

Brokerage Office Procedures and Back-Office Operations

INTRODUCTION

Guidelines for the practices that a brokerage firm uses to conduct the operation of its daily business are regulated by industry, state, and federal regulators. These guidelines are the foundation for the way that the firm handles all business, from hiring a new agent to executing a customer's order. All Series 99 candidates must have a full understanding of a brokerage firm's operations and procedures to successfully complete the exam.

HIRING NEW EMPLOYEES

A registered principal of a firm will be the individual who interviews and screens potential new employees. The registered principal must thoroughly investigate the candidate's professional and personal backgrounds. With few exceptions, other than clerical personnel, all new employees will be required to become registered as an associated person with the firm. The new employee will begin the registration process by filling out and submitting a Uniform Application for Securities Industry Registration, also known as Form U4 along with a fingerprint card. The Form U4 is used to collect the applicant's personal and professional history, including:

- 10-year employment history.
- Five-year resident history.

- Legal name and any aliases used.
- Any legal or regulatory actions.

The principal of the firm is required to verify the applicant's employment information for the last three years and must attest to the character of the applicant by signing Form U4 prior to its submission to FINRA. All U4 forms will be sent to the Central Registration Depository (CRD) for processing and recording. Any applicant who has answered yes to any of the questions on the form regarding his or her background must give a detailed explanation in the DRP pages attached to the form. The applicant is not required to provide information regarding:

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

The only information regarding the employee's finances that is disclosed on Form U4 is whether the associated person has ever declared bankruptcy. Any development that would cause an answer on the associated person's U4 to change requires that the member update the U4 within 30 days of when the member becomes informed of the event. In the case of an event that could cause the individual to become statutorily disqualified, such as a felony conviction or misdemeanor involving cash or securities, the member must update the associated person's U4 within 10 business days of learning of the event.

RESIGNATION OF A REGISTERED REPRESENTATIVE

If a registered representative voluntarily resigns or has his or her association with a member firm terminated for any reason, the member must fill out and submit a Uniform Termination Notice for Securities Industry Registration, which is known as Form U5. The member must submit the U5 to FINRA within 30 days of the termination. The member firm is required to give a copy of the U5 to the representative upon termination. The member must also state the reason for the termination, either voluntary or for cause. An associated person's registration is nontransferable. A representative may not simply move his or her registration from one firm to another. The employing firm that the representative is leaving must fill out and submit a U5 to FINRA, which terminates the representative's

registration. The new employing firm must fill out and submit a new U4 to begin a new registration for the associated person with the new employer. The new employer is required to obtain a copy of the U5 form filed by the old employing member either from the employee or directly from FINRA within 60 days of submitting the new U4. The previous employer is not required to provide a copy to the new member firm. If the new employing member asks the associated person for a copy of the U5, it must be provided within two business days. If the member requests a copy of the U5 from an agent who has not received a copy of the U5 from the old employer, the agent must promptly request it from the old employer and provide it to the new employer within two business days of receipt. A representative who leaves the industry for more than 24 months is required to requalify by exam. During a period of absence from the industry of two years or less FINRA retains jurisdiction over the representative in cases involving customer complaints and violations. Agents who volunteer or who are called to active duty with the military have their registrations “tolled,” and their registrations are placed in special inactive status. During this time, the 24-month requirement is not in effect. The agent may continue to receive compensation from transactions but may not contact customers during the period of active military duty.

REGISTRATION EXEMPTIONS

The following individuals are exempt from registration:

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

PERSONS INELIGIBLE TO REGISTER

Individuals applying for registration must meet the association’s requirements in the following areas:

- Training.
- Competence.

- Experience.
- Character.

Anyone who fails to meet the association's requirements in any of the above listed areas may not become registered. An individual may also be disqualified by statute or through rules for any of the following:

- Expulsion, suspension, or disciplinary actions by the Securities and Exchange Commission (SEC) or any foreign or domestic self-regulatory organization (SRO).
- The individual caused the expulsion or suspension of a broker dealer or principal.
- The individual made false or misleading statements on the application for registration on Form U4 or Form B-D.
- Felony conviction or misdemeanor involving securities, bribery, falsification of reports, perjury, or any other felony within the last 10 years.
- Court injunction or order barring the individual.

