UNIT 10 Regulation of Investment Adviser Representatives

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- LO 10.a **Define** an investment adviser representative.
- LO 10.b **Identify** exclusions and exemptions from the definition of investment adviser representative under the Uniform Securities Act.
- LO 10.c **Describe** the investment adviser representative registration process, required post-registration filings, and business activities.

Your exam will include approximately four questions from the topics covered in Unit 10.

INTRODUCTION

In Unit 9, we defined an investment adviser and determined who was excluded from the definition or exempt from registration and, if required to register, with whom and how. In this unit, we will cover those individuals who represent investment advisers: investment adviser representatives. One important regulatory note is that, unlike investment advisers who register either on a federal or a state level, registration requirements of representatives only come under the jurisdiction of the states. That is why this is a NASAA exam rather than one sponsored by FINRA or the SEC.

LESSON 10.1: WHO IS AN INVESTMENT ADVISER REPRESENTATIVE?

LO 10.a Define an investment adviser representative.

Let's begin by looking at the final word in the phrase investment adviser representative: *representative*. Representatives always represent someone else. In this case, these are individuals who represent an investment advisory firm. As defined in the law, an *investment adviser representative (IAR)* is any partner, officer, director (or an individual occupying a similar status or performing similar functions), or other individual employed by or associated with an investment adviser and is registered or required to be registered under the Uniform Securities Act. Remember, IARs register only with the states. An individual meets the definition of an IAR by doing any of the following:

- Makes any recommendations or otherwise renders advice regarding securities
- Manages accounts or portfolios of clients
- Determines which recommendation or advice regarding securities should be given
- Solicits, offers, or negotiates for the sale of or sells investment advisory services
- Supervises employees who perform any of the foregoing

EXAMPLE

An individual employed by an investment adviser who manages investment portfolios for clients is considered an investment adviser representative. So is the individual who supervises that person. Under state law, there is no distinct registration for supervisory persons as there is under FINRA's rules for broker-dealers; even the CEO is registered as an IAR.

TAKE NOTE

The use of the term *individual* here is important. Only an individual, or a natural person, can be an investment adviser representative. The investment advisory firm is the legal person (entity) that the IAR (natural person) represents in performing the above listed functions.

TAKE NOTE

An individual may act as both an investment adviser and an investment adviser representative. This is typically the case when the business is organized as a sole proprietorship. However, an individual who acts solely as an investment adviser representative is excluded from the definition of investment adviser.

LO 10.b Identify exclusions and exemptions from the definition of investment adviser representative under the Uniform Securities Act.

Just as with investment advisers, the laws provide for exclusions for the definition and exemptions for those who are defined as IARs.

Exclusions from the Definition of Investment Adviser Representative

Certain employees of investment advisory firms are excluded from the term *investment adviser representative,* provided their activities are confined to clerical or administrative duties or those activities that are solely incidental to the investment advisory services offered, such as mailing out a research report to an advisory client when directed by an IAR. Should the investment advisory employee "step over the line," as the saying goes, and perform any activity that makes one an IAR, the employee would then have to register as an investment adviser representative.

In addition, an individual is not an investment adviser representative if the person does not on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser or provides only impersonal investment advice.

Let's define that last term because you're going to see it a number of times in this course. *Impersonal investment advice* means investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts.

PRACTICE QUESTION

Which of the following individuals would be defined as an investment adviser representative?

A. Melinda, one of the firm's research analysts who has no contact with public clients
B. Johnny, an employee who makes cold calls soliciting for new advisory clients
C. Mel, who prepares client account statements
D. Jane, who is the firm's VP of HR services

Answer: B. One of the functions that makes a supervised person an IAR is soliciting for new business. Research personnel are not considered IARs unless they have client relationships. Mel's job is purely clerical and, even though Jane is a vice president, the HR department is far removed from anything to do with giving investment advice.

Exemptions from Registration as an Investment Adviser Representative

There are three different exemptions available for those defined as IARs. Two of these are for those who represent state-registered IAs and the other for those who represent federal covered IAs.

- If the individual represents a state-registered adviser, there is a de minimis exemption. Just as is the case with investment advisers, if an IAR does not maintain a place of business in the state and, during the preceding 12-month period, has had no more than five retail clients, registration in the state is not required.
- The previously mentioned *snowbird* exemption also applies to these IARs.

- If the individual represents a federal covered investment adviser, there is a special exemption under Section 203A of the 1940 Act. Keeping it simple, it states that for those performing as IARs for covered advisers, IAR registration is required only in those states where that individual has a place of business. Place of business of an investment adviser representative means:
  - an office at which the investment adviser representative regularly provides investment advisory services or solicits, meets with, or otherwise communicates with clients; and
  - any other location that is held out to the general public as a location at which the investment adviser representative provides investment advisory services or solicits, meets with, or otherwise communicates with clients.

PRACTICE QUESTIONS

1. Under the Uniform Securities Act, which of the following is **not** required to register as an investment adviser representative?
   A. A director of a state-registered investment advisory firm who determines specific recommendations for clients
   B. An associate in an SEC-registered investment advisory firm who has a place of business in the state and manages the account of only one individual client
   C. A clerk employed by a state-registered investment advisory firm
   D. A vice president of a state-registered investment advisory firm who supervises employees who solicit clients for the firm

   Answer: C. Clerical and ministerial (administrative) personnel are specifically excluded from the definition of investment adviser representative. Specifically included in the definition are directors, officers, partners, associates, and employees of state-registered advisers who carry out investment advisory or solicitation functions or who supervise those functions. Also included in the definition are persons who perform similar functions for SEC-registered advisers and who have a place of business in the state. Once there is a place of business in the state, the de minimis rule no longer applies.

2. Which of the following individuals would be required to register with the Administrator of a state?
   A. Walter, who represents a state-registered adviser, has no place of business in the state and only serves existing clients who vacation in the state.
   B. May, who represents a covered adviser, has no place of business in the state and has 38 clients who reside in the state.
   C. Aliza, who represents a state-registered adviser, has no place of business in the state and had fewer than six individual clients who were residents of the state during the past 12 months.
   D. Joe, who represents a covered adviser, has a place of business in the state and had four retail clients who were residents of the state during the past 12 months.

   Answer: D. Once an IAR maintains a place of business in a state, they must register in that state regardless of the number of clients—such is the case with Joe. Walter need not register because he qualifies for the snowbird exemption. May qualifies for the exemption as an IAR of a federal covered investment adviser. She is only required to register in those states where she maintains a place of business. Aliza qualifies for the de minimis exemption (fewer than six is the same as five or fewer).

Important note: Even if May's employer had a place of business in the state, she would not have to register because she, the IAR, doesn't. Of course, her employer, being federal covered, doesn't register in any states.

KNOWLEDGE CHECK 10.1

1. Which of the following would be permitted to register as an investment adviser representative?
   A. A corporation
   B. An individual
   C. A partnership
   D. All of these
2. An individual representing a state-registered investment adviser would *not* qualify for the de minimis exemption in a state if, over a 12-month period, she had
   A. five retail clients.
   B. five or fewer retail clients.
   C. fewer than six retail clients.
   D. six or fewer retail clients.

LESSON 10.2: REGISTRATION AND POST-REGISTRATION REQUIREMENTS OF INVESTMENT ADVISER REPRESENTATIVES

LO 10.c Describe the investment adviser representative registration process, required post-registration filings, and business activities.

IAR Registration Process

As we learned with investment advisers, if you are not excluded from the definition of investment adviser representative or if you don't qualify for one of the exemptions, then you have to register. And, as pointed out earlier, it is only on the state level that an IAR registers, so we don't have the issue of comparing state and federal law as we do with IAs.

Unless properly registered, it is unlawful for any registered investment adviser to engage the services of an individual as an investment adviser representative if that individual is required to register. This is true whether the investment adviser is state-registered or federal covered. All IARs must be registered in at least one state (they have to have a place of business somewhere, right?).

Registration is accomplished by filing a Form U4 (a Form U10 can be used in certain cases, but that is unlikely to be tested) through FINRA's CRD (Central Registration Depository). Most of you have already completed that form, so you know it asks about your personal history and details. One of the most important parts is the DRPs, the Disclosure Reporting Pages. It is on these pages that the applicant discloses past disciplinary events. Form U4 requires disclosing if you have ever been convicted or even just charged (an arrest without a charge is not reportable), with no time limit, for any felony or securities-related misdemeanors. In Unit 12, we'll discuss how those can affect the application. Another important part of Form U4 is the Consent to Service of Process, mentioned earlier in Unit 9 in conjunction with the registration of an IA.

One other requirement—the reason you are reading this book—you must pass an exam, either the Series 65 or, if appropriate, the Series 66. Please refer to the Introduction for a list of the professional designations for which a waiver from taking the Series 65 exam is available.

Automatic Registration of Certain Individuals

Here is an important item dealing with registration that is frequently tested.

The Uniform Securities Act states, "Registration of an investment adviser automatically constitutes registration of any investment adviser representative who is a partner, officer, or director, or a person occupying a similar status or performing similar functions."

It isn't only the title that determines your registration; it is also the function performed. Note that the rule quoted above states that the IAR is a partner, officer, or director of the investment adviser. Doesn't that mean they are already registered? What is the purpose of "automatic" registration to someone already registered?

When a state-registered IA expands its business so that registration is required in another state (or states), the application process is basically the same as their initial state registration. That is, a Form ADV is filed. That filing includes the names and other pertinent information about all of the partners, officers, or directors who are already acting as IARs. Therefore, when the firm's registration becomes effective in that "new" state, those individuals included in the filing are granted automatic registration—they don't have to file an individual Form U4. Please note that it is not any IAR, but only those listed or, as the rule states, those occupying a similar status, etc., who receive this treatment. Any of the firm's other existing IARs who will need to be registered in the "new" state must file an amended Form U4 with the Administrator and wait for their supervisor to tell them that the firm has received the word that their registration is effective with that state.

PRACTICE QUESTION

When an investment adviser registers in a new state, which of the following are automatically registered as IARs?

A. Any employee who is functioning as an IAR in at least one state
B. Officers, partners, and directors of the firm who are functioning as IARs
C. Clerical employees stuffing the envelopes with research reports
D. Any employee who will be soliciting clients for the adviser

Answer: B. As we just stated, the "automatic registration" provision applies to those officers, partners, and directors of the IA who are already IARs in at least one state.

Important note: For those of you who have taken a FINRA exam, you know there is a supervisory level of registration—registered principal. No such gradations apply under NASAA rules. So, no matter how high ranking the officer of the investment advisory firm, that individual registers as an IAR. Therefore, anytime you see reference made to your supervisor, remember, that person is an IAR just like you.

