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# So, Now You Own a Broker-Dealer!

*Regulatory Considerations for Integrating a Brokerage Firm into a Corporate Group*

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## I. INTRODUCTION

Companies form or acquire broker-dealers for a variety of reasons. A private equity firm might buy one to facilitate sales of the funds that it sponsors or as a portfolio investment. A foreign financial institution might set up a broker-dealer as an entry point to service U.S. customers seeking to invest in foreign markets or foreign customers seeking to participate in the U.S. market. In some cases, an acquirer of any nature might come to own a broker-dealer as part of its acquisition of a larger financial entity target. Regardless of the impetus for the transaction, due to the unique regulatory framework that applies to broker-dealers, care will be required to integrate a broker-dealer into a corporate group and to operate it properly. The regulatory scheme for broker-dealers is very detailed and prescriptive and also features intensive examinations and active enforcement programs that can create unanticipated compliance, financial and reputational risks for the acquirer. Moreover, in some cases, regulatory requirements that apply to the parent or other members of the corporate group can effectively limit doing business with or through the new broker-dealer, or restrict the new broker-dealer's activities.

In general, the nature and extent of integration challenges will depend on the size and complexity of the broker-dealer's operations, and the degree to which the broker-dealer's activities will be integrated with affiliates' businesses and services. However, even the acquisition of the simplest broker-dealer and with the least degree of proposed integration will require some changes in compliance infrastructure and processes at the parent level and, in some cases, at other affiliates, necessitating coordination and advance planning.

This article provides an introduction to common regulation-driven integration considerations and suggests approaches to addressing them. Section II discusses how the acquirer of a broker-dealer might build regulatory requirements into an integration work plan ("**Integration Action Plan**"). Section III provides a brief overview of the regulatory regimes applicable to broker-dealers. Finally, Section IV highlights some of the regulatory requirements that must be considered in order to successfully integrate a new broker-dealer into the corporate family, depending upon the business of the broker-dealer and its new corporate family.

## II. BUILDING REGULATORY REQUIREMENTS INTO AN INTEGRATION ACTION PLAN

A critical driver for successful integration of a broker-dealer is a comprehensive Integration Action Plan that identifies and addresses the regulatory implications of affiliating with the broker-dealer and the regulatory complications of pursuing various strategic goals.

### A. KEY REGULATORY COMPONENTS OF AN INTEGRATION ACTION PLAN

A robust Integration Action Plan should, at a minimum:

- present an organized roadmap for identifying and addressing regulatory issues relating to the chosen post-acquisition business strategy and target operating model;
- provide for a governance and organizational structure designed to support the strategic goals of the acquisition while satisfying regulatory supervision, licensing and related requirements; and

- set forth a plan for establishing and maintaining processes, systems and infrastructure that will enable the broker-dealer and its affiliates to comply with various regulatory reporting, disclosure and financial and operational requirements while supporting the integration and desired end state.

Each of these dimensions, broken down into its appropriate subcomponents, can in turn form the basis for creating workstreams with assigned owners, objectives, plans and milestones to implement the integration plan. Given that legal and compliance considerations are critical to the success of the integration, it is important to have the direct involvement of regulatory specialists in each workstream. Workstreams should be formed as early as possible, since the Integration Action Plan will necessarily include many regulatory and other tasks required to complete the transaction, including those mentioned in the sidebar entitled "Getting to Closing" in Section III.

### *1. Business Strategy and Operating Model*

Clearly articulating the strategic vision for the combined business is critical during integration planning. Depending on the nature and extent of integration, management will need to define objectives for customer strategy, distribution, and branding; products and pricing; and inter-affiliate services and centralization.

Each of these business objectives has regulatory implications. The Integration Action Plan should identify those issues and delegate them to workstreams charged with addressing them. For example, if the group wishes to implement a cross-selling or co-branding strategy, it will be important to develop and use clear disclosures to avoid customer confusion around which legal entity is providing the product and services. If the group aspires to unlock synergies and save costs across functions that can share processes, systems and infrastructure — such as operations, finance, human resources, information technology, marketing and compliance — the new parent and the broker-dealer will need to consider FINRA rules related to third-party service providers. Because "outsourcing" of a function does not relieve the broker-dealer of its ultimate responsibility to achieve compliance with applicable laws and regulations, the workstream charged with addressing these requirements will need to ensure that the broker-dealer establishes an appropriate due diligence, monitoring and supervision framework vis-á-vis arrangements with service providers (even if the service provider is an affiliate under the control of a common parent entity).

### *2. Governance and Organization*

Firms must establish effective governance and organizational structures designed to support the strategic goals of the acquisition. To this end, the group may introduce new managers to the broker-dealer or dual-hatted roles for certain positions. According to FINRA rules, supervision of the broker-dealer's activities and those of its associated persons must be performed by designated and registered principals. There may be registration consequences and significant regulatory supervisory obligations for managers from the acquiring entity that take a management role in the broker-dealer business. The Integration Action Plan should identify the various supervision, reporting, licensing (including related qualification examinations) and related issues that may arise in connection with establishing the desired post-acquisition governance and organizational structure and assign them to one or more appropriate workstreams to consider and address those issues.

### *3. Processes, Systems and Infrastructure*

Having a broker-dealer in the family will also trigger reporting and disclosure obligations and may impose activities restrictions that will require coordinated information tracking, alerts and planning across entities within the group. The Integration Action Plan should outline these issues in detail and ensure that one or more workstreams with appropriate representation from business, operations, IT, Legal, Compliance and others have been charged with establishing the requisite

processes, systems and infrastructure of the broker-dealer to comply with these requirements. For example, having a broker-dealer in the corporate group may impose reporting obligations to the SEC or FINRA that require informational input from affiliates of a broker-dealer and their respective officers and directors. An Integration Action Plan will need to identify these requirements and assign them to one or more workstreams to ensure that they will be adequately addressed in a coordinated fashion at the group level or among impacted affiliates.