DISCIPLINARY ACTIONS AGAINST A REGISTERED REPRESENTATIVE

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

- The SEC.
- An exchange or association.
- A state regulator.
- A clearing firm.
- A commodity regulatory body.

All disclosures must include the type of action brought as well as the name of the party bringing the actions and the name of the representative involved. FINRA members are required to regulate the activities of its associated people and must disclose to the association any action that the member takes against a registered representative.

TERMINATION FOR CAUSE

A member may terminate a registered representative for cause if the representative has:

- Violated firm policy.
- Violated the rules of the New York Stock Exchange (NYSE), FINRA, the SEC, or any other industry regulator.
- Violated state or federal securities laws.

A firm may not terminate a representative who is the subject of investigation by any securities industry regulator until the investigation is completed.

OUTSIDE EMPLOYMENT

If a registered representative wants to obtain employment outside of his or her position with a member firm, the registered representative must first provide written notification to the employing member firm. The member firm may reject or limit the representative's outside employment. Exceptions to this rule are if the registered representative is a passive investor in a business or if the representative owns rental property. All other outside business activities must be disclosed to the member firm. If the member is a NYSE member, the firm must provide the representative with prior written approval before the representative engages in any outside activity.

PRIVATE SECURITIES TRANSACTIONS

A registered representative may not engage in any private securities transactions without first obtaining the broker dealer's prior written approval. The registered representative must provide the employing firm with all documentation regarding the investment and the proposed transaction. An example of a private securities transaction would be if a representative helped a startup business raise money through a private placement. If the representative is going to receive compensation, the employing member firm must supervise the transaction as if the firm itself executed the transaction. If a representative sells investment products that the employing member does not conduct business in without the member's knowledge, then the representative has committed a violation known as selling away. An exception to this is if the

representative is helping an immediate family member raise money and the representative receives no compensation for his or her role in the private transaction. In this case, the notification and permission of the member is not required.

GIFT RULE

Broker dealers may not pay compensation to employees of other broker dealers. If a broker dealer wants to give a gift to an employee of another broker dealer, it must:

- Be valued at less than \$100 per person per year.
- Be given directly to the employing member firm for distribution to the employee.
- Have the employing member's prior approval for the gift.

The employing member must obtain a record of the gift, including the name of the giver, the name of the recipient, and the nature of the gift. These rules have been established to ensure that broker dealers do not try to influence the employees of other broker dealers. An exception to this rule would be in cases where an employee of one broker dealer performs services for another broker dealer under an employment contract. The following are also excluded from the \$100 limit:

- Occasional meals.
- Occasional tickets to sporting events.
- Business-related travel.

Records of gifts and employment contracts must be retained for three years. Prior FINRA approval is not required for employment contracts between members. The gift rule also applies to gifts given to or received from customers of the firm or agent. In the case of a mutual fund holding a seminar, the mutual fund may pay for a registered representative's travel-related expenses and the seminar must be held at a "reasonable" location. Spouses of agents are allowed to attend; however, the mutual fund may only pay for the travel expenses of the agent. The agent's expenses may not be paid for by the fund in exchange for past sales or the promise of sales in the future.

 **TAKENOTE!**

Firms and agents also may not give a gift to influence any report or dissemination of information designed to influence the price of a security.

SHARING IN A CUSTOMER'S ACCOUNT

It is permissible for a representative to maintain a joint account with a customer as long as the firm approves it in advance. The representative may share in the profit and loss of the account only in direct relation to the representative's contribution to the account. A registered representative is precluded from sharing in the profit and loss of an account without making any financial contribution to the account.

BORROWING AND LENDING MONEY

A registered representative or an investment adviser may not borrow money or securities from a client unless the client is a bank or other financial institution that is in the business of lending money. Registered representatives are also prohibited from lending money or securities to a client. Broker dealers making margin loans are excluded from this rule.

ORDER TICKETS

Prior to executing a customer's order the representative must fill out the appropriate order ticket and present it to the trading department or wire room for execution. All order tickets will include:

- Buy or sell.
- Name of security.
- Number of shares or bonds.
- Account name and number.
- Account type (i.e., cash or margin).
- Price and time limits, if any.