Testing

Unless a waiver is granted (see Introduction), passing the Series 65 exam is a requirement for registration as an investment adviser representative. We do expect you to pass, but, if an applicant is not successful on the first or second attempt, there is a 30-day waiting period before the exam may be retaken. After the third (and subsequent) attempts, the waiting period is 180 days.

Now that you know how to register, what about termination procedures?

IAR Termination Procedures

If an investment adviser representative terminates employment with an investment adviser, notification requirements depend on how the investment adviser is registered.

If the investment adviser is a state-registered adviser, the firm must notify the Administrator. If the investment adviser is a federal covered adviser, the investment adviser representative must notify the Administrator. All notifications must be made **promptly**.

A clue that might help is to visualize the "*I*" in IAR as the number "1" to remember that only one person gives notification. What is the story if the IAR leaves one firm to go to another?

PRACTICE QUESTION

Zack is an IAR with Unicorn Investment Advisers (UIA), an investment adviser registered in State W. Zack has accepted an employment offer from Elite Research Associates (ERA), an investment adviser also registered in State W. What are the notification requirements to the State W Administrator?

A. Zack is the only person who notifies the Administrator.
B. UIA is the only person who notifies the Administrator.
C. ERA is the only person who notifies the Administrator.
D. UIA and ERA notify the Administrator.

Answer: D. This is bit sneaky. We've just told you to remember the "I" in IAR resembles the number "1," so only one person must notify. We've also stated that, if the IAR represents a state-registered investment adviser, it is the IA who does the notification. In this specific instance, because two IA firms are involved, each of them must notify the Administrator: UIA that Zack is no longer under their control and ERA that Zack now is. This is just an example of how every rule has an exception.

Financial Requirements of IARs

Unlike an investment adviser, there are no financial requirements—no net worth or bonding requirements—to register as an investment adviser representative. The fact that the IAR applicant must be solvent (not adjudicated bankrupt) is not considered a financial requirement.

Recordkeeping Requirements of IARs

Unlike an investment adviser, there are no ongoing recordkeeping requirements for IARs. Annual renewal on December 31 requires the payment of fees. If there are any material changes, especially of a disciplinary nature, the individual's Form U4 must be updated within 30 days.

TEST TOPIC ALERT

If there should be a change to any material information in Form U4 (e.g., change of permanent address or change to military status), an amendment must be filed within 30 days.

PRACTICE QUESTION

When an investment adviser representative's permanent residence address changes, updates must be made to the information on file with the regulatory bodies. The proper procedure to be followed is

A. file a Form U4 within 30 days.
B. file a Form U4 within 45 days.
C. file a Form U5 within 30 days.
D. file a Form U5 within 45 days.

Answer: A. Amendments are made to Form U4 and must be filed within 30 days. Form U5 is for terminations.

KNOWLEDGE CHECK 10.2

1. Registration of an investment adviser automatically confers registration on
   A. officers of the firm who are functioning as IARs.
   B. partners of the firm who are functioning as IARs.
   C. directors of the firm who are functioning as IARs.
   D. all of the above.

2. Angelo is registered as an agent for Rentable Investment Brokers (RIB). The firm has just registered as an investment adviser in order to offer wrap fee programs to its customers. If Angelo wishes to offer this program to his clients, he will have to apply for registration as an investment adviser representative on an amended
   A. Form ADV.
   B. Form BD.
   C. Form U4.
   D. Form U5.

KNOWLEDGE CHECK ANSWERS

Knowledge Check 10.1

1. **B** Only individuals (natural persons) are eligible to register as IARs. If the question simply asked about registering as an investment adviser, the correct answer would have been all of the above.

   LO 10.a

2. **D** Because the maximum is five retail clients in a 12-month period, choice D, with six clients, is over the limit. Notice that "fewer than six" and "five or fewer" mean the same thing.

   LO 10.b

Knowledge Check 10.2

1. **D** Section 202 of the Uniform Securities Act states that registration of an investment adviser automatically constitutes registration of any investment adviser representative who is a partner, officer, or director, or a person occupying a similar status or performing similar functions.

   LO 10.c

2. **C** Even though Angelo has already filed a Form U4 when he became an agent, he now must file another Form U4 amending the original application to indicate this new requested registration. Form U5 is for termination, and the ADV and BD are for the firms, not individuals.

   LO 10.c

UNIT 11

Regulation of Broker-Dealers and Their Agents

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- LO 11.a **Define** a broker-dealer.
- LO 11.b **Identify** broker-dealer exclusions and exemptions under the Securities Exchange Act of 1934 and the Uniform Securities Act.
- LO 11.c **Define** an agent.
- LO 11.d **Identify** agent exclusions and exemptions under the Uniform Securities Act.
- LO 11.e **Describe** the initial and post-registration requirements of the Securities Exchange Act of 1934 and the Uniform Securities Act regarding broker-dealers.
- LO 11.f **Describe** the initial and post-registration requirements of the Securities Exchange Act of 1934 and the Uniform Securities Act regarding agents.

Your exam will include approximately four questions from the topics covered in Unit 11.

INTRODUCTION

We have already discussed two of the four securities professionals covered under the Uniform Securities Act (and federal law): investment advisers and those who represent them, investment adviser representatives. This unit will cover the other two: broker-dealers and those who represent them, agents.

LESSON 11.1: WHO IS AND WHO IS NOT A BROKER-DEALER?

LO 11.a Define a broker-dealer.

When describing the exclusions from the definition of an investment adviser (Unit 9, LO 9.a), we gave a brief definition of a broker-dealer (BD). Let's get into more detail.

A **broker-dealer** is defined in the Securities Exchange Act of 1934 (the federal law regulating broker-dealers and their representatives) and in the USA as any *person* (think back to the broad definition we gave you at the beginning of Unit 9) engaged in the business of effecting transactions in securities for the accounts of others or for its own account. Any person (e.g., a securities firm, even one organized as a sole proprietorship) with an established place of business (an office) in the state that is in the business of buying and selling securities for the accounts of others (customers) and/or for its own proprietary account is a defined as a broker-dealer.

In other words, broker-dealers are firms for which agents (registered representatives) work. They are firms that engage in securities transactions, such as sales and trading. When acting on behalf of their customers—that is, buying and selling securities for their clients' accounts—broker-dealers act in an agency capacity. When broker-dealers buy and sell securities for their own accounts, called proprietary accounts, they act in a principal capacity as dealers. We'll cover their activity in this regard in Unit 23.

TAKE NOTE

Individuals who buy and sell securities for their own accounts are not broker-dealers because they are engaged in personal investment activity, not the business of buying and selling securities for others. They are individual investors, not securities dealers.

TEST TOPIC ALERT

One of the roles of a broker-dealer is underwriting (distributing) shares of new securities for issuers. When they do that, they generally earn a spread (the difference between the public offering price and what they pay the issuer) or receive a commission on the sales, which they then use to pay their agents who actually made the sales to the clients. Previously, in Unit 8, we covered the registration and issuance of securities.

LO 11.b Identify broker-dealer exclusions and exemptions under the Securities Exchange Act of 1934 and the Uniform Securities Act.

Exclusions from the Definition of Broker-Dealer

Broker-dealers are firms that buy and sell securities for others or themselves as a business. There are, however, many persons, legal and natural, that effect securities transactions that are excluded from the definition of broker-dealer for purposes of state regulation. Persons **excluded** from the definition of broker-dealer are:

- agents (those individuals who represent broker-dealers);
- issuers (those entities such as corporations and governments who raise money by issuing securities); and
- banks, savings institutions, and trust companies.

Today, most banks and other financial institutions engage in securities activities through broker-dealer subsidiaries of the bank holding company. The broker-dealer subsidiaries of banks are, as a result, not excluded from the definition of a broker-dealer and therefore subject to the same securities regulations as other broker-dealers. Keep in mind that formation of these subsidiaries eliminates the need for the bank holding companies to register as broker-dealers. Their broker-dealer subsidiaries must, of course, register.

- Broker-dealers with no place of business in the state. This exclusion is very much like the one offered to investment advisers. States exclude from the definition of broker-dealer those broker-dealers that:
  - have no place of business in the state and deal exclusively with the issuers of the securities involved in the transactions, other broker-dealers, and other financial institutions, such as banks, savings and loan associations, trust companies, insurance companies, investment companies, or employee benefit plans with assets of not less than $1 million ($1,000,000);
  - have no place of business in the state but are licensed in a state where they have a place of business, and offer and sell securities in the state only with persons in the state who are existing customers and who are not residents of the state; or
  - qualify under the snowbird rule—similar to the rule for investment advisers and their representatives, the USA also allows broker-dealers and their agents to do business with existing customers who are temporarily in a state to avoid unnecessary multiple registrations.

EXAMPLE

As long as your client has not changed their state of residence, there is no time limit. Many people, after a couple of years in the workforce, decide to get an MBA. If they go out of state to a resident program for a year or two, that does not mean they've changed their state of residence, but merely that they are not commuter students. Only when official residency is changed (new driver's license or voter registration) does the 30-day rule apply.

TEST TOPIC ALERT

Unlike investment advisers and their IARs, there is no de minimis exemption for broker-dealers. That is, even if the BD does not maintain a place of business in the state, a single retail client means registration is required.

State Exemptions from Registration as a Broker-Dealer

Obviously, there was no internet when the Uniform Securities Act was written in 1956. As with other changes in the way we do business, NASAA has written Model Rules to update the regulatory scheme. A firm's website, considered advertising, can be seen everywhere. Does that mean the firm has a place of business in the state? Without getting too technical, there are several requirements to ensure that the person is not deemed to be in the state:

- The communication clearly states that the person may only do business in this state if properly registered or exempt from registration.
- Any follow-up individualized responses with prospects in this state that involve either the effecting or attempting to effect transactions in securities, or the rendering of personalized investment advice for compensation, as may be, will not be made without compliance with state broker-dealer, investment adviser, agent, or IA representative registration requirements, or an applicable exemption or exclusion.

- The site may only make available general information, not specific advice or recommendations.

In the case of an agent or IAR:

- the affiliation with the broker-dealer or investment adviser of the agent or IAR is prominently disclosed within the communication;
- the broker-dealer or investment adviser with whom the agent or IAR is associated retains responsibility for reviewing and approving the content of any internet communication by an agent or IAR;
- the broker-dealer or investment adviser with whom the agent or IAR is associated first authorizes the distribution of information on the particular products and services through the internet communication; and
- in disseminating information through the internet communication, the agent or IAR acts within the scope of the authority granted by the broker-dealer or investment adviser.