Across all three of these dimensions, a key element of the Integration Action Plan will be to review the adequacy and appropriateness of current policies and procedures and to determine where they will need to be modified or supplemented. There is a strong broker-dealer regulatory expectation that detailed policies and procedures must exist relating to the activities of the broker-dealer and its associated persons. Any substantial changes to the business brought on by the integration will necessitate a corresponding change in policies and procedures.

In Section IV below, this article addresses in more detail the regulatory considerations across these three Integration Action Plan dimensions.

### B. Understanding the Regulatory Requirements

An important early step in developing an Integration Action Plan will be to consider top to bottom the regulatory implications of integrating the broker-dealer and of pursuing the strategic goals underlying the acquisition, and to develop a comprehensive list of the regulatory requirements that will need to be addressed and satisfied.

Some regulatory requirements will apply in all cases where a broker-dealer is acquired and remains a member of the corporate group. Other regulatory requirements may apply as a result of pursuing particular strategic objectives or goals involving affiliated entities, such as where an investment management group wishes to exploit the distribution or trading capabilities of the new broker-dealer to reach new markets or lower trading costs. In order to successfully target the right set of issues and to be comprehensive, it is critical that the design of the Integration Action Plan, as well as the workstreams formed to implement the plan, involve from the earliest stages not only the persons directly involved with the acquisition, but also key members of business, operations, risk, IT and other units and functions that will be responsible for implementing and achieving the desired end state for the acquisition. These groups should be prepared to conduct "due diligence" on the business activities of the acquirer and the broker-dealer and consider them in light of the business objectives of the integration in order to fully surface

**Common strategic objectives of broker-dealer acquisitions (not exhaustive)**

The table below identifies some common strategic objectives of acquisitions and the degree of integration typical for each. Each of these models can have unique regulatory implications that must be identified and addressed in the Integration Action Plan.

| Acquiring Group | Strategic Objectives | Illustrative Changes for Broker-Dealer | Typical Degree of Integration |
|---|---|---|---|
| Private Equity Firm | • Hold as portfolio investment | • Change of ownership | • Low |
| | • Facilitate sales of sponsored funds<br>• Capture investment banking fees | • Integration of products | • Medium |
| Foreign banking institution | • Use as an entry point to service U.S. customers seeking to invest in foreign market | • Change of customer strategy | • Medium |
| | • Use as an entry point for foreign customers seeking to participate in the U.S. market | • Change of customer strategy | • Medium |
| Domestic banking institution | • Portion of a larger transaction (e.g., another bank) | • At a minimum, change of ownership | • Low to High |
| | • Expand capabilities of the bank into the broker-dealer space | • At a minimum, change of ownership | • Low to High |
| Other broker-dealers | • Expand services, technology, or other capabilities | • Integration with another broker-dealer | • Medium to High |
| | • Expand market share (i.e., client base) for comparable services | • Integration with another broker-dealer | • Medium to High |

regulatory considerations. If properly coordinated, this can be carried out as part of the transactional due diligence process for the acquisition.

If proposed intra-group synergies and affiliate impacts are not fully considered from a regulatory perspective, it can set the stage for regulatory failures and lead to significant examination headaches, regulatory enforcement-related risks, and attendant liabilities and reputational concerns.

## III. BROKER-DEALER BASICS

Broker-dealers are subject to a comprehensive regulatory scheme designed to ensure that they have adequate capital, treat their customers fairly and observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business. They are examined by the SEC, Financial Industry Regulatory Authority ("**FINRA**"), and any other self-regulatory organizations ("**SROs**") of which they are members, and the states in which they are registered. Regulatory violations often lead to civil and administrative proceedings, and sanctions against the firm and the individuals involved.

### A. SEC AND FINRA OVERSIGHT

Section 15(a) of the Securities Exchange Act of 1934 (the "**Exchange Act**") generally prohibits any person from acting as a broker or a dealer unless registered with the Securities and Exchange Commission ("**SEC**").[1] Membership in FINRA, previously known as the National Association of Securities Dealers ("**NASD**"), is also required in most cases.

#### *1. Registration and FINRA Membership*

The SEC registration form for broker-dealers, known as "**Form BD**," requires a broker-dealer to provide information about the activities it engages in; its directors, executive officers, other control persons and certain direct and indirect owners and affiliates; and prior legal, regulatory and criminal disciplinary events.

FINRA members enter into a membership agreement which lists the permissible activities and any restrictions that FINRA has imposed on the firm when it approves its broker-dealer membership application.

**Getting to Closing**

Acquirers and targets need to address various broker-dealer regulatory issues in order to complete the acquisition of a broker-dealer, depending upon the structure of the transaction (e.g., stock purchase versus asset purchase) and the nature of any proposed "day 1" integration (e.g., assumption by one broker-dealer of the accounts, representatives and branches of another). Examples include: FINRA's notification and approval process for changes of control or business operations of a broker-dealer (NASD Rule 1017); transfers of the broker-dealer's representatives; customer account transfer issues; back office, operations and systems migration considerations; and books and records retention issues, among others.

More information is provided on the FINRA website (http://www.finra.org/industry/checklist-organizational-change-important-steps-related-merger-acquisition-or-succession).

The rules and procedures of clearing organizations and exchanges of which the broker-dealer is a member should also be consulted.

