsuperscript{455}

Shortly after rule 3b-9 was adopted, the American Bankers Association (the Association) sought a declaratory judgment in federal court that the rule was invalid, as well as an injunction prohibiting the SEC from enforcing it. On a motion for summary judgment, in November 1985, the United States District Court for the District of Columbia Circuit on a bench ruling held for the defendant and dismissed the Association's complaint.\textsuperscript{456} In November 1986, the United States Court of Appeals for the District of Colum-

\textsuperscript{450} Rule 3b-9(a)(1), 17 C.F.R. § 240.3b-9a(1) (1987).
\textsuperscript{451} Rule 3b-9(a)(2), 17 C.F.R. § 240.3b-9a(2) (1987).
\textsuperscript{452} Rule 3b-9(a)(3), 17 C.F.R. § 240.3b-9a(3) (1987).
\textsuperscript{454} Id. at 810-11.
\textsuperscript{455} Id. at 819.
bia Circuit held that rule 3b-9 contravenes the intent of Congress.\textsuperscript{457} In reversing the district court, the court of appeals ordered it to declare rule 3b-9 unlawful and to enjoin its operation against member banks of the Association. In December 1986, the Commission requested an en banc review by the court of appeals of the three-judge panel decision,\textsuperscript{458} which was denied in January 1987. The Commission did not request certiorari from the Supreme Court. Before rule 3b-9 was struck down, 170 banks had complied with the rule by registering brokerage subsidiaries and affiliates.\textsuperscript{459} Hundreds of other banks were reported to have complied with the rule by establishing networking relationships with registered brokers who effected transactions for bank customers.\textsuperscript{460}

The court of appeals decision, which reversed the district court, was based on three arguments.\textsuperscript{461} In an opinion written by Chief Judge Patricia Wald, the court first held that rule 3b-9 "directly conflicts" with the statutory language of the 1934 Act.\textsuperscript{462} The court stated that sections 3(a)(4)\textsuperscript{463} and 3(a)(5)\textsuperscript{464} of the 1934 Act clearly exclude banks from the definition of both broker and dealer. Rule 3b-9 was invalid, however, insofar as it required registration of some banks as broker-dealers by defining the term "bank" to exclude those banks that engage in brokerage business for profit.\textsuperscript{465} Judge Wald found that the rule-generated definition of bank was inconsistent with the statutory definition of bank in the 1934 Act, which does not contain any exception for a bank engaging in brokerage activities for profit.\textsuperscript{466} To this end, the court discovered "no ambiguity or imprecision" in the statutory definition of the term "bank."\textsuperscript{467}

\textsuperscript{457} American Bankers Ass'n v. SEC, 804 F.2d 739, 740 (D.C. Cir. 1986).
\textsuperscript{458} Id.; see 19 Sec. Reg. & L. Rep. (BNA) 17 (Jan. 2, 1987).
\textsuperscript{460} Id.
\textsuperscript{461} American Bankers Ass'n, 804 F.2d at 740.
\textsuperscript{462} Id. at 744.
\textsuperscript{464} Id. § 78c(a)(5).
\textsuperscript{465} American Bankers Ass'n, 804 F.2d at 743. Actually, rule 3b-9 did not exclude from the definition of banks only those banks that engaged in the brokerage business for profit. Two of the three categories of banks excluded from the definition, banks that solicited brokerage business and banks that managed accounts, were banks which received transaction-related compensation. Rule 3b-9(a)(1) to (2), 17 C.F.R. § 240.3b-9a(1)-(2) (1987). The third category of banks, banks that underwrite securities, was not defined in terms of compensation. Rule 3b-9(a)(3), 17 C.F.R. § 240.3b(3) (1987). In all likelihood, however, the third category of bank would be operating as an underwriter only for profit. Consequently, Judge Wald's characterization would not be inaccurate.
\textsuperscript{466} American Bankers Ass'n, 804 F.2d at 743-44.
\textsuperscript{467} Id. at 744.
The court of appeals also held that rule 3b-9 was inconsistent with congressional intent. Judge Wald stated that "Congress intended to preclude SEC regulation of institutions meeting the statutory definition of 'bank' in order to avoid duplicative regulation."\(^\text{468}\) She rejected the SEC's argument that Congress excluded banks from the Commission's regulation of brokers merely because it believed that banks would be precluded from engaging in brokerage activities for nonbanking customers by the Glass-Steagall Act.\(^\text{469}\) Judge Wald reasoned that in order for the Commission's argument to be valid, an assumption unsupported by the legislative history must be made.\(^\text{470}\) The assumption is that, had Congress foreseen how the Comptroller of the Currency and the courts would interpret the Glass-Steagall Act, it would not have exempted banks from broker-dealer regulation.\(^\text{471}\) Judge Wald found it "entirely possible" that even if Congress had anticipated the more liberal interpretation of the Glass-Steagall Act, it still might have chosen "to leave banks in the hands of bank regulators alone, so as not to subject banks to the double-whammy of additional federal oversight."\(^\text{472}\) The fact that Congress did not place banks under the regulatory umbrella of the Commission in the 1975 amendments, even after administrative interpretations of the Glass-Steagall Act were undergoing revision, further demonstrated lack of congressional intent to authorize the SEC to regulate banks.\(^\text{473}\)