What this basically means is that if you just generally advertise on the internet, you don't have to be registered in the state. However, if you follow-up with advice (IAR) or offer securities (agent), you either have to register or find some kind of exemption.

TEST TOPIC ALERT

The exam focuses more on the exclusions from the definition of broker-dealer than on the definition itself. Know these exclusions well.

EXAMPLE

This is an example of the exclusion from the definition of broker-dealer:

First Securities Corporation (FSC) is a broker-dealer registered in State A, the location of its only office. One of their agents contacts a client who is currently on vacation in State B and recommends the purchase of XYZ common stock. The client agrees and purchases 100 shares of XYZ. Neither the broker-dealer nor the agent is registered in State B. Is this a problem? What if the client enjoys being in State B to the extent that it becomes his permanent residence?

When a broker-dealer has no place of business in a state and deals with an existing client who is temporarily in that state, the USA does not define that entity as a broker-dealer in the state. Therefore, FSC would not be required to register in State B, and neither would any of its agents.

Things change, however, if the client becomes a resident of State B. Once that client's residence has officially changed, the relationship can only continue for a maximum of 30 days. After that, both FSC and the agent would have to register in State B if they wanted to keep the client. Let's take the example one step further.

First Securities Corporation (FSC) is a broker-dealer registered in State A, the location of its principal office. They have begun doing business in State B with the First Fidelity Bank and Trust Company and open a small branch office in State B to service the account. Which of the following statements is **correct**?

A. FSC does not need to register in State B because its only client is an institution.
B. FSC needs to register in State B because it has a place of business in the state.
C. Broker-dealers are only required to register in the state where their principal office is located.
D. FSC would have to register in State B even if it didn't have a place of business there.

We learned that the USA excludes from the definition of broker-dealer a firm with no place of business in a state whose only clients are, among others, institutions, such as banks. That exclusion only applies when there is no place of business in the state; opening a small branch in State B voids that exclusion, so B is the correct answer. Even if there is no place of business in the state, if they have a single individual (called a *retail client* on the exam) who resides in the state, then registration is always required.

Federal Exemptions from Registration as a Broker-Dealer

A broker-dealer that conducts all of its business in one state is exempt from registration with the SEC. The exception provided for intrastate broker-dealer activity is very narrow. To qualify, all aspects of all transactions must be done within the borders of one state. This means that, without SEC registration, a broker-dealer cannot participate in any transaction executed on a national securities exchange. Intrastate broker-dealers register with the state in which they are located.

This chart should help (the "you" here does not mean individuals like yourself—it is referring to the brokerage firm).

Under the USA, you are a broker-dealer if:	**Under the USA, you are not a broker-dealer if:**
1. you have a place of business in the state regardless of the nature of your clients; or	1. you have no place of business in the state AND
2. you have even one retail client in the state.	2. your only clients are other BDs, institutions, and issuers of the security involved in the transaction; or
	3. you are registered in a state where you do maintain a place of business and only do business in this state with existing clients who are not residents of this state (snowbirds).

KNOWLEDGE CHECK 11.1

1. Under the Uniform Securities Act, a broker-dealer is defined as any person who
   A. buys securities.
   B. sells securities.
   C. is in the business of effecting securities transactions for its own account or for the accounts of others.
   D. is registered with the SEC.
2. A broker-dealer, having no place of business in the state, would be exempt from registration under the Uniform Securities Act if its only clients were
   I. banks or other financial institutions.
   II. investment companies.
   III. accredited investors.
   A. I and II
   B. I and III
   C. II and III
   D. I, II, and III

LESSON 11.2: WHO IS AND WHO IS NOT AN AGENT?

LO 11.c Define an agent.

Agent means any individual, other than a broker-dealer, who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities. As agents, they act, usually on a commission basis, on behalf of others. Other than on this exam, agents are often referred to as **registered representatives**, whether they sell registered securities or securities exempt from registration.

The use of the term *individual* here is important. Only an individual (a natural person) can be an agent. A corporation, such as a brokerage firm, is not a natural person—it is a legal entity. The brokerage firm is the legal person (legal entity) that the agent (natural person) represents in securities transactions.

TAKE NOTE

As just mentioned, *agent* is the term used under state law, and that (or *broker-dealer agent*) is the only term that will be used on the exam. However, unlike investment adviser representatives, who register solely on a state level, almost all agents representing broker-dealers register on both the state and federal level by taking both a NASAA-sponsored exam and a FINRA exam.

Definition: associated person. A person associated with a broker-dealer is any partner, officer, or director of the broker-dealer (or any individual performing similar functions) or any person directly or indirectly controlling or controlled by the broker-dealer, including any employees of the broker-dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of the term.

TEST TOPIC ALERT

Even "outside" directors or partners whose only connection to the firm is the contribution of capital are considered associated persons of the broker-dealer. If that is their only function, they are not required to register as agents.

LO 11.d Identify agent exclusions and exemptions under the Uniform Securities Act.

Clerical and administrative (sometimes referred to as *ministerial*) employees of a broker-dealer are generally not included in the definition of agent and, therefore, are not required to be registered. The logic for this exclusion from the definition should be obvious. Clerical and administrative employees do not effect securities transactions with the public. They attend to the administration of the broker-dealer as a business organization. Under these circumstances, they are like clerical employees of any other corporation. A testable fact is that if the broker-dealer they work for wishes to pay their employees, including this group, a year-end bonus based on company profits (not related to any individual's sales efforts), it would be allowable and would not require registrations of the clerical personnel.

The situation changes when administrative personnel take on securities-related functions. When they do so, they lose their exemption and must register as an agent.

TAKE NOTE

Secretaries and sales assistants are not agents if their activities are confined to administrative activities, including responding to an existing client's request for a quote. However, if secretaries or sales assistants accept customer transactions or take orders over the phone, they are engaging in securities transactions and are subject to registration as agents.

TEST TOPIC ALERT

Cold callers working for a broker-dealer would be defined as an agent if they did any more than ask if clients wanted to receive information. For example, if they prequalified clients or suggested ways to receive more money for their stocks or bonds, they would be considered agents.

As is customary in other industries, broker-dealers frequently hire summer interns. If these interns received any selling related compensation, such as $10 for each existing client solicited, they would be considered agents and would have to register.

Basically, there is no way for an individual to represent a broker-dealer in a securities sales function without being an agent.

Exclusions from the Definition of Agent for Personnel Representing Issuers

In many cases, individuals who represent issuers of securities are agents and therefore must register as such in the states in which they sell the issuers' securities. When does something like this occur? In many cases, a local company is looking to raise some additional capital—something in the range of several million dollars. Instead of going through the normal investment banking procedure (and paying all of those fees and commissions to the investment bankers), the company (known under the USA as the issuer) either uses its own employees or hires an outside sales force to sell the new securities. In general, these individuals are required to register as agents of the issuer. There is an exception as follows:

- Individuals are excluded from the definition of agent and, therefore, are exempt from registration in a state when representing issuers in effecting transactions:
  - in certain exempt securities (listed below),
  - exempt from registration (exempt transactions), or
  - with existing employees, partners, or directors of the issuer if no sales-related commission or other remuneration is paid or given directly or indirectly for soliciting any person in this state.

Effecting Transactions in Exempt Securities

Securities exempt from registration are called **exempt securities.** Although there are almost a dozen different securities that qualify for exemption under the Uniform Securities Act (discussed previously in Unit 8), an individual is excluded from the term *agent* only when that individual represents an issuer in effecting transactions for the following five categories of exempt securities:

- Any security issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency of one or more of these; or any security issued or guaranteed by Canada, any Canadian province, or any political subdivision of any such province
- Securities of foreign governments with which the United States has diplomatic relationships
- Any security issued by, or guaranteed by, any bank organized under the laws of the United States; or any bank, savings institution, or trust company organized and supervised under the laws of any state
- Commercial paper rated in the top three categories by the major rating agencies with denominations of $50,000 or more with maturities of nine months or less
- Any investment contract issued in connection with an employees' stock purchase, savings, pension, profit-sharing, or similar benefit plan

Effecting Exempt Transactions

An employee of an issuer is not an agent when representing an issuer in exempt transactions. Transactions exempt from registration are called **exempt transactions**. Some examples are:

- unsolicited brokerage transactions;
- transactions between the issuer and underwriters;
- transactions with financial institutions; or
- private placements

Exempt securities and exempt transactions were covered in thorough detail in Unit 8, so you will probably want to go back and review that information after this.

TAKE NOTE

An employee of an issuer is not an agent when representing an issuer if the issue is exempt from registration, as long as it is one of the five exemptions listed above. Alternatively, the employee is not an agent when representing an issuer in exempt transactions (e.g., transactions between an underwriter and issuer).

An individual employed by a corporation (not a broker-dealer) to sell a new IPO to the public would be considered an agent of the issuer needing registration, even if not paid compensation based on sales. The only exception would be if all transactions were exempt, such as selling the shares only to institutional investors.

TAKE NOTE

Keep in mind that an individual who works for an issuer of securities is excluded from the definition of agent when engaging in transactions with employees involving the issuer's securities, provided that the individual is not compensated for such participation by commissions or other remuneration based either directly or indirectly on the amount of securities sold. In other words, salaried employees engaged in distributing their employers' shares as part of an employee benefit plan would not be required to register as agents because they are, by definition, excluded from the definition. If such employees were compensated on the basis of the number of shares sold, they would be defined as agents and therefore would be subject to registration.

TEST TOPIC ALERT

Individuals representing broker-dealers in a sales capacity must register as agents whether they sell registered securities or securities exempt from registration or engage in exempt transactions.

Agent Exemptions from Registration

Just as with broker-dealers, there is no de minimis exemption for agents. If you have a single client in a state, regardless of whether or not you have a place of business there, you are an agent in that state and require registration.

There are only two exemptions. First is the snowbird exemption we've discussed several times before. The second is when the firm is excluded from the definition of BD because it has no place of business in the state and only deals with other broker-dealers and institutions. In that case, the BD's employees who service those clients are not considered to be agents in that state.

PRACTICE QUESTION

Under the Uniform Securities Act, which of the following would be considered an agent?