Of course, acquirers also need to consider regulatory schemes that govern the acquirer and its affiliates (e.g., banking law).

[1] This article assumes that the broker-dealer being acquired is registered with the SEC and does not discuss issues pertaining to unregistered broker-dealers that are exempt from registration or that operate in violation of applicable registration requirements. This article focuses mainly on regulatory requirements under U.S. securities laws. We do not address any non-U.S. law requirements.

## *2. Significant Ongoing Compliance Requirements*

Significant ongoing obligations of broker-dealers under the SEC and FINRA rules include the following:

<table>
<tr><th>Financial and Operations</th><th>Supervision and Governance</th><th>Products and Services</th></tr>
<tr><td>

- Net capital requirements
- Margin requirements
- Reserve account and segregation requirements for customer assets
- Financial reporting
- Recordkeeping requirements
- Independent audit

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- Supervisory responsibilities over personnel, offices and service providers (including affiliates) and maintaining written supervisory procedures ("**WSPs**")
- CEO and CCO responsibilities (including annual certifications)
- Background screening, fingerprinting, and registration of and qualification requirements for personnel engaged in specified activities and supervisors (i.e., principals)
- Outside business activities, private securities transactions and outside securities account monitoring for personnel
- Surveillance for insider trading
- Training of personnel
- Restriction on payments to unregistered persons
- New product review processes

</td><td>

Additional requirements will apply if the broker-dealer is involved in providing certain products and services, such as:

- Options
- Mutual funds
- Annuities
- Direct participation programs
- Municipal securities
- Underwriting
- Market-making, dealing and otherwise trading as a principal

</td></tr>
<tr><th>Reporting and Regulator Communications</th><th>Customer Relationships and Business Conduct</th></tr>
<tr><td>

- Regulatory event reporting requirements (including FINRA reporting and SEC Form BD updating requirements)
- Notice and approval for changes in control and material changes in business operations
- Filing Form U4s when adding new personnel, updating representatives' registration disclosures, and filing Form U5s when they are terminated or otherwise depart
- Trade reporting

</td><td>

- Know Your Customer and suitability
- Business conduct rules
- Order handling, best execution and markups
- Communications and research reports
- Securities offering rules
- Protection of customer information and other information sharing requirements
- AML program

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In addition to SEC and FINRA requirements, a broker-dealer may also be subject to a variety of other regulatory regimes depending on its activities, including those listed in the sidebars below.

### Broker-Dealers Within Banking Organizations

A banking group integrating a broker-dealer into its family must establish systems, policies and procedures to ensure compliance with the Bank Holding Company Act ("**BHC Act**") and other banking law requirements. This is because the BHC Act gives the Federal Reserve authority not only over bank holding companies ("**BHCs**") and financial holding companies ("**FHCs**") themselves, but also their subsidiaries (broadly defined), and its rules govern the activities and investments of the banking group and certain relationships between members of the group.

Examples of regulatory restrictions or requirements that apply to the entire banking organization and its affiliates include:

- The ***BHC Act*** imposes restrictions on the activities in which BHCs and FHCs, and their subsidiaries, can engage.
- The ***Volcker Rule*** (which is part of the BHC Act) restricts the ability of banking entities to engage in proprietary trading and to acquire or retain ownership interests in and have certain relationships with covered funds. It also includes "backstop provisions," which prohibit certain material conflicts of interest unless the entity makes certain disclosures or establishes information barriers. It also requires the establishment of an enterprise-wide compliance program.
- ***Sections 23A and 23B of the Federal Reserve Act, and related Regulation W*** impose limitations and conditions on dealings between a U.S. bank or U.S. branch of a foreign bank, on one hand, and its affiliates (and in some cases with third parties where there is a benefit to the affiliate), on the other.
- A broker-dealer that is co-marketing products or services with its bank affiliates should be aware of product-related restrictions applicable to banks under the ***Interagency Statement on Retail Sales of Nondeposit Investment Products***.

### Other Regulatory Regimes

Depending upon the activities that the broker-dealer engages in, it may also be subject to other regulatory regimes, including:

- Investment Advisers Act of 1940 ("**Investment Advisers Act**"), the Investment Company Act of 1940 and rules thereunder;
- Commodity Exchange Act of 1936 and rules thereunder;
- Employee Retirement Income Security Act of 1974 ("**ERISA**"), Department of Labor rules and/or applicable tax rules;
- Treasury auction rules;
- Exchange Act disclosure and reporting rules;
- Rules of the Municipal Securities Rulemaking Board ("**MSRB**"); and
- Rules imposed by exchanges and other SROs.

In some cases, these regimes impose restrictions or requirements on affiliates that must be considered on a group-wide basis in connection with the integration of a new broker-dealer, including principal trading and cross-trading restrictions under the Investment Advisers Act, fiduciary obligations and disclosures under ERISA/Department of Labor rules and MSRB rules, and SEC rules for municipal advisors and municipal securities dealers.

## IV. INTEGRATION ISSUES AND ACTION ITEMS

To successfully integrate a new broker-dealer into the family, participants in the Integration Action Plan workstreams will need to consider a variety of regulatory requirements when designing and implementing the Plan. Of course, whether particular requirements listed below will apply depends upon the businesses of the broker-dealer and its new affiliates, and the business plan for integration.

## A. Business Strategy and Operating Model

### *1. Corporate Branding and Cross-Selling; Dual-Hatting*

Multi-service financial organizations often seek synergies with their newly acquired broker-dealer, including by pursuing group-wide branding and expanding offerings to customers and cross-selling. They may also implement dual-hatting arrangements to expand offerings to customers under the umbrella of existing client relationships and to utilize affiliate resources and achieve efficiencies, while satisfying requisite regulatory and licensing requirements. These arrangements raise a plethora of regulatory issues, including disclosure and supervision considerations.

