

CHAPTER 6

US Broker-Dealer Regulation

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US FEDERAL BROKER-DEALER REGULATION

The US capital markets are inhabited by various types of market participants, each performing different roles and subject to different oversight regimes. Broker-dealers play a key role in these markets—among other things, they underwrite securities offerings, prepare research, make markets, and hold and service customer accounts for retail and institutional customers.

The Securities Exchange Act of 1934 (Exchange Act) defines the term “broker” as “any person engaged in the business of effecting transactions in securities for the account of others,”¹ and it defines “dealer” as “any person engaged in the business of buying and selling securities for such person’s own account through a broker or otherwise.”² Most firms function as both brokers and dealers, and thus are called broker-dealers.

Broker-dealers are subject to regulatory oversight by the federal government, the states, and self-regulatory organizations (SROs). The rules and regulations governing broker-dealers and their activity are encyclopedic in volume and detail. As such, this chapter provides only a survey of the federal oversight regime governing the operations and conduct of broker-dealers. It is intended to provide basic background on the subject of federal broker-dealer regulation in the United States and to demonstrate the extent of the regulatory

requirements that apply to broker-dealers. These requirements generally fall into three main categories: (1) registration, (2) financial responsibility and customer protection, and (3) conduct.

The first part of this chapter consists of a high-level factual summary of the rules applicable to broker-dealers, while the second part consists of a normative, market-based critique of the broker-dealer regulatory regime. As will be seen, the broker-dealer regime does incorporate significant market-oriented elements. It would benefit, however, from a return to true self-regulation by SROs as well as increased economic analysis on the part of both the US Securities and Exchange Commission (Commission or SEC) and the SROs—in particular, analysis that takes into account the existing regulatory burden on broker-dealers.

Registration as a Broker-Dealer

The cornerstone of the federal regulatory regime for broker-dealers is registration with the SEC. Registration is required when firms engage in certain activities identified in the federal securities laws. Failure to register when required is a stand-alone cause of action in the securities laws.

Broker-dealers are required to register with the SEC pursuant to Section 15(a) of the Exchange Act.³ A broker-dealer registers with the SEC by filing an application on Form BD, which requires extensive information about the background of the applicant, including the type of business in which it proposes to engage; the identity of the applicant's direct and indirect owners and other control affiliates; and whether the applicant or any of its control affiliates have been subject to criminal prosecutions, regulatory actions, or civil actions in connection with any investment-related activity.⁴

An SEC order granting registration generally will not become effective until a broker-dealer has become a member of at least one SRO.⁵ Membership in one or more SROs, which consist of the Financial Industry Regulatory Authority (FINRA) and the national securities exchanges registered with the SEC, entails additional regulatory requirements for broker-dealers.⁶ SROs are statutorily required to promulgate and enforce rules that govern all aspects of their members' securities business, including their financial condition, operational capabilities, sales practices, and the qualifications of their members' employees.⁷

A broker-dealer that limits its transactions to the national securities exchanges of which it is a member and meets certain other conditions may be required only to be a member of those exchanges;⁸ however, any broker-dealer with a public customer business that effects securities transactions other than on a national securities exchange of which it is a member (including any over-the-counter business), must become a member of a “national securities association” as well, which in practice means FINRA, the only currently registered national securities association.⁹ Lastly, firms that engage in transactions in municipal securities must also register with and comply with the rules of the Municipal Securities Rulemaking Board (MSRB), an SRO that makes rules governing transactions in municipal securities. Broker-dealers must comply with the rules of each of the SROs of which they are members.

The Exchange Act generally prohibits registered broker-dealers from conducting a securities business unless their associated persons who effect or are involved in effecting securities transactions are licensed in accordance with the qualification standards of each SRO of which they are members.¹⁰ Most SROs have established various qualification exams for associated persons of broker-dealers, with licenses based on an associated person’s job functions.¹¹ Broker-dealers and their associated persons may also need to register with the securities authority of one or more states, in accordance with the applicable laws of each state in which they do business.¹² The broker-dealer registration process is coordinated through the Central Registration Depository (CRD) system operated by FINRA.¹³

Financial Responsibility Rules

Broker-dealers must meet certain financial responsibility requirements under the Exchange Act. These requirements are designed to protect customers from the consequences of the financial failure of a broker-dealer by requiring the safeguarding of customer securities and funds held by the broker-dealer and requiring the broker-dealer to maintain minimum capital levels. The SEC’s financial responsibility rules require broker-dealers to maintain more than a dollar of highly liquid assets for each dollar of liabilities, prohibit broker-dealers from using customer securities and cash to finance their own business, and require broker-dealers to maintain accurate books and records. The financial

responsibility rules for broker-dealers are particularly complex; as such, the following represents a broad overview of the subject.