Finally, the court of appeals held that the clause indicating "unless the context otherwise requires," which precedes all definitions in the 1934 Act, does not refer to "out-of-Act market or regulatory circumstances," but only to textual inconsistencies.\(^\text{474}\) Judge Wald stated that, in Marine Bank,\(^\text{475}\) the Supreme Court "suggest[ed] that the context clause may authorize an agency or court to take account of outside circumstances in construing a term defined in the 1934 Act."\(^\text{476}\) She found, however, that the Supreme Court's "observation" was "unnecessary to the Court's holding and preferred only in a passing reference with no explanation or discussion."\(^\text{477}\) Judge Wald also stated that the legislative history of the Act suggests that the term "context" was used as a term synonymous with "text."\(^\text{478}\) Thus, the Com-

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468. Id. at 744-45.
469. Id. at 748-49.
470. Id. at 749.
471. Id.
472. Id.
473. Id. at 749-50.
474. Id. at 753.
475. 455 U.S. 551 (1982).
476. American Bankers Ass'n, 804 F.2d at 753.
477. Id.
478. Id. at 754.
mission could not look to circumstances external to the statute to interpret defined terms found in the 1934 Act. In conclusion, Judge Wald advised the Commission as to how to obtain authority to regulate banks engaging in the brokerage business. Recognizing "the dramatic changes in the nature of financial institution and market practices in the last fifty years," she suggested that Congress may choose to reexamine the Glass-Steagall Act and the Securities Exchange Act.\textsuperscript{479}

The Commission's own evaluation of its alternatives following the ruling by the court of appeals on rule 3b-9 was not dissimilar from the advice offered by Judge Wald. Rather than request certiorari from the Supreme Court, the Commission, in May 1987, submitted to Congress a legislative package proposing to include banks within the 1934 Act definition of broker and dealer.\textsuperscript{480} The proposed amendments to section 3(a)(4) and 3(a)(5) of the 1934 Act would modify the exception granted to banks from the definitions of broker and dealer. The proposed amendments would allow the Commission to accomplish what it sought to accomplish under rule 3b-9. Under the proposal, a bank would no longer be excluded from the definitions of broker or dealer if the bank: (1) publicly solicited brokerage business; (2) received transaction-related compensation for brokerage services provided to advisory accounts supervised by the bank; or (3) dealt in or underwrote securities.\textsuperscript{481} The proposed legislation would also introduce a new section 3(e) to the 1934 Act which would allow the Commission to exempt banks by rule, regulation or order from the definition of broker or dealer.\textsuperscript{482} This provision would permit the Commission to replicate by rule the numerous express exceptions from the redefinition of bank that existed in rule 3b-9. Finally, the proposed legislation would also amend section 15(a) of the 1934 Act to require a bank to establish a separate entity to conduct its securities activities.\textsuperscript{483} Such a requirement, unlike the provisions of rule 3b-9, would prevent a bank which chose to operate itself as a registered broker-dealer from being required to comply with potentially conflicting regulatory regimes. The Commission indicated that requiring a bank to establish a separate securities entity would serve to diminish regulatory conflicts.\textsuperscript{484} Were the bank itself to register as a broker-dealer, it would be compelled to com-

\textsuperscript{479} \textit{Id.} at 755.