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Co-Branding Strategy for Products**<br><br>FINRA Rule 2210 | ▪ To implement a co-branding strategy for its regulated financial products and services, the broker-dealer and its affiliates must clearly disclose information to avoid customer confusion, and must periodically review the content and presentation of branding materials to reasonably ensure that they comply with applicable regulatory requirements.<br>▪ FINRA rules impose specific requirements for communications that mention non-members in the communication, and for specific products (such as deposits). | ▪ Implement policies and procedures<br>▪ Develop and provide proper disclosures<br>▪ Ensure that communications by or about the broker-dealer are properly reviewed and meet FINRA and other applicable regulator (e.g., banking and SEC) guidelines |
| **Cross Selling; Networking Arrangements**<br><br>SEC Regulation R; FINRA Rule 3160 | ▪ Networking arrangements between a broker-dealer and a financial group are subject to specific SEC and FINRA rules governing those arrangements. | ▪ Implement policies and procedures<br>▪ Develop and provide proper disclosures<br>▪ Enter into written agreements with affiliates governing any networking arrangements |
| **Dual-Hatting Arrangements**<br><br>FINRA Rules 3110, 3270 and 3280; Form U4s | ▪ A broker-dealer's personnel may be authorized also to act on behalf of an affiliate.<br>▪ Job responsibilities and reporting lines should be clearly delineated and periodically reviewed to reasonably ensure compliance with broker-dealer supervision requirements.<br>▪ See also "Part B. Governance and Organization," below. | ▪ Implement policies and procedures<br>▪ Implement supervisory controls and recordkeeping requirements, including relating to outside business activities, private securities transactions and personal trading of associated persons<br>▪ Consider registration consequences and form updating requirements |

### *2. Protection of Confidential Information and Information Sharing*

A key driver in acquiring a broker-dealer may be to take advantage of various cross-marketing and cross-selling opportunities. If so, the ability to collect and share customer information across the relevant affiliated entities will be beneficial. It is important to note, however, that a broker-dealer is subject to legal and regulatory requirements that limit its ability to share information with affiliates and to use customer information for certain purposes, some of which are summarized in the table below. FINRA and exchange rules may impose additional information barrier requirements on a broker-dealer that conducts market-making. Other regulated entities may also be subject to such requirements under other regimes that are applicable to them.

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Material Non-Public Information**<br><br>Exchange Act Rule 10b-5; Insider Trading and Securities Fraud Enforcement Act of 1988 / Exchange Act § 15(g) | ▪ A broker-dealer must protect material non-public information. | ▪ Implement policies and procedures<br>▪ Implement information barriers<br>▪ Implement surveillance of trading and limitations on employee trading |
| **Protection of Customer Information**<br><br>Gramm-Leach-Bliley Act §§ 502(a) and 503(a); SEC's Regulation S-P; SEC's Regulation S-AM | A broker-dealer must:<br>▪ adopt policies and procedures to safeguard its individual customer records and information;<br>▪ send such customers privacy notices about the sharing of customer information with affiliates and unaffiliated third parties and provide customers with an opportunity to opt out of disclosure of non-public personal information; and<br>▪ comply with applicable restrictions on sharing certain customer information with third parties (whether directly or indirectly through an affiliate). | ▪ Implement policies and procedures<br>▪ Develop and provide proper client disclosures |
| **Reporting of Suspicious Transactions and Related Limitations on Information Sharing**<br><br>31 U.S.C. 5318(g)(2); 31 CFR 1023.320(e)(1) | ▪ A broker-dealer is generally prohibited by the Bank Secrecy Act and the Department of Treasury's Financial Crimes Enforcement Network regulations from disclosing Suspicious Activity Reports ("**SARs**") or any information that would reveal the existence of a SAR even to a parent or an affiliate unless certain conditions are satisfied, except for sharing with its:<br>o parent, if they have entered into a written confidentiality arrangement; or<br>o its U.S. affiliate, if the affiliate itself is subject to a SAR rule, among other things. | ▪ Implement policies and procedures<br>▪ Review or implement written confidentiality arrangements |

### *3. Conflicts of Interest and Disclosures*

There are numerous rules that require broker-dealers to disclose conflicts or potential conflicts to customers, including, in many cases, those that potentially arise due to the business of the broker-dealer's affiliates. From a regulatory perspective, being part of a new affiliate group means that new conflicts of interest may arise that need to be managed and disclosed or, in some cases, eliminated. In order to comply with these rules, firms need to implement systems that gather the necessary information for all covered affiliates. In some instances, systems must ensure that customers, potential customers and others receive appropriate and timely notices. In other cases, customer consents must be obtained. Finally, in some cases, it is necessary to prevent, generally through the use of systemic blocks, transactions from occurring.