Net Capital Rule. Since 1942, the Commission has prescribed capital requirements for broker-dealers based on a net liquid assets test pursuant to Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder (the “net capital rule”).¹⁴ The net capital rule is designed to ensure that a broker-dealer holds, at all times, more than one dollar of highly liquid assets for each dollar of liabilities (e.g., money owed to customers and counterparties), excluding liabilities that are subordinated to all other creditors by contractual agreement.¹⁵ The premise underlying the net capital rule is that if a broker-dealer fails, it should be in a position to meet all unsubordinated obligations to customers and counterparties and generate resources sufficient to wind down its operations in an orderly manner without the need of a formal proceeding.

The rule requires a broker-dealer to perform two primary calculations: (1) a computation of required minimum net capital (that is, the amount of net capital a broker-dealer must maintain in order to legally operate a securities business); and (2) a computation of actual net capital. A broker-dealer must ensure that its actual net capital exceeds its required minimum net capital at all times.

For most broker-dealers, the required minimum amount is the greater of a fixed-dollar amount or an amount computed using one of two financial ratios.¹⁶ The first ratio provides that a broker-dealer shall not permit its aggregate indebtedness to all other persons to exceed 1,500 percent of its net capital (i.e., a 15-to-1 aggregate indebtedness to net capital requirement).¹⁷ The second financial ratio, used by broker-dealers that carry customer accounts, provides that a broker-dealer shall not permit its net capital to be less than 2 percent of aggregate customer debit items (i.e., customer obligations to the broker-dealer).¹⁸ After performing the applicable financial ratio calculation, the broker-dealer compares that amount to its applicable fixed-dollar requirement (e.g., \$250,000). The larger amount—fixed-dollar or ratio—is the broker-dealer’s required minimum.

Once the required regulatory net capital is determined, broker-dealers must undertake the calculation of their actual net capital. A broker-dealer begins this process by calculating its net worth using generally accepted accounting principles (GAAP).¹⁹ It then subtracts illiquid, or “non-allowable,” assets such as real estate or goodwill²⁰ and adds back qualified subordinated loans.²¹

Finally, a broker-dealer is required to subtract an amount, determined by taking percentage deductions (referred to as “haircuts”), from the mark-to-market value (i.e., the current market value) of each allowable asset (e.g., equity or debt securities). The size of the haircut for each allowable asset is prescribed by rule and depends on the inherent market and liquidity risk of the asset. In addition, certain larger broker-dealers may, upon application to and approval by the Commission, compute their actual net capital using an “alternative net capital” method, which entails the use of value at risk, or VaR, models in lieu of the standardized haircuts prescribed by the net capital rule.²²

Customer Protection Rule. Exchange Act Rule 15c3-3 (the customer protection rule) applies to all registered broker-dealers, with certain exemptions. The customer protection rule imposes two important obligations on “carrying” broker-dealers—that is, broker-dealers that carry customer accounts—as well as on “clearing” broker-dealers, those through which other broker-dealers or customers clear their trades. First, each broker-dealer subject to the customer protection rule must obtain physical possession or control over customers’ fully paid and excess margin securities,²³ meaning that the broker-dealer must hold these securities free of lien in one of several categories of locations specified in the rule (e.g., a bank or clearing agency).²⁴ Under Rule 15c3-3, a broker-dealer must make a daily determination from its books and records (as of the preceding day) of the quantity of fully paid and excess margin securities in its possession. Second, a broker-dealer must maintain at a bank or banks cash or qualified securities on deposit in a Special Reserve Bank Account for the Exclusive Benefit of Customers equaling at least the net amount computed by adding customer credit items (e.g., cash in securities accounts) and subtracting from that amount customer debit items (e.g., margin loans).²⁵

The customer protection rule is designed to protect customer funds and securities by generally segregating them from the carrying broker-dealer’s proprietary business activities. As such, if the carrying broker-dealer fails, customer funds and securities should be readily available to be returned to customers. The rule requires carrying broker-dealers to compute the customer reserve requirement on a weekly basis, except where customer credit balances do not exceed \$1 million (in which case the computation can be performed monthly, provided that the broker-dealer maintains 105 percent of the required deposit amount).

Broker-dealers that do not hold customer funds or securities can claim an exemption from the requirements set forth in Rule 15c3-3.²⁶ For example, an “introducing” broker-dealer that clears all transactions with and for customers on a fully disclosed basis with a clearing broker-dealer, and who promptly transmits all customer funds and securities to the clearing broker-dealer, is not required to comply with Rule 15c3-3.²⁷

Some broker-dealers that do not carry customer accounts receive securities and cash from customers for the limited purpose of effecting securities transactions. These broker-dealers can also claim an exemption from Rule 15c3-3 provided they promptly transfer all securities to customers and effectuate all financial transactions with customers through a bank’s “Special Account for the Exclusive Benefit of Customers of [the broker-dealer].”²⁸ The amount of money that must be deposited into the account is the total amount of money the broker-dealer has received from customers. If the broker-dealer fails, the cash in this account is used to meet any outstanding obligations to customers (ahead of any general creditors of the broker-dealer).