- Solicited or unsolicited.
- Discretionary authority exercised or discretionary authority not exercised, if applicable.
- Time stamp when entered, executed, changed, or canceled.

EXECUTING AN ORDER

An important part of executing a customer's order lies in the operational procedures that route the order to the markets and handle trade input functions for the order once it has been executed. The brokerage firm assigns specific departments to handle all of the important functions of trade execution and input. The departments are:

- Sales department.
- Order room/wire room.
- Purchase and sales department.
- Margin department.
- Cashiering department.
- Custody department.
- Corporate action department.

SALES DEPARTMENT

The sales department is where registered representatives interact with the investing public. Representatives work with individual and institutional investors, manage portfolios, make recommendations, and accept orders.

ORDER ROOM/WIRE ROOM

Once a representative has received an order from a client, the representative must present the order for execution to the order room. The order room will promptly route the order to the appropriate market for execution. Once the order has been executed, the order room will forward a confirmation of the execution to the registered representative and to the purchase and sales department.

PURCHASE AND SALES DEPARTMENT

Once the order has been executed the purchase and sales department inputs the transaction to the customer's account. The purchase and sales department,

sometimes called P&S, is also responsible for mailing confirmations to the customer and for all billing.

MARGIN DEPARTMENT

All transactions, regardless of the type of account, are sent through the margin department. The margin or credit department calculates the amount of money owed by the customer and the date when the money is due. The margin department will also calculate any amount due to a customer.

CASHIERING DEPARTMENT

The cashiering department handles all receipts and distributions of cash and securities. All securities and payments delivered from clients to the firm are processed by the cashiering department. The cashiering department will also issue checks to customers and, at the request of the margin department, forward certificates to the transfer agent.

CUSTODY DEPARTMENT

The custody department maintains physical control of customer and firm assets. The custody department, sometimes referred as the “cage,” safeguards the physical securities in the firm’s possession. Employees in the custody department will create stock records for each security in the firm’s control and will record which securities belong to the firm and which securities belong to customers. The box count of physical securities will take place in the custody department, and any long or short differences in securities positions will be investigated by members of the custody department.

CORPORATE ACTION DEPARTMENT

The corporate action department handles communications between the investors and the issuers of securities. The corporate action department will mail proxies and prospectuses to beneficial owners of securities and handles mergers, reorganizations, and name changes relating to issuers. The corporate action department also manages the collection of interest and dividend payments.

BECOMING A STOCKHOLDER

Although some people purchase the shares directly from the corporation when the stock is offered to the public directly, most investors purchase the shares

from other investors. These investor-to-investor transactions take place in the secondary market on the exchange or in the over-the-counter (OTC) market. Although the transaction in many cases only takes seconds to execute, trades actually take several days to fully complete. We will now review the important dates regarding transactions which are done for a regular-way settlement.

TRADE DATE

The trade date is the day when the order is actually executed. Although an order has been placed with a broker, it may not be executed on the same day. Certain types of orders may take several days or even longer to execute. A market order, however, will be executed as soon as it is presented to the market, making the trade date the same day the order was entered.

SETTLEMENT DATE

The buyer of a security actually becomes the owner of record on the settlement date. When an investor buys a security from another investor, the selling investor's name is removed from the security and the buyer's name is recorded as the new owner. Settlement date is three business days after the trade date. This is known as T + 3 for all regular-way transactions in common stock, preferred stock, corporate bonds, and municipal bonds. Government bonds and options all settle the next business day following the trade date. Any trade done on a cash basis settles on the same day, regardless of the security involved in the transaction. Settlement dates are set by the Uniform Practice Code.

PAYMENT DATE

The payment date is the day when the buyer of the security has to have the money to the brokerage firm to pay for the purchase. Under industry rules, the payment date for securities is five business days after the trade date, or T + 5. Payment dates are regulated by the Federal Reserve Board under Regulation T of the Securities Exchange Act of 1934. Although many brokerage firms require their customers to pay for their purchases sooner than the rules state, the customer has up to five business days to pay for the trade.

VIOLATION

If the customer fails to pay for the purchase within the five business days allowed, the customer is in violation of Regulation T. As a result, the brokerage firm will "sell out" and freeze the customer's account. On the sixth business