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Disclosure of Control**<br><br>Exchange Act Rule 15c1-5 / FINRA Rule 2262 | ▪ Before entering into a contract with or for a customer to transact in a security issued by an affiliate, a broker-dealer generally must disclose the affiliation. | ▪ Update systems to monitor transactions<br>▪ Develop and provide proper disclosures |

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Transactions Involving Broker-Dealer Affiliates of Investment Advisers**<br><br>Investment Advisers Act Section 206(3) and rules thereunder | ▪ Registered and unregistered investment advisers must comply with Section 206(3) disclosure and consent requirements when they, or their broker-dealer affiliates, engage in principal or agency cross transactions with their advisory clients.<br>▪ If an investment adviser uses an affiliated broker-dealer to execute client trades, the adviser must disclose such practice and potential conflicts of interest to its clients. Such practice is subject to the adviser's general fiduciary duties to clients, including its obligation to seek best execution. | ▪ Implement policies and procedures<br>▪ Update systems to monitor transactions and, where necessary, block transactions<br>▪ Develop and provide proper client disclosures, and obtain consents where necessary |
| **Transactions Involving Registered Investment Companies**<br><br>Investment Company Act of 1940 Section 17 and the rules thereunder | ▪ If an investment adviser acts as the adviser to a registered investment company, transactions involving such registered investment company and the adviser's broker-dealer affiliates would be subject to additional restrictions.<br>▪ For example, Section 17(a) generally prohibits principal transactions between a registered investment company and an affiliate, such as its adviser or any affiliate of its adviser. | ▪ Implement policies and procedures<br>▪ Update systems to monitor transactions and, where necessary, block transactions |
| **ERISA and Department of Labor Fiduciary Duty Rule** | ▪ An affiliate's relationship with a benefit plan may make the broker-dealer a "party in interest" under ERISA with respect to that plan, and prohibit the broker-dealer from engaging in certain transactions with that plan. Similarly, if the broker-dealer provides services to a benefit plan, the other affiliates in the corporate group may become "parties in interest" and be prohibited from engaging in certain transactions with that plan.<br>▪ These so-called "prohibited transaction" rules under ERISA (and under the Internal Revenue Code with respect to individual retirement accounts ("**IRAs**")) are broad, and the consequences of violating these rules can be draconian. | ▪ Implement policies and procedures<br>▪ Update systems to monitor transactions and, where necessary, block transactions |
| **Municipal Securities and Advisory Activities**<br><br>MSRB Rules G-17, G-23, G-37 and G-42 | ▪ An underwriter must provide a number of disclosures to an issuer of municipal securities at varying stages of the underwriter-issuer relationship, including disclosures concerning potential or actual material conflicts, including with respect to affiliates.<br>▪ Broker-dealers in municipal securities and their affiliates must refrain from "role switching" from financial advisor to underwriter placement agent.<br>▪ A broker-dealer or municipal securities dealer (i) is prohibited from engaging in municipal securities business with a municipal entity if certain political contributions have been made; (ii) may not solicit any affiliate to make | ▪ Implement information-gathering system<br>▪ Develop and provide proper disclosures<br>▪ Update systems and controls to monitor contributions<br>▪ Implement process for quarterly reporting |

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| | such a contribution; and (iii) must disclose quarterly to the MSRB certain political contributions on Form G-37.<br>■ A broker-dealer that is a registered municipal advisor has various obligations to its clients, including fiduciary duties when providing advice to municipal entity clients, that may impact affiliates and require making additional disclosures. | |
| **Research Reports**<br><br>FINRA Rules 2241 and 2242 | ■ FINRA rules require disclosure in research reports of various relationships between the broker-dealer issuing the report and affiliates, on the one hand, and the issuer that is the subject of the research, on the other.<br>■ Firms subject to the 2004 "Global Research Settlement" may have additional research-related requirements. | ■ Implement information-gathering system and program disclosure of disclosable relationships |
| **Public Offerings of Securities with Conflicts of Interest**<br><br>FINRA Rule 5121 | ■ A broker-dealer cannot participate in a public offering in which it has a conflict of interest unless certain conditions are met.<br>■ A conflict of interest exists (i) if securities are issued by a FINRA member or if the issuer is affiliated with a "participating member" (as defined in FINRA Rule 5110) or one of its associated persons; (ii) where 5% or more of the net offering proceeds are used to reduce or retire a loan or credit facility extended by a participating member or otherwise directed to a participating member; or (iii) where, as a result of the public offering, the participating member will become an affiliate of the issuer, among other things. | ■ Implement policies and procedures<br>■ Review offering documents |
| **Offering of Affiliates' Securities**<br><br>FINRA Rule 5122 | ■ This rule prescribes requirements for FINRA members participating in private offerings of a FINRA member or that of a "control entity," subject to certain exceptions. | ■ Implement policies and procedures |

In addition to the above, the Volcker Rule's backstop provisions also prohibit a banking entity from engaging in certain otherwise permitted activities involving a material conflict of interest unless it satisfies specific conditions. This issue is discussed further in the textbox entitled "Broker-Dealers Within Banking Organizations" above.

### *4. Shared Services*

Firms often seek to achieve cost reductions and create centralized visibility into customer activity and corporate risks through the provision of intra-group services on a group-wide basis. In designing and configuring a framework for the provision of inter-affiliate services, the new parent and the broker-dealer will need to be mindful of FINRA rules relating to the supervision, recordkeeping and related requirements governing third-party service providers.

As noted above, "outsourcing" of a function to an affiliate does not relieve the broker-dealer of its ultimate responsibility to achieve compliance with all applicable securities laws and regulations. In addition, any parties that conduct activities that require registration under the applicable FINRA

rules will need to be registered and will be considered associated persons of the broker-dealer under SEC and FINRA rules, even if such persons are employed, as a matter of employment, tax or other applicable laws and regulations, by an unregulated affiliate.