Recordkeeping Requirements. Exchange Act Rule 17a-3 sets forth the basic recordkeeping requirements applicable to brokers and dealers. Examples of records required to be made and kept current under Rule 17a-3 include trade blotters itemizing trades, receipts, or deliveries of securities, as well as disbursements of cash and other debits and credits; a stock record of positions held in various securities; trial balances; a record of the firm’s computation of net capital and aggregate indebtedness; trade confirmations; complaints regarding associated persons; and compliance records. Exchange Act Rule 17a-4 governs the retention periods for these records, which vary by record type, as well as for other records, such as information supporting a firm’s financial reports and communications sent or received by the firm that relate to the firm’s business.

Exchange Act Rule 17a-5 contains important reporting requirements for broker-dealers. Under Rule 17a-5, a broker-dealer is required, among other things, to periodically file unaudited reports. These reports—known as Financial and Operational Combined Uniform Single (FOCUS) Reports—contain information about a broker-dealer’s financial and operational condition. Also under Rule 17a-5, a broker-dealer must annually file its financial statements and other reports, including a report covering the financial

statements and reports prepared by the broker-dealer's independent public accountant, which must be registered with the Public Company Accounting Oversight Board (PCAOB). Rule 17a-5 reporting supports compliance with Rules 15c-3-1 and 15c3-3 and facilitates examinations by the SEC, state regulators, and SROs.

More specifically, under Rule 17a-5, broker-dealers must prepare and file with the SEC annual reports consisting of a financial report and either a compliance report or an exemption report prepared by the broker-dealer, as well as certain reports that are prepared by an independent public accountant covering the financial report and the compliance report or the exemption report. A broker-dealer must prepare and file a compliance report if the firm did not claim it was exempt from Rule 15c3-3 throughout the most recent fiscal year. A broker-dealer must prepare and file an exemption report if the firm did claim that it was exempt from Rule 15c3-3 throughout the most recent fiscal year.

General Conduct Rules

Like all securities market participants, broker-dealers must comply with the antifraud provisions of the federal securities laws,²⁹ which prohibit misstatements or misleading omissions of material facts, as well as fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities. In practice, these prohibitions entail several broad conduct requirements.

For example, broker-dealers owe their customers a duty of "fair dealing" that "is derived from the antifraud provisions of the federal securities laws."³⁰ The Commission's interpretive statements and enforcement actions and court cases have filled out the requirement of fair dealing by identifying specific actions required of broker-dealers to fulfill that broad duty. As the Commission staff has noted, "these include the duties to execute orders promptly, disclose certain material information (i.e., information the customer would consider important as an investor), charge prices reasonably related to the prevailing market, and fully disclose any conflict of interest."³¹

Broker-dealers also have a "suitability" duty—that is, an obligation to recommend only those specific investments or overall investment strategies that are suitable for their customers. In practice, this duty obligates a broker-dealer

to have an “adequate and reasonable basis” for any recommendation that it makes on a customer-specific basis.³²

The duty of “best execution” requires a broker-dealer to seek to obtain the most favorable terms available under the circumstances for its customer orders.³³ Some SRO rules also include a duty of best execution. For example, FINRA members must use “reasonable diligence” to determine the best market for a security and buy or sell the security in that market, so that the price to the customer is as favorable as possible under prevailing market conditions.³⁴

Broker-dealers also must comply with a number of SEC rules pertaining to specific circumstances. For example, Regulation SHO addresses the requirements that must be met for a “short sale” (i.e., the sale of a security the seller does not own), including a “locate” requirement, which requires a broker-dealer to have reasonable grounds to believe the relevant unowned security can be borrowed prior to its delivery date, as well as an additional “close-out” requirement for securities in which there are a relatively substantial number of extended delivery failures at a registered clearing agency.³⁵

Additionally, broker-dealers must comply with Regulation M,³⁶ which applies when securities are being offered in a distribution. Regulation M prohibits broker-dealers (as well as underwriters and other distribution participants) from bidding for, purchasing, or attempting to induce any person to bid for or purchase, any security that is the subject of a distribution until the applicable restricted period has ended.³⁷

Finally, broker-dealers are required to supervise their personnel and ensure their compliance with all relevant rules and regulations. Failure to do so could lead to “failure to supervise” liability under Section 15(b) of the Exchange Act.