\textsuperscript{480} The legislative package was approved by the Commission on April 29, 1987 and it was submitted to Congress on May 4, 1987. The package was submitted to Vice President Bush, Senators Proxmire, Roegle, Garn, and Armstrong, and Congressmen Wright, Dingell, Lent, Markey, and Rinaldo [hereinafter Legislative Proposal].

\textsuperscript{481} Legislative Proposal, \textit{supra} note 480, at 2.

\textsuperscript{482} \textit{Id.} at 14.

\textsuperscript{483} \textit{Id.} at 17.

\textsuperscript{484} \textit{Id.}
ply with the Commission's net capital rule requirements which might differ from capital requirements imposed by bank regulators. In addition, in the event of liquidation, a bank registered as a broker-dealer might be subject to the liquidation procedures of both the Federal Deposit Insurance Corporation as well as the Securities Insurance Protection Corporation.

The proposed legislation did not include a provision, as was found in rule 3b-9, that would automatically exempt from registration banks that established a "networking" arrangement with a registered broker-dealer. The Commission indicated, however, that it anticipated using the exemptive rulemaking power proposed in the legislation to allow banks that entered into networking arrangements to avoid registration as broker-dealers. 485

In proposing these amendments, the Commission advised that it was seeking to "ensure that all entities engaged in the securities business will be subject to the regulatory scheme for broker-dealers that Congress has established and charged the Commission with administering."486 The proposed amendments are designed to achieve a functional regulation of securities activities rather than regulation based upon industry classification. It is not at all clear, however, that Congress is prepared to engage in either a piecemeal or a total legislative review of its legislation regulating the separation between banking and securities activities. Without that legislative review, the functional approach to regulating banks in the brokerage business will continue to lie dormant.

XI. CONCLUSION

After plowing through a primer on broker-dealer registration, it is difficult not to be overwhelmed by the volume and complexity of questions that must be explored in order to determine when broker-dealer registration is necessary. Because the regulatory function of broker-dealer registration is critical to the smooth operation of the securities markets, it is incumbent upon regulators to make the broker-dealer registration process as comprehensible as possible for those who must comply with its dictates.

Unfortunately, such questions as "who is a broker-dealer" and "which broker dealers should be exempt from registration" do not promote simple responses. Consequently, the regulatory system governing these matters will be equally as complex. The broker-dealer regulatory system must insure that those who conduct a business exposing the public to the risks inherent in a broker-dealer operation will be required to register as broker-dealers. Concomitantly, the system should not burden businesspeople with the re-

485. Id. at 15.
486. Id. at 1.
requirements of broker-dealer registration if their businesses do not generate the risks to the public associated with broker-dealer operations.

When the regulatory system can be made more approachable, it should be modified. The practice of relying heavily upon no-action letters to provide advice to potential brokers must be revisited. No-action letters are often confusing in their information and they are difficult to systematically review for guidance. The staff must make greater efforts to identify important aspects of fact patterns discussed in no-action letters. Inconsistencies among different staff no-action responses must be identified and explained. Explanation should also be provided when inconsistencies exist between the facts described in inquiry letters and the facts of response letters. To avoid the necessity of researching voluminous no-action letters, principles that have gained acceptability in no-action letters should routinely be collected and disseminated in interpretive releases and ultimately in rules.

Even if the use of no-action letters in regard to broker-dealer registration is reduced or simplified, the determination of who needs to register will remain complex. The answers will not always be black and white; a myriad of statutes, rules, cases, interpretive releases and no-action letters governing matters including registration requirements, exemptions, and definition of securities will have to be consulted. This primer is intended merely as a basic guide to assist in making a more manageable determination of who needs to register as a broker-dealer.