A. An individual employed by a small community bank for the purpose of selling stock in the bank
B. A broker-dealer with a place of business in the state with an extensive retail clientele
C. An individual whose broker-dealer is registered in the state, but her only clients are institutions
D. An individual with no place of business in the state dealing with more than five existing clients who are vacationing in the state

Answer: C. Even though the individual's only clients are institutions, the fact that her BD is registered in the state means she must register as well. Yes, transactions with institutions are exempt transactions, but that exemption only applies to individuals selling on behalf of the issuer, not when representing a broker-dealer. Individuals selling the securities of certain exempt issuers (like a bank) are excluded from the definition, as are broker-dealers. If the individual has no place of business in the state and only deals with existing clients (regardless of the number) who are temporarily in the state, that individual is exempt from registration.

Remember, we learned earlier in this unit that broker-dealers with no place of business in the state, dealing exclusively with other broker-dealers or institutional clients, are not considered to be BDs in the state (as long as they are properly registered in at least one state—the location of their principal office). Let's apply that to the following situation.

ABC Securities is a broker-dealer registered in State A. It has no place of business in State B, but it does effect transactions on behalf of a number of banks and insurance companies located in State B. Therefore, it is not considered a BD in State B and is exempt from registering. Should ABC Securities sell some government securities to these clients, neither ABC nor the agents making the sale are required to be registered. This is not because the government securities are exempt (that just means that *they* don't have to register with the Administrator), but because, under the USA, ABC does not meet the definition of a broker-dealer in State B.

However, should ABC decide to have any of its agents sell these government bonds to individual (sometimes referred to as *retail*) clients in State B, then even though the bonds are exempt securities, both ABC and the selling agents must register in that state.

The same applies to exempt transactions. One of the most common cases is when a client calls an agent to purchase a security that is not exempt and not registered in the agent's state. But, because the transaction has been initiated by the client, as an unsolicited trade, it is an exempt transaction and, therefore, the trade may be made even though the security is not registered.

One way the exam will try to trick you is by asking about an individual calling an agent from a state in which the agent is not registered. The broker-dealer is registered in that state, and the individual is a client of the firm, but not of that particular agent. The individual wishes to enter an unsolicited order—can the agent accept it? No! Although the transaction is exempt (which only means that the security does not have to be registered in that state), an agent can only do business with a resident of a state if the agent is properly licensed in that state. In this case, the agent would have to turn the order over to an agent who is licensed in that other state.

KNOWLEDGE CHECK 11.2

1. Which of the following persons is defined as an agent by the Uniform Securities Act?
   A. A silent partner of a broker-dealer whose only relationship to the firm is a contribution of capital
   B. The secretary of a branch office sales manager who is in charge of scheduling the manager's interviews with new agents
   C. A clerk at a broker-dealer who is authorized to take orders for stock, but not bonds
   D. The vice president of diversity training for a broker-dealer who is not authorized to solicit or transact securities business
2. Under the Uniform Securities Act, the term *agent* would include an individual who represents the issuer in effecting nonexempt transactions in
   A. a city of Montreal general obligation bond.
   B. common stock offered by a commercial bank.
   C. a New Jersey Turnpike revenue bond.
   D. commercial paper with a 19-month maturity.

LESSON 11.3: REGISTRATION AND POST-REGISTRATION REQUIREMENTS OF BROKER-DEALERS AND AGENTS

LO 11.e Describe the initial and post-registration requirements of the Securities Exchange Act of 1934 and the Uniform Securities Act regarding broker-dealers.

Under the USA, if a person is included in the definition of a broker-dealer, that person must register as a broker-dealer in the states where it does business. The USA is clear about broker-dealer registration. It states, "It is unlawful for any person to transact business in this state as a broker-dealer . . . unless he is registered under this Act."

This means every person (legal entity) that falls within the definition of a broker-dealer must register with the Administrator of the state. Again, keep in mind that if a person falls under one of the exclusions from the definition, that person or legal entity does not have to register in the state. The rules are basically the same for agents.

In most jurisdictions, registration is accomplished by filing the SEC's Form BD modified to meet the needs of the state. If any material information on the BD becomes inaccurate, *prompt* notice must be given to the Administrator.

While the exam will focus on state registration requirements, you need to know that almost all broker-dealers register with the SEC. That means that unlike investment advisers, who only register with one regulator, you can assume that any broker-dealer referred to in a question (unless something tells you otherwise) registers with the SEC **and** at least one state.

TAKE NOTE

The "automatic" registration of officers, etc., that we discussed with regard to investment advisers applies here as well. And, as mentioned before, unlike FINRA, there is no separate principal registration, so these individuals are registered as agents.

Submitting an Application

All persons must complete and submit an **initial application** (as well as renewals) to the state securities Administrator. For broker-dealers, the application is Form BD. The application must contain whatever information the Administrator may require by rule, and will include:

- form and place of business;
- proposed method of doing business;
- a list of all jurisdictions in which the applicant is registering (or already registered);
- qualifications and business history (broker-dealers must include the qualifications and history of partners, officers, directors, and other persons with controlling influence over the organization);
- court-issued injunctions and administrative orders;
- adjudications by the SEC or any securities SRO (self-regulatory organization, such as FINRA) within the past 10 years;
- convictions of misdemeanors involving a security or any aspect of the securities business (including charges as well as convictions);
- felony convictions, whether securities related or not (including charges as well as convictions);
- financial condition and history (but only of the firm—no credit reports on the officers); and
- any current unsatisfied liens and judgments as well as any declaration of bankruptcy within the past 10 years.

The Administrator also may require that an applicant publish an announcement of the registration in one or more newspapers in the state.

Payment of Initial and Renewal Filing Fees

States require **filing fees** for initial applications as well as for renewal applications. If an application is withdrawn or denied, the Administrator is entitled to retain a portion of the fee. Filing fees for broker-dealers, investment advisers, and their representatives need not be identical. As was the case with investment advisers, a registered broker-dealer may file an application for registration of a successor, whether or not the successor is then in existence, for the unexpired portion of the year. There is no filing or registration fee until renewal

(December 31) of the firm's license, but the successor firm would have to file a new consent to service of process.

As described previously, under normal circumstances, registration becomes effective for all securities professionals at noon of the 30th day after filing. In the case of agents (or IARs), the Administrator will notify the employing firm of effectiveness, and they will tell the new registrants when they are "good to go." By rule or by order, the Administrator may authorize an earlier effective date of licensing. In other words, there could be an occasion where, in effect, a person was the subject of a rush order.

Once registered, broker-dealers are subject to numerous administrative requirements to keep their registrations current and in good order.

Books and Records

Every registered broker-dealer must make and keep such accounts, blotters (records of original entry), correspondence (including emails), memoranda, papers, books, and other records as the state Administrator by rule prescribes. All records so required shall be maintained and preserved in an easily accessible place for a period of not less than three years from the end of the fiscal year during which the last entry was made on record, the first two years in the principal office of the broker-dealer.

These records must be current, complete, and accurate. Broker-dealers are obligated *to promptly file* correcting amendments. State securities Administrators cannot impose recordkeeping requirements that are in excess of those prescribed by the SEC. Please review LO 9.g to see the allowable methods of records storage. The records broker-dealers are required to maintain are subject to periodic, special, or other examinations by representatives of the Administrator of the state where the broker-dealer's principal office is located or of any other state in which the broker-dealer is registered as the Administrator deems necessary or appropriate in the public interest.

TEST TOPIC ALERT

Included in the recordkeeping requirements are electronic communications, particularly emails. However, it is not required to maintain emails of a personal nature sent to nonclients (e.g., "Honey, I'm stuck at the office and will be late for dinner").

TEST TOPIC ALERT

Although it is required to keep all records relating to customers, there are no requirements to keep copies of their tax returns.

Financial Requirements for Broker-Dealers

The Administrator may establish **net capital requirements** for broker-dealers. Net capital requirements of the states may not exceed those required by federal law—in this case, the Securities Exchange Act of 1934. The Administrator of a state may require those broker-dealers that have custody of, or discretionary authority over, clients' funds or securities to post **surety bonds.** Just as with net capital, the amount of surety bonds required by the states is limited to the amount set by the Securities Exchange Act of 1934. No bond may be required of any broker-dealer whose net capital exceeds the amounts required by the Administrator.

Stated simply, when it comes to broker-dealers, regardless of how many states in which they are registered, other than enforcing antifraud statutes, the Administrator has relinquished most control to the SEC.

TEST TOPIC ALERT

You will have to know that broker-dealers who meet the SEC's net capital or bonding requirements cannot be required to meet higher ones in any state in which they do business.

TEST TOPIC ALERT

In lieu of a surety bond, the Administrator will accept deposits of cash or securities.

LO 11.f Describe the initial and post-registration requirements of the Securities Exchange Act of 1934 and the Uniform Securities Act regarding agents.

Before we continue, there is an important term found in the Securities Exchange Act of 1934 that needs to be defined: **statutory disqualification**.

Because the Exchange Act deals with the registration of persons (the "people" act), the SEC sets forth certain actions making a person disqualified under statute (law) from becoming registered or associated with a broker-dealer or investment adviser. The person is subject to a **statutory disqualification** if that person:

- has been or is expelled or suspended from membership or being associated with a member of any SRO (think FINRA);
- is subject to an order of the SEC or other appropriate regulatory agency (think the Administrator) denying, suspending, or revoking his registration as a broker-dealer, or barring or suspending his association with a broker or dealer;
- by his conduct while associated with a broker-dealer, has been found to be a cause of any effective suspension, expulsion, or order of the type described in the two points above;
- has been convicted within the past **10** years of a securities violation or a misdemeanor involving finance or dishonesty, bribery, embezzlement, forgery, theft, and so forth, or **any** felony;
- is subject to a temporary or permanent injunction from a competent court of jurisdiction prohibiting him from engaging in any phase of the securities business;
- has willfully violated any federal securities law; or
- has made a false or misleading statement in any filing with information requested by an SRO (omitting important facts is a cause as well).

TAKE NOTE

Loss of a civil lawsuit, even one involving securities, is not a cause for statutory disqualification

The registration requirements for an agent who is not exempt are similar to those for a broker-dealer. An application, generally Form U4, must be completed. Two things, however, that are on the agent's application that do not apply to a broker-dealer are disclosing *citizenship* and *employment history.*

The USA states, "It is unlawful for any person to transact business in this state as an agent unless he is registered under this act." In other words, an individual may not conduct securities transactions in a state unless that person is properly registered in the state where he conducts business. This is true even when receiving unsolicited orders. If an agent does business in a state, she must be registered in that state, even if there is only one client. This is not like investment advisers and their representatives, who enjoy a de minimis exemption. So, what can an individual who has been hired to become an agent of a broker-dealer do while registration is pending? After all, one does not fill out Form U4 and become an agent immediately. Permitted activities would be those allowed to any other employee of the broker-dealer who is not required to be registered. That would include clerical functions, such as posting trade details to client accounts, or administrative activities like assisting with research. As long as it does not involve customer contact relating to selling/offering securities or opening accounts, these "newbies" can hang around the office and try to make themselves useful. Of course, most of their time should be spent preparing to pass the exam.