A MARKET PERSPECTIVE ON US FEDERAL BROKER-DEALER REGULATION

A market-based critique of the broker-dealer regulatory regime must begin with an acknowledgement that the regime does, in fact, include significant market-oriented elements, especially in comparison with other extant financial regulatory regimes. Over the past several years, however, prudential regulators overseeing the banking sector have made efforts to bring the SEC’s comparatively market-oriented approach to broker-dealer regulation more in line with the “safety and soundness” approach of banking regulations. This effort has intensified with the passage of the Dodd-Frank Wall Street Reform

and Consumer Protection Act (Dodd-Frank)³⁸ and the establishment and operation of the bank regulator-dominated Financial Stability Oversight Council (FSOC). Tellingly, the FSOC has invoked Section 120 of Dodd-Frank, which grants it the authority to “provide for more stringent regulation of financial activity by issuing recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards,”³⁹ only once, in an effort to pressure the Commission to tailor its regulations governing money market mutual funds in a manner more suitable to the prudential regulators of FSOC.⁴⁰

One key difference between the banking and the broker-dealer regulatory regimes is their differing capital rules. Bank capital rules are inherently centralized on both a national and a supranational basis, focusing on the safety and soundness not only of individual banks but of the banking sector as a whole. There is no broker-dealer equivalent to the Basel framework underlying bank capital requirements throughout the developed world (although the largest broker-dealers are generally subsidiaries of bank holding companies, which are subject to the Basel-based capital regime for banks). Crucially, there is no acknowledgment in the SEC’s net capital rule—tacitly or otherwise—of the concept of a too big to fail broker-dealer. The SEC’s net capital regime for broker-dealers focuses not on “systemic risk” but instead on the protection of individual investors.

Whereas bank capital requirements are predicated on the reduction of risk and the avoidance of failure, broker-dealer requirements are designed to *manage* failure by providing enough of a “cushion” to ensure that a failed broker-dealer can liquidate in an orderly manner, allowing for the orderly transfer of customer assets to another broker-dealer. Capital requirements for broker-dealers reflect the fact that the capital markets are based, in large part, on risk. They form a system designed to *encourage* investors and institutions to take risks—informed risks that they freely choose in pursuit of a return on their investments.

While bank failure is anathema to bank regulators, for broker-dealer regulators failure is a fact of life—an unavoidable element of the creative destruction that underpins capitalism. The broker-dealer net capital regime, with its different haircut requirements for different investment products, is heavily weighted in favor of highly liquid assets precisely because broker-dealers can, and do, fail.⁴¹ The goal of the net capital rule is to ensure that in the event of failure, a broker-dealer will have the necessary assets not only to cover its liabilities but

to facilitate a quick and orderly self-liquidation of the firm. Crucially, the net capital rule is designed to work in conjunction with the customer protection rule—the segregation of customer assets is meant to ensure an easy transfer of accounts from a failing broker-dealer to a healthy one.

The Securities Investor Protection Corporation (SIPC), a nonprofit membership corporation created pursuant to the Securities Investor Protection Act (SIPA),⁴² exists for the purpose of facilitating the liquidation of troubled broker-dealers and the return of customer property in a market-oriented manner. In a SIPA liquidation, SIPC (and in most cases a court-appointed trustee) work to return customers' securities and cash as quickly as possible. Unlike the Federal Deposit Insurance Corporation (FDIC), which is an independent federal agency providing, in essence, federally mandated deposit insurance, SIPC is primarily concerned with overseeing the liquidation of failed or failing firms with the goal of returning customer assets. SIPC's board of directors determines its policies and governs operations. Of its seven directors, five are appointed by the president subject to Senate approval. Three of those five directors represent the securities industry, while two are from the general public. The president is also responsible for designating a chairman and vice chairman. The remaining two directors are appointed by the secretary of the Department of the Treasury and the Federal Reserve Board from among the officers and employees of those organizations.

Another market-oriented element of broker-dealer regulation is the concept of self-regulation as embodied in the SRO construct. The Exchange Act codified the self-regulatory role of exchanges, requiring all existing exchanges to register with the newly formed SEC and function as SROs. Four years later, the Maloney Act of 1938 (Maloney Act)⁴³ authorized, and required the registration of, national securities associations to oversee over-the-counter (OTC) market participants. The legislative history of the Maloney Act explained Congress's desire to maintain and indeed increase its reliance on SROs, noting that relying solely on government regulation “would involve a pronounced expansion of the organization of the [SEC]; the multiplication of branch offices; a large increase in the expenditure of public funds; an increase in the problem of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation of business conduct by law.”⁴⁴

In 1975, the US Congress passed a number of amendments to the Exchange Act (the “1975 Amendments”),⁴⁵ which, among other things, endorsed the role

of SROs in securities regulation while simultaneously curtailing their independence. The legislative history of the 1975 Amendments explains Congress's determination that it was "distinctly preferable" to rely on "cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers, and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation," especially in light of the "sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale."⁴⁶ The 1975 Amendments, however, fundamentally altered the role of SROs by requiring, for the first time, that any new SRO rule or rule amendment be approved by the SEC. This laid the groundwork for criticism of the SROs' enhanced role based on the belief that they are essentially quasi-governmental entities serving as "deputies" to the SEC.