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Responsibilities when Outsourcing**<br><br>NASD Notice to Members 05-48; NASD Notice to Members 06-23; FINRA Regulatory Notice 11-33 | ▪ A broker-dealer must establish oversight processes over its service providers.<br>▪ If a broker-dealer outsources certain core broker-dealer functions, like order taking, trade execution or specific operational roles, the service company or its personnel may be treated as an associated person of the broker-dealer.<br>▪ A broker-dealer cannot outsource its supervisory responsibilities away from its direct control. | ▪ Review contractual arrangements for compliance<br>▪ Implement supervisory controls and processes<br>▪ Maintain recordkeeping systems<br>▪ Analyze outsourcing arrangements for registration and licensing issues |
| **Payments to Unregistered Persons**<br><br>FINRA Rule 2040 | ▪ Subject to exceptions, an affiliate that receives transaction-based compensation may need to register as a broker-dealer. A broker-dealer will need "reasonable support" for any determination that payments do not trigger a registration requirement for the affiliate. | ▪ Review fee-sharing arrangements for compliance<br>▪ Document "reasonable support" |
| **Expense-Sharing Agreements**<br><br>NASD Notice to Members 03-63 | ▪ Expense-sharing arrangements could attract capital charges for the broker-dealer unless applicable regulatory requirements and guidance are satisfied. | ▪ Review proposed contractual arrangements for compliance |
| **Payroll Processing**<br><br>SEC Payroll Processor Guidance | ▪ Outsourcing arrangements with a payroll processing service provider should be structured to avoid broker-dealer registration issues for the service provider. Specifically, the service provider should have no discretion concerning the amount of payments to broker-dealer personnel. | ▪ Review proposed contractual arrangements and processes for compliance |
| **Maintaining Books and Records**<br><br>Exchange Act Rules 17a-3 and 17a-4; FINRA Rule 4511 | ▪ A broker-dealer is required to maintain books and records with respect to a variety of information in the form and manner and for the durations specified in the broker-dealer recordkeeping rules.<br>▪ A broker-dealer must ensure that requisite records are being maintained either by it or by its service provider; various conditions apply to the use of third-party recordkeepers. | ▪ Review proposed processes for compliance<br>▪ Ensure that any required filings and Form BD updates are made |
| **Fingerprinting**<br><br>Exchange Act Rule 17f-2 | ▪ Generally, every person who is a partner, director, officer or employee of a broker-dealer must be fingerprinted, unless an exemption applies.<br>▪ Anyone with regular access to the keeping, handling or processing of securities, money or original books and records relating to securities or money must be fingerprinted. | ▪ Implement policies and procedures<br>▪ Maintain recordkeeping systems |
| **Disaster Recovery** | ▪ Broker-dealers must maintain and update | ▪ Review disaster recovery plans |

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Plan**<br><br>FINRA Rule 4370 | written disaster recovery plans. | and website summary in connection with proposed integrations and update them as necessary |

### *5. Other Operating Model Considerations: Acquisitions of IPO Shares by Broker-Dealer Affiliates*

FINRA rules prohibit the sale of IPO shares by a broker-dealer to any account in which specified "restricted persons" (which includes most owners and certain affiliates of a broker-dealer) has a beneficial interest of 10% or more, unless an exemption applies. This rule is designed to protect the integrity of the public offering process by ensuring that, among other things, industry insiders do not take advantage of their position to purchase IPO shares at the expense of public investors. This rule could limit the ability of a broker-dealer's new parent and affiliates to buy IPO shares, unless they can benefit from one or more of the specified exemptions in the rule.

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Restrictions on Participating in IPOs**<br><br>FINRA Rule 5130 | ▪ A "restricted person," which includes most owners and certain affiliates of a broker-dealer, cannot buy IPO shares via any account in which the restricted person has a beneficial interest of more than 10%, unless it benefits from an exemption.<br>▪ This rule can have significant implications for purchasers of broker-dealers that are not already restricted persons under this rule. | ▪ Conduct appropriate analysis<br>▪ Implement policies and procedures |

## B. GOVERNANCE AND ORGANIZATION

A broker-dealer must comply with applicable registration and supervision requirements with respect to its associated persons. Those that control a broker-dealer or are members of a broker-dealer's board of directors have specified roles and responsibilities in a broker-dealer's supervision system. Some of these requirements, roles and responsibilities are described in the table below.

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Supervision Generally**<br><br>FINRA Rules 3110–3130 | ▪ A broker-dealer must establish and maintain a supervisory structure in which its activities and those of its associated persons are supervised by properly qualified and designated registered principals.<br>▪ The chief compliance officer ("**CCO**") of the broker-dealer and the CEO (both of whom must also be registered principals of the broker-dealer) have specific responsibilities under FINRA rules. | ▪ Implement proper reporting lines<br>▪ Review policies and procedures |
| **Registration of Representatives and Principals**<br><br>NASD Rules 1031 and 1021 | ▪ All persons engaged in the investment banking or securities business of a broker-dealer and who are to function as representatives must be registered as such with FINRA and appropriately licensed.<br>▪ All such persons who are to function as "principals" (e.g., supervisors and officers | ▪ Review personnel roles and responsibilities in light of post-acquisition business model and organizational structure.<br>▪ Ensure that personnel are properly licensed and subject to relevant broker-dealer policies and |

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| | actively engaged in the management of the firm's investment banking or securities business) must be registered with FINRA and licensed as principals.<br>■ These requirements may limit the ability of persons outside the broker-dealer to have direct involvement in performing certain core functions of the broker-dealer, unless such persons are treated as associated persons (and principals, as the case may be) of the broker-dealer.<br>■ Any member of a broker-dealer's board of directors must be registered as a principal, unless they limit their activities and sign a certification.<br>■ The chain of supervision of a broker-dealer must ultimately report up to the CEO, who must be a registered principal with FINRA. | procedures<br>■ Implement appropriate supervisory framework and implement proper reporting lines. |
| **Supervision of shared services, dual-hatted persons and outsourced activities** | ■ See Section IV.A.1 above. | ■ See Section IV.A.1 above. |
| **Liability of Controlling Persons**<br><br>Exchange Act Section 20(a); Exchange Act Section 21C | ■ A controlling person will be jointly and severally liable with a controlled person, such as a broker-dealer, that is in violation of the Exchange Act, unless the controlling person acted in good faith and did not directly or indirectly induce the act that is the cause of action. In addition, the SEC may sanction persons who "aid and abet" or "cause" securities law violations by a broker-dealer. | ■ The broker-dealer's parent and its executives should develop an approach to overseeing the broker-dealer's activities that are sensitive to these potential liability issues |