An agent's registration is not effective during any period when the agent is not associated with a broker-dealer registered in the state. Therefore, if the broker-dealer's registration is terminated, the agent is no longer considered licensed. The terminology depends on the specific state. In some cases, the agent's license is placed in *suspense.* In other states, it is put on *hold* or similar language. Whatever the phrase, when the broker-dealer closes up shop, either voluntarily or involuntarily (think revocation of registration by the Administrator), the agent cannot function because there is no broker-dealer affiliation. This is also true of an investment adviser representative when the investment adviser's registration is terminated.

One place where IARs and agents differ is in their termination notice procedures. When an agent begins or terminates a connection with a broker-dealer or issuer, or begins or terminates those activities that make him an agent, the agent and the broker-dealer or issuer must **promptly** notify the Administrator.

1. IAs register on the federal level (SEC) or state level, never both.
2. IARs only register on the state level.
3. BDs register on the federal level (through FINRA) **and** the state level.
4. Agents register on the federal level (through FINRA) **and** the state level.

TEST TOPIC ALERT

If an agent terminates employment with a broker-dealer, both parties must notify the Administrator promptly. If an agent terminates employment with one broker-dealer to join another broker-dealer, all three parties must notify the Administrator. One way to remember this is that in the case of an agent, the first letter, **A**, tells us that **A**ll the parties involved must notify the Administrator. All notifications must be made **promptly. Please note how this differs from the termination of an IAR.**

PRACTICE QUESTION

The City of Chicago issues bonds for the maintenance of local recreational facilities. Purchasers have two choices: they can purchase the bonds directly from the city through Ms. Stith (an employee of the city responsible for selling the bonds), or they can purchase them from Mr. Thompson (an employee of First Allied Securities Corporation). Neither Ms. Stith nor Mr. Thompson charges a commission, although FASC is remunerated with an underwriting fee. It would be correct to state that

A. Ms. Stith and Mr. Thompson must be registered as agents.
B. Ms. Stith must be registered as an agent, but Mr. Thompson is excluded.
C. Mr. Thompson must be registered as an agent, but Ms. Stith is excluded.
D. Mr. Thompson and Ms. Stith are excluded from the definition of agent.

Answer: C. Any individual selling securities while representing a registered broker-dealer is always defined as an agent, even when the securities are exempt from registration (as are these municipal bonds). When an individual represents the issuer of certain exempt securities, such as municipal bonds, that individual is excluded from the definition of agent and does not register. This means the correct answer is C. It is important to remember the five categories of exempt issuers to which this exclusion applies.

Exemptions from registration as an agent generally apply to representatives of issuers rather than to representatives of broker-dealers.

Financial Requirements of Agents

There are no financial requirements, or **net worth requirements**, to register as an agent. The Administrator may, however, require an agent to be bonded, particularly if the agent has discretion over a client's account.

TEST TOPIC ALERT

Please note that, unlike FINRA registration requirements, individuals applying for registration do **not** have to submit fingerprints.

Multiple Registrations

An individual may not act at any one time as an agent for more than one broker-dealer or for more than one issuer, unless the broker-dealers or issuers for whom the agent acts are affiliated by direct or indirect common control or the Administrator grants an exception. In the event an agent does wish to affiliate with a second broker-dealer, the agent would have to go through the registration process with the second firm in the same manner as the original application (filing another Form U4).

Limited Registration of Canadian Broker-Dealers and Agents

Provided the limited registration requirements noted below are met, a broker-dealer domiciled in Canada that has no office in a given state may effect transactions in securities with or for or attempt to induce the purchase or sale of any security by:

- a person from Canada who is temporarily a resident in this state who was already a client of the broker-dealer; or
- a person from Canada who is a resident in this state, whose transaction is in a self-directed, tax-advantaged retirement plan in Canada of which the person is the holder or contributor. In Canada, the equivalent of an IRA is called a Registered Retirement Savings Plan (RRSP).

An agent who will be representing a Canadian broker-dealer who registers under these provisions may effect transactions in securities in this state on the same basis as permitted for the broker-dealer.

For the Canadian broker-dealer to register in this fashion, it must:

- file an application in the form required by the jurisdiction where it has its principal office in Canada;
- register in each of the states where it is serving customers;
- file a consent to service of process;
- provide evidence that it is registered in good standing in its home jurisdiction; and
- be a member of an SRO or stock exchange in Canada.

Requirements for agents are the same, except that membership in an SRO or stock exchange is not relevant.

However, just as with domestic broker-dealers, if there is no place of business in the state, there are no registration requirements if the only securities transactions are with issuers, other broker-dealers, and institutional clients.

TAKE NOTE

Renewal applications for Canadian broker-dealers and agents who file for limited registration must be filed before December 1 each year.

Comparing the Four Securities Professionals

In our many years of preparing applicants for this exam, one thing we have observed is that many students do not have a clear idea of the difference between a broker-dealer and an investment adviser and, similarly, between an agent and an investment adviser representative. Perhaps the following will help:

Broker-Dealer	Investment Adviser
Primary business function is executing transactions in securities Compensation is earned in the form of commissions and markups (markdowns)	Primary business function is giving advice Compensation is earned in the form of fees or other charges, generally based on the amount of assets managed
Agents	**IARs**
Individuals employed by broker-dealers to handle their customer orders to buy or sell securities Separate function from an IAR (although many in large firms wear both hats)	Individuals employed by investment advisers to give advice to their clients After an IAR advises a client about a specific security, the next step is to contact the broker-dealer where that client maintains a brokerage account to give the buy/sell order to an agent

KNOWLEDGE CHECK 11.3

1. Under the Uniform Securities Act, which of the following statements regarding the registration of a successor firm is **true**?
   A. The appropriate filing fee must be included with the application.
   B. The successor firm must be in existence before the filing of the application.
   C. The registration of the successor firm will be effective until the December 31 renewal date without payment of a registration fee.
   D. All of the above
2. When an agent's permanent residence address changes, updates must be made to the information on file with the regulatory bodies. The proper procedure is to file
   A. a Form U4 within 30 days.
   B. a Form U4 within 45 days.
   C. a Form U5 within 30 days.
   D. a Form U5 within 45 days.

KNOWLEDGE CHECK ANSWERS

Knowledge Check 11.1

1. **C** A broker-dealer is any person engaged in the business of effecting securities transactions for the accounts of others (broker) or for its own account (dealer).

   LO 11.a

2. **A** Do not be misled by the term *accredited investor*. It has absolutely no meaning other than when referring to a private placement of securities under the Securities Act of 1933. This term will appear frequently on the exam out of context (i.e., unrelated to private placements). Whenever it does, you can make the question easier by replacing the term with the phrase "ordinary public investor who needs all of the protection available under the law." As long as the broker-dealer has no place of business in the state, it is exempt from registration if its only clients are institutional investors such as banks, insurance companies, investment companies, other investment advisers, broker-dealers, $1 million or larger employee benefit plans, college endowment funds, and governmental units.

   LO 11.b

Knowledge Check 11.2

1. **C** Anyone who solicits or receives an order while representing a broker-dealer is an agent. Silent partners and administrative personnel are not agents under the terms of the USA if they do not solicit or receive orders. As long as the officer has no supervisory role or other active participation in the securities business of the broker-dealer, the USA does not consider this position to require registration as an agent. An example might be the vice president of human resources. Remember, broker-dealers are not agents; agents represent broker-dealers. If, however, any of these individuals were authorized to accept orders, registration as an agent would be required.

   LO 11.c

2. **D** As long as the individual represents the issuer in a transaction involving specified exempt securities, such as those issued by government or banks, he is not included in the definition of agent, even when the transaction is nonexempt. On the other hand, when the securities themselves are nonexempt and the transactions are nonexempt, the individual is defined as an agent. And, yes, you may see this many negatives in a single question. Notice that a 19-month commercial paper is not an exempt security (it is over 9 months), but the other choices are.

   LO 11.d

Knowledge Check 11.3

1. **C** No filing fee is necessary, nor is it required that the successor firm even be in existence at the time of filing. The registration is effective for the unexpired portion of the year and then must be renewed (with a renewal fee) each December 31.

   LO 11.e

2. **A** Form U4 is most commonly used when registering as an agent of a broker-dealer. Changes to material information, such as one's home address or a bankruptcy filing, are accomplished by filing an amended Form U4 within 30 days. Form U5 is used for terminations or withdrawals.

   LO 11.f

UNIT 12 Remedies and Administrative Provisions

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- LO 12.a **Recognize** the jurisdiction and authority of the state securities Administrator.
- LO 12.b **Identify** the administrative actions that may be taken by the Administrator.
- LO 12.c **Recall** the reasons for the Administrator to deny, suspend, revoke, or cancel registrations.
- LO 12.d **Describe** the civil rights of recovery for a security's sale or investment advice purchased in violation of the Uniform Securities Act.
- LO 12.e **Identify** civil and criminal liability and penalties for violations of the Uniform Securities Act.

Your exam will include approximately two questions from the topics covered in Unit 12.

INTRODUCTION

This unit addresses the administrative provisions of the act and the remedies available to the Administrator. Under the Uniform Securities Act, the state Administrator has jurisdiction over securities transactions that originate in, are directed into, or are accepted in the Administrator's state.

When a securities transaction falls within the Administrator's jurisdiction, the Administrator has the power to make rules and orders; conduct investigations and issue subpoenas; issue cease and desist orders; and deny, suspend, or revoke registrations. Both civil liabilities and criminal penalties exist for violating the act.

LESSON 12.1: AUTHORITY OF THE STATE SECURITIES ADMINISTRATOR

The jurisdiction and powers of the Administrator extend to activities related to securities transactions originated in the state, directed to the state, or accepted in the state. Securities transactions involve an offer and a sale, so we need to know what those terms mean, and then we can focus on the Administrator's jurisdiction.

TAKE NOTE

The SEC's authority does not extend over state securities regulation (the Uniform Securities Act).

LO 12.a Recognize the jurisdiction and authority of the state securities Administrator.