As explained in a 2005 SEC "Concept Release Concerning Self-Regulation" (SRO Concept Release),⁴⁷ the Exchange Act, the Maloney Act, and the 1975 Amendments "reflect Congress' determination to rely on self-regulation[.]" as a fundamental component of U.S. market and broker-dealer regulation[.] The SRO Concept Release noted a number of reasons for this determination, including the view that directly regulating the intricacies of the securities industry would be cost-prohibitive and inefficient, the desirability of SRO regulatory staff to be "intimately involved" with the complexities of rulemaking and enforcement, and the ability of SROs to set standards that exceeded those imposed by the Commission (e.g., just and equitable principles of trade and detailed proscriptive business conduct standards).⁴⁸ As the SRO Concept Release explained, "In short, Congress determined that the securities industry self-regulatory system would provide a workable balance between federal and industry regulation."⁴⁹

Self-regulation is, in theory, significantly more market-oriented than external regulation. Executed properly, self-regulation empowers the parties most familiar with the actual workings of securities transactions and with the greatest stake in ensuring public trust and confidence in the markets. It is more cost-effective and fluid than governmental regulation, allowing its members to react quickly and decisively to changes in the industry that they observe directly on a daily basis. Furthermore, the status of each exchange as an SRO introduces an element of competition that, ideally, negates the possibility of a "race to the bottom," allowing investors displeased with the self-policing methods and

results of a given exchange to transfer their business to one more suited to their tastes. Ironically, given prudential regulators' distaste for the decentralization and unpredictability of securities regulation, self-regulation embodies the concept of "skin in the game" mandated for securitizers of asset-backed securities in the "risk retention" provisions of Section 941 of Dodd-Frank.⁵⁰

Unfortunately, the present-day implementation of the self-regulatory concept falls short of its market-oriented potential. Beginning with the 1975 Amendments' requirement that the SEC approve new rules or rule amendments by SROs, a number of developments over the past several decades have resulted in a significant move away from the traditional SRO construct. A 1996 settlement between the SEC and the National Association of Securities Dealers (NASD), the predecessor of FINRA and the owner of the NASDAQ electronic stock market, over the failure of the NASD to enforce its rules against anti-competitive pricing policies by NASDAQ market makers required the NASD to agree to a number of undertakings that led to profound changes in its governance structure. These changes included the addition of public members to the NASD board and the increased prominence of professional staff in NASD regulatory matters, which substantially decreased the role of NASD members in self-regulation. As such, they marked a watershed event in what has been referred to as "the NASD's transformation into a professional regulator largely independent of its membership."⁵¹ Since then, the NASD and later FINRA have prioritized corporate governance issues (e.g., independent board membership) over member self-regulation, fundamentally altering the SRO concept.

An additional key development in the move away from the traditional SRO construct has been the transformation of exchanges into demutualized, for-profit entities. Notably, the then chairman and chief executive officer of the NASD highlighted, in a 2005 congressional hearing, "the concern . . . that for-profit, publicly traded exchanges will be faced with the conflicting goal [*sic*] of having to maximize profits while not compromising regulation."⁵²

In 2007, the NASD merged with the regulatory arm of the New York Stock Exchange to form FINRA. Since this event, exchanges have increasingly delegated their regulatory responsibilities to FINRA, calling into question the role of exchanges as SROs. In a 2013 letter to SEC Chair Mary Jo White, the Securities Industry and Financial Markets Association (SIFMA) explicitly seconded my call for a "comprehensive market and regulatory structure review, including a review of the self-regulatory paradigm as a whole."⁵³ SIFMA

noted that the incorporation of the role of SROs into federal securities law “was intended to serve two primary purposes: . . . it relieved the government of some of the burden of regulating the securities markets by instead delegating to and leveraging its oversight of the SROs [and] it was thought that regulation was more effective when conducted by an organization, such as an exchange, more familiar with the nuances of the business.” SIFMA concluded, however, that “with exchanges having outsourced and delegated a substantial majority of regulatory functions to [FINRA], neither reason justifies why exchanges should continue to act as SROs.”⁵⁴