## C. PROCESSES, SYSTEMS AND INFRASTRUCTURE

### *1. Regulatory Reporting*

A broker-dealer is subject to various reporting obligations that may be triggered by events affecting or involving its affiliated entities. In some cases, group-wide or affiliate reporting systems will need to be adapted to incorporate the new broker-dealer's activities and disciplinary events. Procedures will need to be revised to ensure that all reporting entities receive, on an ongoing basis, all information that they need to assess the regulatory impact of activities and regulatory events, and to comply with any applicable reporting obligations.

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Change in Ownership or Control**<br><br>NASD Rule 1017 | ■ A broker-dealer must provide notice to, and ultimately obtain approval from, FINRA if there is a change in direct or indirect ownership or control of the broker-dealer that exceeds specified 25% thresholds.<br>■ Thus, any direct or indirect change of control in the ownership chain above the broker-dealer will require FINRA notice and approval.<br>■ If the broker-dealer, after integration into its new | ■ Implement policies and procedures |

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| | family, intends to materially expand its size or activities, then it may also need to file an application for FINRA approval. | |
| **Statutory Disqualification**<br><br>Section 3(a)(39) of the Exchange Act; FINRA Bylaw Article III; Section 3(d) of FINRA Rule 9522 | ■ Disciplinary, criminal or other adverse actions by a domestic or foreign court, regulator or an SRO could cause a broker-dealer or its associated person to become statutorily disqualified, resulting in various adverse collateral consequences.<br>■ These consequences could disrupt the broker-dealer's ability to function normally, including becoming automatically barred from membership in FINRA and other SROs or no longer being able to satisfy the requirements of securities registration exemptions.<br>■ If a broker-dealer or an associated person becomes statutorily disqualified, the broker-dealer must apply to FINRA for continued membership or continued association of the associated persons, as the case may be.<br>■ In other cases, waivers need to be sought from the SEC or other regulators to avoid undesirable consequences. | ■ Implement policies and procedures<br>■ Develop internal processes and systems for centralized information gathering, alerts and coordination among affiliated entities relating to regulatory actions, sanctions or disciplinary events |
| **Form BD** | ■ The Form BD must be amended promptly whenever the information on file becomes inaccurate or incomplete, including (i) if the broker-dealer has new parents or affiliates, (ii) if the broker-dealer has experienced a change in control, (iii) or if the broker-dealer or a "control affiliate" becomes subject to disciplinary, criminal or other adverse actions. | ■ Implement policies and procedures |
| **Regulatory Reporting to FINRA**<br><br>FINRA Rule 4530 | ■ A broker-dealer must promptly report certain adverse actions against the broker-dealer or its associated persons.<br>■ Certain reporting events can be triggered by events affecting a broker-dealer's affiliate, including if the broker-dealer or an affected person (i) is the director or officer of an investment company, investment adviser, underwriter or insurance company that had its registration suspended or revoked, among other things, (ii) is associated in such a capacity with a bank or other financial institution that was convicted of or pleaded no contest to, any felony or misdemeanor, or (iii) involved in certain financial transactions with any person that is subject to a statutory disqualification. | ■ Implement policies and procedures<br>■ Develop internal processes and systems for centralized information gathering, alerts and coordination among affiliated entities relating to regulatory actions, sanctions or disciplinary events |

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Material Associated Persons Reporting**<br><br>Exchange Act Rules 17h-1T and 17h-2T | ■ Certain broker-dealers must maintain and preserve information regarding those affiliates, subsidiaries and holding companies whose business activities are reasonably likely to have a material impact on the broker-dealer's operations, subject to exceptions.<br>■ Certain information must be filed on Form 17-H on a quarterly basis. | ■ Implement policies and procedures<br>■ Implement process for quarterly reporting |
| **Branch Office Registration**<br><br>Form BR | ■ Branch offices must be registered with FINRA by filing a Form BR in the Central Registration Depository system. | ■ Update Form BR if integration entails changes in branch locations |

Events at the broker-dealer may also trigger reporting or other consequences at regulated affiliates under other applicable regulatory regimes, such as those governing banking organizations, or under exchange, clearing organization or rules of non-U.S. jurisdictions. Firms should have a system to immediately alert a centralized function within an organization when regulatory actions, sanctions or disciplinary events occur within the broker-dealer or a parent or affiliate, or to their respective employees, officers or directors.

### *2. Disclosure of Interest and Aggregation Rules*

Many financial regulation regimes limit or impose reporting requirements on significant positions or corresponding actions. In most cases, these regimes apply to affiliated groups under common control on an aggregate basis. An important integration task when acquiring a broker-dealer is to incorporate the new entity into existing systems for tracking and reporting under these regimes.