Offer or Offer to Sell

The USA defines **offer** or **offer to sell** as every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value. For test purposes, you should know that:

- any security given or delivered with, or as a bonus on account of, a purchase of securities or anything else (a car, jewelry, and so forth) is considered to constitute part of the subject of the purchase and to have been offered and sold for value;
- a purported gift of *assessable* stock is considered to involve an offer and a sale (assessable stock is stock issued below par for which the issuer or creditors have the right to assess shareholders for the balance of unpaid par); and
- every sale or offer of a warrant or right to purchase or subscribe to another security of the same or another issuer, as well as every sale or offer of a security which gives the holder a present or future right or privilege to convert into another security of the same or another issuer, is considered to include an offer of the other security.

If a car dealer, as an essential part of a car sale, offers $1,000 in corporate bonds as an incentive, this would be considered a bonus under the act and, therefore, this now becomes a securities sale and falls under the jurisdiction of the state securities Administrator. As a result, to do this, and I know it is hard to believe, the car dealer would have to register with the state as a broker-dealer.

Sale or Sell

The USA defines **sale** or **sell** as every contract of sale, contract to sell, and disposition of a security or interest in a security for value. This means that any transfer of a security in which money or some other valuable consideration is involved is covered by this definition and subject to the act.

TAKE NOTE

You must be able to distinguish between a sale and an offer to sell. The offer is the attempt; a transaction has not taken place. In a sale, there has been an actual transaction involving money or another form of consideration for value. One must be properly registered to make both the offer and then the sale.

Gifts of Assessable Stock

When assessable stock is given as a gift, the Administrator has jurisdiction over the transaction because there is a potential future obligation in that either the issuer or, more likely, creditors can demand payment for the balance of the par value.

TAKE NOTE

If an individual owned assessable stock and felt that the issuer was on the verge of bankruptcy, that person could give the stock as a present. If the bankruptcy occurred, the new owner would then be subject to the assessment.

TEST TOPIC ALERT

Assessable stock no longer exists, but the exam may ask about it. Look for this direct quote from the Uniform Securities Act: "A purported gift of assessable stock is considered to involve an offer and sale."

Exclusions from the Definition of Sale/Sell *and* Offer/Offer to Sell

The terms *sale* or *sell* and *offer* or *offer to sell* do not include any:

- bona fide pledge or loan (pledging stock as collateral for a loan, such as for a loan at the bank, is not a sale; you expect to get your stock back when the loan is paid off—you haven't sold it);
- gift of nonassessable stock (this is the way all stocks are today);
- stock dividend, whether the corporation distributing the dividend is the issuer of the stock or not, if nothing of value is given by stockholders for the dividend (and this would include stock splits);
- class vote by stockholders, pursuant to the certificate of incorporation or the applicable corporation statute, or a merger, consolidation, reclassification of securities, or sale of corporate assets in consideration of the issuance of securities of another corporation; or
- act incident to a judicially approved reorganization with which a security is issued in exchange for one or more outstanding securities, claims, or property interest, or partly in such exchange and partly for cash.

TEST TOPIC ALERT

Because you have just learned that the gift of nonassessable stock is not considered a sale, you have to be careful not to be tricked by a question on the exam in which shares of nonassessable stock are given free as a bonus with the purchase of something else (e.g., a security, a car, a house). This would not be a gift and would, in fact, be an offer or a sale.

Legal Jurisdiction of the Administrator

Under law, for any agent of a state (e.g., the Administrator) to have authority over an activity such as a sale or offer of securities, he must have legal jurisdiction to act. **Jurisdiction** under the USA specifically means the legal authority to regulate securities activities that take place in the state.

The USA describes activities considered to have taken place in the state as any offer to buy or sell a security, as well as any acceptance of the offer, if the offer:

- originated in the Administrator's state;
- is directed to the Administrator's state; or
- is accepted in the Administrator's state.

TAKE NOTE

Because securities transactions often involve several states, more than one Administrator may have jurisdiction over a security or a transaction.

PRACTICE QUESTIONS

Let's work through some practice questions to see how this might appear on your exam.

1. Jane is an agent registered in States A and B. While sitting in her office in State A, she contacts a client who lives in State B with a recommendation to buy ABC stock. The client agrees to make the purchase. Jurisdiction here would belong to
   A. the State A Administrator.
   B. the State B Administrator.
   C. both the State A and State B Administrators.
   D. neither Administrator because this is an existing client.

   Answer: C. In this case, it would be the Administrators of both States A and B. Why is that? Remember that the Administrator has jurisdiction over any offer that originated in his state, and clearly this offer originated from Jane in State A. Recall that the Administrator has jurisdiction over any offer that was accepted in his state, and this client who accepted the offer lives in State B. The status of the client, existing or prospective, does not affect the Administrator's jurisdiction.

   Let's take a look at another possible question:

2. Jane has another State A–based client, Sally, who spends the winters in State C, a state where neither Jane nor her broker-dealer have a place of business or any retail clients. Jane sends Sally a research report with a strong buy recommendation for XYZ stock. Sally calls Jane with an order to purchase 100 shares of XYZ. Jurisdiction over this transaction belongs to
   A. the State A Administrator.
   B. the State C Administrator.
   C. both the State A and State B Administrators.
   D. both the State A and State C Administrators.

   Answer: D. Just as with the previous question, we have an offer being made from State A resulting in that Administrator having jurisdiction. Although the client lives in State A, the offer was accepted while she was in State C, so the State C Administrator has jurisdiction.

Although not related to the issue of jurisdiction, for review purposes, we should ask ourselves, "Can this transaction legally take place?" Jane is not registered in State C—how can she make the offer to a client who is there, and how can she (and her broker-dealer) accept a retail order when neither of them are registered in State C? As noted in Unit 11, a broker-dealer with no place of business in a state who deals with existing clients (such as Sally) who are temporarily in the state (as Sally is) is not defined as a broker-dealer in that state and, therefore, does not register (nor do their agents).

TAKE NOTE

The Administrator's authority does not stop at the state line. The Administrator of any state where the registrant is registered may demand an inspection during reasonable business hours with whatever frequency the Administrator deems necessary.

TAKE NOTE

To avoid unnecessary duplication of examinations, the Administrator may cooperate with the securities administrators of other states, the SEC, and any national securities exchange or national securities association registered under the Securities Exchange Act of 1934.

Publishing and Broadcast Exceptions to Jurisdiction

There are special rules regarding the Administrator's jurisdiction over offers made through a TV or radio broadcast or a bona fide newspaper.

The Administrator would not have jurisdiction if the offer were made under any of the following circumstances:

- Television or radio broadcast that originated outside of the state
- Bona fide newspaper or periodical published outside of the state
- Newspaper or periodical published inside the state but with more than two-thirds (66%) of its circulation outside the state in the last year

TAKE NOTE

A bona fide newspaper is a newspaper of general interest and circulation, such as *The New York Times*. Private investment advisory newsletters, usually distributed by subscription, are not bona fide newspapers and therefore are not included in the publishing exception.

TEST TOPIC ALERT

A radio or television program is considered to originate in the state where the microphone or television camera is located.

PRACTICE QUESTION

Wayne and Grayson, Ltd., is a broker-dealer with offices in Gotham, New Jersey. They place an ad for a new securities issue in the *Gotham Gazette*. Approximately 55% of the *Gazette's* readership is in Delaware. Under the Uniform Securities Act, jurisdiction over this ad would lie with

A. the Administrator of New Jersey.
B. the Administrator of Delaware.
C. the Administrators of both New Jersey and Delaware.
D. the Administrator of neither New Jersey nor Delaware.

Answer: A. Although more than half the readers of the *Gazette* live in Delaware, under the terms of the publishing and broadcasting exemption of the USA, the offer is not made in Delaware because the paper is not published there. Therefore, the Administrator of New Jersey has sole jurisdiction over the offering. No dual or multiple jurisdiction applies in this case, unless the offer is actually accepted in Delaware. What would the answer be if the question stated that more than 2/3 of the circulation was outside of New Jersey? Once that happens, believe it or not, no state has jurisdiction.

KNOWLEDGE CHECK 12.1

1. A state's securities Administrator has jurisdiction over a securities offering if
   - I. the security was registered in that state.
   - II. it originated in that state.
   - III. it was accepted in that state.
   - IV. the broker-dealer is registered in that state.

   A. I and II
   B. I and IV
   C. II and III
   D. III and IV

2. An Administrator has jurisdiction over an offer to sell securities if it was made in a newspaper published within the state with no more than
   A. one-third of its circulation outside the state.
   B. one-half of its circulation outside the state.
   C. two-thirds of its circulation outside the state.
   D. 90% of its circulation outside the state.

LESSON 12.2: ADMINISTRATIVE ACTIONS

LO 12.b Identify the administrative actions that may be taken by the Administrator.

The USA not only establishes the jurisdiction of the Administrator but also outlines the powers or the actions that the Administrator can take within its jurisdiction. The four broad powers the Administrator has to enforce and administer the act in his state are to:

- make, amend, or rescind rules and orders and require the use of specific forms;
- conduct investigations and issue subpoenas;
- issue cease and desist orders and seek injunctions; and
- deny, suspend, cancel, or revoke registrations and licenses.

Because the Administrator has the power to enforce the act for the benefit of the public, the Administrator, as well as his employees, has an obligation not to use the office for personal gain. Administrators are, as a result, prohibited from using for their own benefit any information derived from their official duties that has not been made public.

Rules, Orders, and Forms

To enforce the USA, the Administrator has the authority to make, amend, or rescind rules, forms, and orders necessary to administer the act. The Administrator may also issue interpretive letters. The USA requires that all rules and forms be published. Rules and orders of the Administrator have the same authority as provisions of the act itself, but these rules and orders are not part of the USA itself. The difference between a rule and an order is that a rule applies to everyone, whereas an order applies to a specific instance.

EXAMPLE

The Administrator may decide to issue a rule requiring all agents to pay an annual registration fee of $250. This rule applies to everyone. Or the Administrator may find that a specific agent has violated a provision of the law and order a 30-day suspension. This order applies only to that particular agent.

Although the Administrator has the power to make and amend rules for compliance with her state's blue-sky law, she does not have the power to alter the law itself.

The composition or content of state securities law is the responsibility of the state legislature, not of administrative agencies. Rules for administration and compliance with the law are the responsibility of the securities Administrator.

EXAMPLE Rules and Orders of the Administrator

Situation: The Administrator of State R requires by rule that all companies registering their securities in State R must supply financial statements in a specific form and with content prescribed by the Administrator. However, the Administrator does not publish the rule because the rule is too long and complex.

Analysis: The USA allows state Administrators to issue rules and orders in carrying out their regulatory functions, and the State R Administrator acted properly in designing the form and content for financial reports. However, it is required by the USA that Administrators publish all rules and orders. The Administrator, despite the latitude given him in administering the USA, cannot suspend any provision of the USA itself. The State R Administrator acted within his authority in designing the forms but acted without authority—that is, he violated the USA—by suspending the requirement that all rules and orders be published.