This decrease in the “self” aspect of FINRA’s self-regulatory function has been accompanied by an exponential increase in its regulatory output. As FINRA acts more and more like a “deputy” SEC, concerns about its accountability grow more pronounced. While FINRA is generally required to address whether a proposed new rule or rule amendment would impose a burden on competition, conflict with the securities laws, or otherwise be inconsistent with the public interest or the protection of investors,⁵⁵ it is not required by statute or rule to conduct a benefit-cost analysis. However, FINRA’s September 2013 announcement of a “Framework Regarding FINRA’s Approach to Economic Impact Assessment for Proposed Rulemaking,”⁵⁶ a voluntary undertaking on its part to “help ensure that its rules are better designed to protect the investing public and maintain market integrity while minimizing unnecessary burdens,”⁵⁷ marked a significant positive development in this space.

FINRA’s voluntary undertaking draws attention to perhaps the most significant deficiency, from a market-oriented perspective, in broker-dealer regulation: the lack of a calculation and acknowledgment of the cumulative cost of compliance for broker-dealers. Although the SEC is not required by law to conduct an extensive economic analysis for every proposed new rule or rule amendment, it has been the Commission’s policy since the early 1980s to consider potential costs and benefits whenever it adopts rules. A staff memorandum issued in 2012 states that “[h]igh-quality economic analysis is an essential part of SEC rulemaking” and sets forth guidance for performing such analysis.⁵⁸ Even the Commission’s most fulsome reviews of potential costs and benefits, however, fail to take into account the existing regulatory burden. This burden, substantial even before the financial crisis of 2008, has arguably grown significantly, and will continue to grow, due to the extensive requirements of Dodd-Frank.

Despite the lack of information on the cumulative cost to broker-dealers of the regulatory regime, one metric does stand out. In September 2007, there were 5,799 broker-dealers registered with the Commission. As of August 2016, that number had dwindled to 4,115.⁵⁹ Obviously, not all of this decrease can be attributed to the increased compliance costs facing broker-dealers in a post-Dodd-Frank world, especially given the intervening financial crisis. Only the most fervent free-market opponents, however, would deny that the ever-increasing cost of compliance has played a role in the reduction of the number of broker-dealers by almost 30 percent in less than a decade.

CONCLUSION

Although the broker-dealer regulatory regime does incorporate significant market-oriented elements, improvements can be made on both the self-regulatory and economic analysis fronts. Specifically, broker-dealer regulation would benefit from a return to true self-regulation by SROs, as opposed to the arguably quasi-governmental “deputy SEC” role they play today. In addition, broker-dealers and their customers would benefit from enhanced economic analysis on the part of both the SEC and the SROs, in particular analysis of the potential costs of new rules or rule amendments that takes into account the existing regulatory burden on broker-dealers.

NOTES

1. 15 U.S.C. § 78c(a)(4).
2. 15 U.S.C. § 78c(a)(5).
3. Section 15(a) of the Exchange Act requires broker-dealers to register with the SEC if the broker-dealer makes “use of . . . any means . . . of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security” other than exempted securities. Section 3(a)(17) of the Exchange Act defines the term “interstate commerce” to include “trade, commerce, transportation, or communication among the several States, or between any foreign country and any State.” Virtually any transaction-related contact between an intermediary meeting the definition of “broker” or “dealer” and the US securities markets or an investor in the United States involves interstate commerce and provides the basis for requiring the intermediary to register as a broker-dealer.
4. See Exchange Act Rule 15b1-1. Form BD also elicits information regarding whether the applicant or any of its control affiliates has been subject to a bankruptcy petition, had a trustee appointed under the Securities Investor Protection Act, has been denied a bond, or has any unsatisfied judgments or liens. Form BD is a consolidated form that was established by the Commission, SROs, and state regulators to allow an applicant to initiate registration with all relevant regulators using one form.