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Option Position Limits**<br><br>FINRA Rule 2360; other SROs have similar rules | ■ A broker-dealer may not effect a transaction which would cause the broker-dealer or any customer on whose account it is acting to own or "control" more than a specified position in equity options, subject to offsets and exceptions. Control is an expansive concept for purposes of this rule and may include holdings by affiliates. | ■ Update systems to monitor and track positions |
| **Treasury Auction Rules** | ■ A broker-dealer that submits bids in U.S. Treasury auctions may be required to aggregate its positions with those of its affiliates so that the firm is counted as one bidder, or it may be required to apply for separate bidder status. A firm will also typically not be allotted more securities than the aggregate amount of orders communicated by the firm. | ■ Update systems to monitor and track positions |
| **Disclosure of Interest; Short-Swing Profits**<br><br>Exchange Act Sections 13 and 16 and related rules | ■ Subject to exceptions, a person who directly or indirectly acquires the beneficial ownership of 5% of any class of an equity security of a U.S. issuer that is registered under the Exchange Act must file statements on Schedule 13D/G and amendments thereto.<br>■ Section 16(a) of the Exchange Act and related rules generally require 10% beneficial owners of a class of equity securities of a U.S. issuer that is registered under the Exchange Act to file on | ■ Update systems to monitor and track positions<br>■ Implement policies and procedures<br>■ Implement information barriers |

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| | Form 3 and report subsequent transactions in the issuer's securities on Form 4.<br>■ Section 16(b) provides that an issuer may recover the "short-swing" profits from any purchase and sale or any sale and purchase by a ten percent beneficial owner within a six-month period.<br>■ In general, a corporate group is deemed to beneficially own all of the securities held by its members, unless specified conditions under SEC guidance for disaggregation can be satisfied. | |
| **SEC Large Trader Registration**<br><br>Exchange Act Rule 13h-1 | ■ Persons who have, or control a person who has, investment discretion over accounts that have traded U.S. listed stocks and listed options, on a gross basis, in excess of a specified threshold must register with the SEC as a large trader by filing a Form 13H. Form 13H requires various information regarding the large trader and its affiliate group. A registered large trader and the persons it controls must provide their brokers with the large trader ID issued by the SEC, update Form 13H on a quarterly basis if any information has become inaccurate or incomplete, and file a Form 13H annually (even if it remains accurate).<br>■ Whether the applicable threshold is breached is determined for a corporate group on a combined basis. | ■ Implement reporting processes<br>■ Update system to monitor and track volume of activities |
| **Swap Dealers, Security-Based Swap Dealers and Futures** | ■ Depending on the broker-dealer's involvement with swaps, futures and other instruments regulated by the CFTC, or with SEC-regulated security-based swaps, there would be additional aggregation requirements. | ■ Update systems to track activities of broker-dealer and/or affiliates |

### *3. Net Capital Implications of Financial Transactions Involving Affiliates*

Broker-dealers are subject to the SEC's net capital rules, which are designed to ensure that broker-dealers have sufficient unencumbered, liquid capital available at all times to satisfy customer claims. These rules impose specific requirements on various financial dealings between and involving affiliates. Affiliate transactions should therefore be analyzed and reviewed carefully to reasonably ensure compliance with applicable rules and, where possible, to mitigate or avoid unfavorable net capital consequences.

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| **Affiliate Receivables**<br><br>Exchange Act Rule 15c3-1(c)(2)(iv)(H) | ■ Any receivable from an affiliate not otherwise deducted from net worth, and the excess market value of collateral given to an affiliate to secure a liability of the broker-dealer, must be deducted from net worth.<br>■ In many cases, holding an affiliate's securities, including debt instruments issued by an affiliate, will result in significant capital charges on the | ■ Implement process for pre-approval and regular review of the affiliate's financial transactions with the broker-dealer |

| Requirement | Summary of Issues | Action Plan |
|---|---|---|
| | broker-dealer. | |
| **Capital Withdrawals**<br><br>Exchange Act Rules 15c3-1(e)(2) and 15c3-1(e)(4)(iv); Exchange Act Rule 17a-11 | ■ The net capital rules place various limitations on capital withdrawals from a broker-dealer.<br>■ An unsecured advance or loan by a broker-dealer to an affiliate and certain other transactions with affiliates will be considered capital withdrawals for purposes of the net capital rule.<br>■ Reporting and rapid withdrawal limits also apply. | ■ Implement process for regular review of any proposal to cause the broker-dealer to make capital distributions or engage in other financial transactions with affiliates<br>■ Develop and provide proper disclosures or notifications |
| **Guarantees**<br><br>Exchange Act Rule 15c3-1 Appendix C; FINRA Rule 4150 | ■ A broker-dealer must consider any guarantees by the broker-dealer of affiliates' obligations when calculating its net capital under the SEC's capital rules. If a broker-dealer provides a general guarantee of the financial obligations of an affiliate, it is required to consolidate into a single computation all of the affiliate's assets and liabilities for net capital computation purposes. Notice to FINRA is required in certain cases.<br>■ This requirement often comes up when a parent or affiliate is negotiating a credit agreement with a lender and the lender requests that the borrower's obligations be guaranteed by all affiliates, including the broker-dealer. | ■ Implement process for prior approval by the broker-dealer's control functions of any guarantees by the broker-dealer |

## V. CONCLUSION

Acquiring a broker-dealer can be an important means of expanding a financial institution's businesses and achieving larger strategic objectives. However, one key to realizing these goals is being sensitive to the myriad of regulatory requirements associated with running and owning a broker-dealer. Vigorous examinations, sanctions, private litigation and costly remediation exercises that can flow from regulatory failures can be substantial distractions and impediments to attaining the stated goals of an acquisition. Considering regulatory requirements as part of an Integration Action Plan, including preparing a comprehensive list of regulatory requirements and embedding regulatory specialists into integration planning and internal workstreams, can prevent costly missteps and pave the way for achieving planned-for synergies.