Conduct Investigations and Issue Subpoenas

The Administrator has broad discretionary authority to **conduct investigations** and **issue subpoenas**. These investigations may be made in public or in private and may occur within or outside of the Administrator's state. Normally, these investigations are open to the public, but when, in the opinion of the Administrator and with the consent of all parties, it is felt that a private investigation is more appropriate, that investigation will be conducted without public scrutiny.

In conducting an investigation, the Administrator, or any officer designated by him, has the power to:

- require statements in writing, under oath, as to all matters relating to the issue under investigation;
- publish and make public the facts and circumstances concerning the issue to be investigated;
- subpoena witnesses and compel their attendance and testimony; and
- take evidence and require the production of books, papers, correspondence, and any other documents deemed relevant.

TEST TOPIC ALERT

If the Administrator of State A wishes to investigate a BD registered in State A but whose principal office is located in State B, does he need the approval of the State B Administrator? No! When can he go in? The Administrator can go in during normal business hours and doesn't need to make an appointment.

So, what happens if a person who is the subject of an investigation refuses to furnish the required evidence or just ignores the subpoena? After all, the Administrator is not a police officer—he doesn't wear a badge and cannot arrest anyone. There is a legal term that describes this type of disobedience. That term is *contumacy,* and here is what the USA says about that:

"In case of contumacy by, or refusal to obey a subpoena issued to, any person, the Administrator may apply to the appropriate court in his state and ask for help. Upon application by the Administrator, the court can issue an order to the person requiring him to appear before the Administrator, or the officer designated by him, to produce documentary evidence if so ordered or to give evidence touching the matter under investigation or in question. Failure to obey the order of the court may be punished by the court as a contempt of court."

Contempt of court can, of course, lead to jail time.

TAKE NOTE

In addition to having the power to conduct investigations, the Administrator may enforce subpoenas issued by Administrators in other states on the same basis as if the alleged offense took place in the Administrator's state. However, the Administrator may issue and apply to enforce subpoenas in his state at the request of a securities agency or Administrator of another state only if the activities constituting an alleged violation for which the information is sought would be a violation of the USA if the activities had occurred in his state.

Issue Cease and Desist Orders

Whenever it appears to the Administrator that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this act or any rule or order hereunder, she may in her discretion bring either or both of the following remedies:

- issue a cease and desist order, with or without a prior hearing, against the person or persons engaged in the prohibited activities, directing them to cease and desist from further illegal activity; or
- bring an action in the appropriate court to obtain enforcement of the order through the issuance of a temporary or permanent injunction. If necessary, the court may appoint a receiver or conservator for the defendant or the defendant's assets.

The Administrator is granted this power to prevent potential violations before they occur. It is sometimes said that the Administrator can act when she "smells the smoke, even without seeing the fire." Sometimes a tipster or whistleblower will divulge information to the Administrator that might be relevant to a serious infraction. To prevent any further damage to investors, a cease and desist order can be entered.

Although the Administrator has the power to issue cease and desist orders, she does not have the legal power to compel compliance with the order. To compel compliance in the face of a person's resistance, the Administrator must apply to a court of competent jurisdiction for an injunction. Only the courts can compel compliance by issuing injunctions and imposing penalties for violation of them. You will need to know that **enjoined** is the legal term that is used to refer to a person who is the subject of an injunction.

TAKE NOTE

Cease and desist orders are not the same as stop orders. **Cease and desist orders** are directed to persons, requiring them to cease activities. Stop orders are directed to applications regarding registration of a security.

EXAMPLE Cease and Desist Orders

Situation: Ms. Thomas is registered to conduct business in State C and makes plans to sell a security within the next few days. The Administrator considers this security ineligible for sale in the state. The Administrator orders Ms. Thomas to stop her sales procedures immediately.

Analysis: The Administrator of State C issued a cease and desist order to Ms. Thomas because there was insufficient time to conduct a public hearing before the sale to determine whether the security was eligible for sale in the state.

Summary Powers

Another of the powers of the Administrator is known as acting **summarily**. This means that she may order, without having to go through the hearing process, a postponement or suspension of a registration pending final determination of any proceeding based upon actions described above. Once the summary order is entered, the Administrator will promptly notify the applicant or registrant, as well as the employer or prospective employer if the applicant or registrant is an agent or investment adviser representative, that it has been entered and of the reasons for it. If the applicant wishes a hearing, a written request must be made and, within 15 days after the receipt of the written request, the matter will be set down for hearing. If no hearing is requested and none is ordered by the Administrator, the order will remain in effect until it is modified or vacated by the Administrator.

Final Orders

A **final order** is one that ends litigation (usually). Under the Uniform Securities Act, it is when the Administrator (or a court) renders a judgment in an action (guilty or innocent). Regardless of whether we're referring to persons, exemptions, or registration, as stated previously (and repeated because it is likely to be on the exam), other than when the Administrator has acted summarily as described above, no final order may be issued without the Administrator:

- giving appropriate prior notice to the affected persons;
- granting an opportunity for a hearing; and
- providing findings of fact and conclusions of law.

LO 12.c Recall the reasons for the Administrator to deny, suspend, revoke, or cancel registrations.

The Administrator has the power to deny, suspend, cancel, or revoke the registration of broker-dealers, investment advisers, and their representatives as well as the registration of securities issues.

Broker-Dealers, Advisers, and Their Representatives

To justify a denial, revocation, or suspension of the license of a **securities professional**, the Administrator must find that the order is in the public interest **and** also find that the applicant or registrant, or in the case of a broker-dealer or investment adviser, any partner, officer, or director, or any person occupying a similar status or performing similar functions:

- has filed an incomplete, false, or misleading registration application;
- has willfully violated the USA;
- has been disqualified from membership in any domestic or foreign securities or commodities regulatory body due to a conviction of a securities-related misdemeanor as a result of action brought within the last 10 years;
- has been convicted of any felony within the last 10 years;
- has been enjoined by law from engaging in the securities business;
- is subject to another Administrator's denial, revocation, or suspension;
- is engaged in dishonest or unethical securities practices;
- is insolvent (is not true in the case of federal covered advisers);
- is the subject of an adjudication that the broker-dealer has willfully violated the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, the Investment Company Act of 1940, or the Commodities Exchange Act;
- has, in the case of a broker-dealer or investment adviser, been found guilty on the charge of failure to supervise;
- has failed to pay application filing fees; or
- is not qualified on the basis of training, lack of experience, and knowledge of the securities business.

TEST TOPIC ALERT

Because of a lack of uniformity in state criminal laws, it can happen that a person is convicted of a misdemeanor in one state and then moves to a state where that same crime is a felony. If the person were to then apply for registration, the Administrator must consider the crime under the statutes of the state where it occurred, not his own. In other words, the Administrator may only consider what is on the person's record.

TEST TOPIC ALERT

If a person is subject to a disqualification by any SRO, even the NASD (before it became FINRA), for something that was *not* a violation of the Uniform Securities Act, that would still be a cause for denial.

TEST TOPIC ALERT

Denial is generally limited to convictions for any felony or investment-related misdemeanors within the past **10 years**. However, as pointed out in a previous unit, these convictions (and even just being charged) must always be disclosed on the application for registration—there is no time limit.

TAKE NOTE

The public's best interest is not reason enough for the denial, suspension, or revocation of a registration. There must be a further reason, as described previously.

Other than when acting summarily, no order to deny, suspend, or revoke may be entered without:

- appropriate prior notice to the applicant or registrant (as well as the employer or prospective employer if the applicant or registrant is an agent or investment adviser representative);
- opportunity for hearing; and
- written findings of fact and conclusions of law.

The Administrator may not suspend or revoke a registration on the basis of facts that were known to the Administrator at the time the registration became effective (unless the proceedings are initiated within 90 days).

Lack of Qualification

An Administrator may not base a denial of a person's registration solely on her lack of experience. However, the Administrator may consider that registration as a broker-dealer does not necessarily qualify one for a license as an investment adviser and may restrict that applicant's registration as a broker-dealer conditional upon its not functioning as an investment adviser.

To better understand these two points, let's look at the wording in the act itself:

1. The Administrator may not enter an order denying registration solely on the basis of lack of experience if the applicant or registrant is qualified by training or knowledge or both. Obviously, a new applicant for registration as an agent or IAR is not going to have any experience selling securities. So, the act says that this lack of experience by itself is not enough to deny the registration as long as the Administrator feels assured that the individual will receive adequate training and/or has the requisite knowledge. One could suppose that passing this exam demonstrates the necessary knowledge.
2. The Administrator may consider that an investment adviser is not necessarily qualified solely on the basis of experience as a broker-dealer or agent. When she finds that an applicant for initial or renewal registration as a broker-dealer is not qualified as an investment adviser, she may, by order, condition the applicant's registration as a broker-dealer upon the firm's agreeing to not engage in business in this state as an investment adviser.

In this case, the act is dealing with a person who has experience, albeit not necessarily in the giving of advice. Just because a person has been a broker-dealer, or an agent for a broker-dealer, does not mean that the person is qualified to be an investment adviser. So, the registration will be limited to acting only in the stated capacity as long as one does not cross over the line and give investment advice.

Securities Issues

As is the case with a securities professional, a securities Administrator may deny, suspend, cancel, or revoke a security's registration if the order is in the public's interest and the securities registrant:

- files a misleading or incomplete registration statement;
- is engaged in an offering that is fraudulent or made on unfair, unjust, or inequitable terms;
- charges offering fees that are excessive or unreasonable;
- has a control person convicted of a securities-related crime;
- is subject to a court injunction;
- is engaged in a method of business that is illegal; or
- is subject to an administrative stop order of any other state.

In addition, the Administrator may deny a registration if the applicant fails to pay the filing fee. When the fee is paid, the denial order will be removed, provided the applicant is in compliance with all registration procedures.

TEST TOPIC ALERT

When the conditions that led to the issuance of the stop order have changed for the better, the legal term (remember, this is a law exam) used to describe the lifting of the stop order is **vacated** (e.g., "the order has been vacated").

PRACTICE QUESTIONS

It is important that you be able to recognize the difference between a cease and desist order and a stop order. Look at the following example questions:

1. An agent of a broker-dealer solicits clients to purchase unregistered promissory notes. The agent claims that promissory notes are not securities and, therefore, do not need to be registered. The Administrator disagrees with that position and would issue
   A. a cease and desist order against the agent.
   B. a cease and desist order against the issuer of the note.
   C. a stop order against the agent.
   D. a stop order against the issuer.