5. Exchange Act Section 15(b)(8). The Exchange Act defines an SRO as “any national securities exchange, registered securities association, or registered clearing agency, or (solely for the purposes of sections 19(b), 19(c) and 23(b) of [the Exchange Act]) the Municipal Securities Rulemaking Board established by section 15B. . . .” See Exchange Act Section 3(a)(26), 15 U.S.C. § 78c(a)(26).
6. There are twenty national securities exchanges registered with the SEC: BATS BZX Exchange, BATS BYX Exchange, BOX Options Exchange, C2 Options Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, EDGA Exchange, EDGX Exchange, International Securities Exchange, The Investors Exchange, ISE Gemini, ISE Mercury, Miami International Securities Exchange, The NASDAQ Stock Market, NASDAQ BX, NASDAQ PHLX, National Stock Exchange, New York Stock Exchange, NYSE MKT, and NYSE Arca. Fast Answers: Exchanges, <https://www.sec.gov/divisions/marketreg/mrexchanges.shtml> (last retrieved August 8, 2016).
7. See, for example, Exchange Act Sections 6(b) and 15A(b), 15 U.S.C. §§ 78f(b) and 78o-3(b).
8. See Exchange Act Sections 6(b)(2) and 6(c), 15 U.S.C. §§ 78f(b)(2) and (c).
9. Exchange Act Section 15(b)(8). Pursuant to Exchange Act Rule 15b9-1, certain broker-dealers that are members of a national securities exchange, carry no customer accounts, and have annual gross income of no more than \$1,000 that is derived from securities transactions effected otherwise than on a national securities exchange of which they are a member (not including income derived from proprietary trading) may be exempt from registration with a national securities association. However, the SEC has proposed to, among other things, limit the scope of Rule 15b9-1 by eliminating the proprietary trading exemption. See “Exemption for Certain Exchange Members,” Exchange Act Release No. 74581 (March 25, 2015).
10. 17 C.F.R. § 240.15b7-1.
11. See, for example, National Association of Securities Dealers Rules 1022 and 1032, and Chicago Board Options Exchange Rule 3.6A(a).
12. Section 3(a)(16) of the Exchange Act defines “State” to mean “any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.” 15 U.S.C. § 78c(a)(16).
13. Exchange Act Rule 15b1-1(b). The CRD was developed and is maintained jointly by the North American Securities Administrators Association and FINRA. The CRD is an online registration data bank and application processing facility used by FINRA, the other SROs, state regulators, and the SEC in connection with the registration and licensing of broker-dealers and their personnel. The CRD was created, in part, to centralize the registration process, allowing applicants to file in one place, rather than filing separately in multiple jurisdictions. “Broker-Dealer Registration and Reporting,” Exchange Act Release No. 41594 (July 2, 1999), 64 Fed. Reg. (July 12, 1999): 37586.
14. 15 U.S.C. § 78o(c)(3); 17 C.F.R. § 240.15c3-1.
15. Typically, affiliates (e.g., the holding company) or owners of the broker-dealer make subordinated loans to the broker-dealer for capital purposes.
16. The fixed-dollar amounts are based on the type of securities business in which the broker-dealer engages. For example, a broker-dealer that carries customer accounts has a fixed-dollar requirement of \$250,000; a broker-dealer that does not carry customer accounts but engages in proprietary securities trading (defined as more than ten trades a year) has a fixed-dollar amount of \$100,000; and a broker-dealer that does not carry accounts for customers or otherwise receive or hold securities and cash for customers, and does not engage in proprietary trading activities, has a fixed-dollar amount of \$5,000.

17. Put another way, the broker-dealer must maintain, at a minimum, an amount of net capital equal to one-fifteenth (or 6.67 percent) of its aggregate indebtedness. This financial ratio is used by smaller broker-dealers that do not carry customer accounts.
18. Customer debit items—computed pursuant to Rule 15c3-3—primarily consist of margin loans to customers and securities borrowed by the broker-dealer to effectuate deliveries of securities sold short by customers. See 17 C.F.R. § 240.15c3-3 and 17 C.F.R. § 240.15c3-3a. This ratio is used by larger broker-dealers that maintain custody of customer securities and cash.
19. Net worth is the amount by which the broker-dealer's assets exceed its liabilities.
20. Non-allowable assets also include unsecured receivables and illiquid securities (e.g., securities that have no ready market).
21. Because of the net capital rule's strict asset liquidity requirements, broker-dealers typically rely on qualifying subordinated loans to meet their minimum net capital requirements. Typically, a control person of the broker-dealer, such as its parent holding company, makes the subordinated loan. The net capital rule prescribes a number of requirements for a subordinated loan to qualify as an add-back to net worth. Most important, the loan agreement must provide that the broker-dealer cannot repay the loan at term if doing so would reduce its net capital to certain levels above the minimum requirement. This contractual prohibition, in effect, makes the subordinated loan similar to preferred stock in that the loan would take on the characteristics of permanent capital if the broker-dealer could not repay it. 17 C.F.R. § 240.15c3-1d(b).
22. For a fuller expert discussion of the net capital rule, see Sirri (Director, Division of Trading and Markets, US Securities and Exchange Commission), "Remarks at the National Economist's Club."
23. 17 C.F.R. § 240.15c3-3(b)(1).
24. 17 C.F.R. § 240.15c3-3(c).
25. 17 C.F.R. § 240.15c3-3(a).
26. 17 C.F.R. § 240.15c3-3(k).
27. 17 C.F.R. § 240.15c3-3(k)(2)(ii).
28. See 17 C.F.R. § 240.15c3-3(k)(2)(i).
29. Exchange Act Sections 9(a), 10(b) and 15(c)(1) and (2); 15 U.S.C. §§ 78i(a), 78j(b), and 78o(c)(1)-(2).
30. See "Study on Investment Advisers and Broker-Dealers," 51. This SEC Staff study cites the "Report of the Special Study of Securities Markets of the Securities and Exchange Commission," H.R. Doc. No. 88-95, at 238 (1st Sess. 1963); "In the Matters of Richard N. Cea et al.," Exchange Act Release No. 8662 at 18 (August 6, 1969), involving excessive trading and recommendations of speculative securities without a reasonable basis; "In the Matter of Mac Robbins & Co. Inc.," Exchange Act Release No. 6846 (July 11, 1962).
31. "Guide to Broker-Dealer Registration."
32. See FINRA Rule 2111.
33. See FINRA Rule 5310.
34. *Ibid.* A member firm, in any transaction for or with a customer or a customer of another broker-dealer, is required to use "reasonable diligence" to determine the best market for a security and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. See also FINRA Regulatory Notice

- to Members 12-13, March 2012, citing five factors that are among those to be considered in determining whether a firm has used reasonable diligence: (1) the character of the market for the security; (2) the size and type of transaction; (3) the number of markets checked; (4) the accessibility of the quotation; and (5) the terms and conditions of the order as communicated to the firm).
35. See 17 C.F.R. § 242.200-204
 36. See 17 C.F.R. § 242.100-105.
 37. Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to conduct a study to evaluate, among other things, the effectiveness of existing legal or regulatory standards of care for broker-dealers as well as whether there are legal or regulatory gaps in the protection of retail customers relating to the standards of care for broker-dealers. See the January 2011 “Study on Investment Advisers and Broker-Dealers.” Dodd-Frank also granted the SEC authority to impose a fiduciary standard on broker-dealers. As of this writing, the SEC has not conducted any additional rulemaking pursuant to this grant of authority. The Department of Labor, however, proposed in 2010, repropoed in 2015, and adopted in 2016 a fiduciary standard for broker-dealers advising employee benefit plans under the Employee Retirement Income Security Act of 1974.
 38. Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
 39. Pub. L. No. 111-203, 124 Stat. 1376, Sec. 120 (2010).
 40. See “Financial Stability Oversight Council: Proposed Recommendations Regarding Money Market Mutual Fund Reform,” 77 Fed. Reg. (November 2012): 69455–483.
 41. That being said, however, far more banks fail. For example, nearly 550 banks have failed since October 1, 2000. See the FDIC, “Failed Bank List.” In contrast, as of December 2015, the SIPC had processed a total of 328 proceedings since its inception in 1973. See SIPC, “2015 Annual Report,” 8.
 42. 15 U.S.C. § 78aaa-III, as amended through July 22, 2010.
 43. Maloney Act of 1938, Pub. L. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o, authorizing the US Securities and Exchange Commission to register national securities associations).
 44. S. Rep. No. 1455, 75th Cong., 3d Sess. I.B.4. (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess. I.B.4. (1938) (duplicate text quoted in both reports).
 45. Securities Acts Amendments of 1975, Pub. L. 29, 89 Stat. 97 (1975).
 46. S. Rep. No. 94-75, 94th Cong., 1st Sess. 7, II (1975).
 47. See Exchange Act 50700 (November 18, 2004), “Concept Release on SRO Structure,” 60 Fed. Reg. (December 8, 2004): 71256.
 48. “Concept Release on SRO Structure.” See generally S. Rep. No. 1455, 73d Cong., 2d Sess. (1934); H.R. Doc. No. 1383, 73d Cong., 2d Sess. (1934); S. Rep. No. 1455, 73d Cong., 2d Sess. (1934).
 49. See “Concept Release on SRO Structure,” 71256.
 50. Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376, Sec. 941 (2010).
 51. Black, “Punishing Bad Brokers,” 36. See generally Peirce, “Financial Industry Regulatory Authority.”
 52. *Self-Regulatory Organizations: Exploring the Need for Reform, Hearing before the Subcommittee on Capital Markets, Insurance, and Government Enterprises of the Committee*

on *Financial Services of the US House of Representatives*, 109th Cong., 1st Session (November 17, 2005) (statement of Robert R. Glauber, chairman and chief executive officer, NASD), 3.

53. Letter from Chair of the SEC Mary Jo White to SIFMA, July 31, 2013 (citing Gallagher, “Market 2012”).
54. *Ibid.*, 4.
55. See 17 C.F.R. 240.19b-4 and Form 19b-4.
56. FINRA, “Framework Regarding FINRA’s Approach.”
57. FINRA, “FINRA Issues Public Statement.”
58. “Current Guidance on Economic Analysis.”
59. This number was calculated from SEC, Current Broker-Dealer Information Report.

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