   Answer: A. Unless we had reason to believe that the issuer was the one claiming that its notes were not securities, the only person guilty here is the agent. Stopping the agent from continuing to solicit the purchase of unregistered securities is done by issuing a cease and desist order.

   Alternatively, if the question went like this:

2. Palterer Products, Inc. (PPI), headquartered in State J, has sent an announcement to a number of broker-dealers in the state promoting their 8% promissory notes as a high-interest nonsecurity alternative to a bank CD. The compliance officer of your firm forwards this to the State J Administrator. What action would the Administrator likely take?
   A. Issue a cease and desist order against the compliance officer with or without a hearing
   B. Issue a cease and desist order against PPI with or without a hearing

C. Issue a stop order against the compliance officer after giving an opportunity for a hearing
D. Issue a stop order against PPI after giving an opportunity for a hearing

Answer: D. Promissory notes are securities, and, therefore, PPI must stop soliciting the sale of them as nonsecurities. The method of doing so is through the issue of a stop order. No order would be forthcoming against the compliance officer; she was only doing her job correctly. Remember, cease and desist orders are against registered securities professionals and stop orders against issuers. Finally, the cease and desist order can be issued with or without a hearing and the stop order only after a hearing.

Nonpunitive Terminations of Registration

A registration can be terminated even if there has not been a violation of the USA. A request for withdrawal and lack of qualification are both reasons for cancellation.

Withdrawal

A person may request on his own initiative a withdrawal of a registration. The withdrawal is effective 30 days after the Administrator receives it, provided no revocation or suspension proceedings are in process against the person making the request. In that event, the Administrator may institute a revocation or suspension proceeding within one year after a withdrawal becomes effective.

Cancellation

If an Administrator finds that an applicant or a registrant no longer exists or has ceased to transact business, the Administrator may cancel the registration.

TEST TOPIC ALERT

For any of the four securities professionals, the Administrator retains jurisdiction for a period of one year after the effective date of withdrawal of registration. That means that an action can commence for a violation discovered during that period. Note that FINRA has the same rule, but their jurisdiction lasts for two years.

TEST TOPIC ALERT

You may encounter this type of question regarding cancellation: "What would the Administrator do if mailings to a registrant were returned with no forwarding address?" The answer is, "Cancel the registration." The Administrator may also cancel a registration if a person is declared mentally incompetent.

TEST TOPIC ALERT

Be familiar with the distinctions between cancellation and denial, suspension, and revocation. Cancellation does not result from violations or a failure to follow the provisions of the act. Cancellation occurs as the result of death, dissolution, or mental incompetency.

TEST TOPIC ALERT

Because an agent's (or IAR's) registration is dependent on being associated with a broker-dealer (or IA), when the employer's registration is suspended or revoked, that

of the registered individual is placed into suspense or some other term with essentially the same effect. When the period of suspension of the firm is over, registration of the individuals is reactivated. If the firm's registration has been revoked, then the individual will have to find a new affiliation or the license will be canceled. Individual agents or IARs who withdraw their registrations must reaffiliate within two years or they will be required to retake the exam to requalify.

KNOWLEDGE CHECK 12.2

1. Which of the following accurately describes a cease and desist order as authorized by the Uniform Securities Act?
   A. An order that a federal agency issued to a brokerage firm to stop an advertising campaign
   B. An Administrator's order to refrain from a practice of business she believes to be unfair
   C. A court-issued order requiring a business to stop an unfair practice
   D. An order from one brokerage firm to another to refrain from unfair business practices
2. The Administrator may cancel the registration of an adviser if
   A. mail is returned with notification that the forwarding notice has expired.
   B. the adviser is not in the business any longer.
   C. a court has declared the adviser to be mentally incompetent.
   D. any of the above.

LESSON 12.3: OTHER PENALTIES AND LIABILITIES

LO 12.d Describe the civil rights of recovery for a security's sale or investment advice purchased in violation of the Uniform Securities Act.

Rights of Recovery from Improper Sale of Securities

If the purchaser of securities feels that the sale has been made in violation of the USA, that purchaser may file a complaint with the Administrator. If the Administrator investigates the claim and finds it has merit, then a case will be opened against the offending broker-dealer and/or agent.

If the client's case is proven, at the direction of the Administrator, the client may recover:

- the original purchase price of the securities ("made whole"); plus
- interest at a rate determined by the Administrator (generally referred to as the state's *legal rate*); plus
- all reasonable attorney's fees and court costs; minus
- any income received while the securities were held.

TAKE NOTE

The exam may refer to the interest paid to the client as being at the state's legal rate.

Right of Rescission for Security Sales

If the seller of securities discovers that a sale has been made in violation of the USA, the seller may offer to repurchase the securities from the buyer. In this case, the seller is offering the buyer the **right of rescission**. To satisfy the buyer's right of rescission, the amount paid back to the buyer must include the original purchase price and interest, as determined by the Administrator.

By offering to buy back the securities that were sold in violation of the act, the seller can avoid a lawsuit (and legal fees and court costs) through a **letter of rescission**. The buyer has 30 days after receiving the letter of rescission to respond. If the buyer does not accept or reject the rescission offer within 30 days, the buyer gives up any right to pursue a lawsuit at a later date.

TAKE NOTE

If the client rejects the offer within the 30-day period, he may sue. But if the offer is not accepted or rejected within that 30-day period, it becomes void.

PRACTICE QUESTION

How might this play out on the exam? Let's take a look at a sample question:

Martha is an agent with Rapid Execution Services (RES), a broker-dealer registered in all 50 states. Martha offers an IPO of a nonexempt security to a client without realizing that the security has not been registered in the client's state. The client purchases 500 shares of the new issue and, six months later, sells the stock at a price 70% below the original purchase price. Because the stock was not registered in the client's state, the client could claim

I. payment of the difference between the proceeds and the purchase price.
II. interest at the state's legal rate, minus any income received from the security.
III. court costs and lawyer's fees if the client has to go to court.
IV. punitive damages equal to the amount of the loss.

A. I and II
B. I, II, and III
C. IV only
D. I, II, III, and IV

Answer: B. When a security is sold in violation of the USA (a nonexempt security must be registered under this scenario), the client can claim to be "made whole" plus interest, plus the expenses of going to court and paying for legal representation. In general, to avoid the legal costs (and publicity) when a case like this is uncovered, the broker-dealer will present an offer of rescission, which gives the client all of this except the court and legal fees (because it is not necessary to go to court). Punitive damages are not part of the client's recovery rights.

Rights of Recovery from Improper Investment Advice

A person who buys a security as the result of investment advice received in violation of the USA also has the right to file a complaint. In the case of securities purchased as a result of improper investment advice, if the client's case is proven, at the direction of the Administrator, the advisory client may recover:

- cost of the advice; plus
- loss as a result of the advice; plus
- interest at a rate determined by the Administrator; plus
- any reasonable attorney's fees; minus
- the amount of any income received from the advice.

Right of Rescission for Investment Advice

Similar to the right of rescission described above for improper securities sales, an investment adviser who realizes that he has given advice that will subject him to civil action may avoid legal expenses by offering the client the same package as he would receive if he had sued—that is, refunding the cost of the advice, losses from the advice, and interest at the state's predetermined rate, less any income received on recommended securities.

TEST TOPIC ALERT

Unlike some federal laws, there is no provision for receiving treble damages; that is, in addition to receiving back your investment, you receive payment equal to three times what you lost. That is primarily found in the federal laws regarding insider trading, but that is not relevant to the Uniform Securities Act.

LO 12.e Identify civil and criminal liability and penalties for violations of the Uniform Securities Act.

Scope of Liability

We need to define two terms:

Civil liability: The accused person has not violated a state criminal code (the law). The aggrieved party has the right to sue for losses incurred. Damages are generally monetary and/or administrative (no jail sentence). These have been covered above in the discussion of the rights of recovery. The successful claim of the client must be paid by the securities professional.

Criminal liability: The accused person has violated the state's criminal code (broken the law). This could result in jail time.

TAKE NOTE

There are cases where the same action could result in both civil and criminal liability.

Under the USA, the actual seller of the securities or the advice is not the only person liable for the violation of the act. Every person who directly or indirectly controls the person who sold the securities or the advice, or is a material aid to the transaction, is also liable to the same extent as the person who conducted the transaction.

The effect of this is that if an agent makes a sale in violation (or an IAR gives improper advice), but it can be shown that officers or partners of the broker-dealer or IA were irresponsible, action can be taken against them as well, and they can be found civilly liable.

Claims Against the Surety Bond

Earlier in this course, we discussed the need for securities professionals to post a surety bond under certain conditions. The USA states:

"Every bond shall provide for suit thereon by any person who has a cause of action under this Act and, if the Administrator by rule or order requires, by any person who has a cause of action not arising under this act. Every bond shall provide that no suit may be maintained to enforce any liability on the bond unless brought within the time limitations of the Act."

TEST TOPIC ALERT

In other words, in order for a surety bond to meet the requirements of the USA, it must provide that any customer who can prove a violation (and does so within the statute of limitations) is entitled to collect against the bond.

TAKE NOTE

Because this is an exam based on the law, it is sometimes necessary for us to delve into the legalities more than we would like. The USA states: "Any person who offers or sells a security in violation of the Act is liable to the person buying the security from him." What this does is impose civil liability when the offer violates one of the specified provisions even though the sale does not. The making of a nonexempted offer before the effective date can create no civil rights on behalf of the offeree (the potential buyer) unless the offer results in a sale. When it does, however, this language means that the buyer may recover damages even though no contract was made until after the effective date.

Statute of Limitations (Civil)

The time limit, or statute of limitations, for violations of the civil provisions of the USA is three years from the date of sale (or rendering of the investment advice) or two years after discovering the violation, whichever comes first. It is unlikely to be tested, but just in case, under federal law, the statute of limitations for bringing action is the earlier of **one year** after discovery of the violation or three years after the date of the action.

TEST TOPIC ALERT

The USA provides that every cause of action under this statute survives the death of any person who might have been a plaintiff or defendant. Therefore, any bond required must provide that the action may be brought for the specified statute of limitations even though the person who is bonded dies before the expiration of that period.

Criminal Liabilities

Upon conviction for willfully violating any provision of the USA, a person may be fined, imprisoned, or both. The maximum penalty is a fine of $5,000, a jail sentence of three years, or both. It is important to note that no person may be imprisoned for the violation of any rule or order if he proves that he had no knowledge of the rule or order. In other words, you have to know that you are willingly in violation in order to get jail time. It is also important to note that while the Administrator does not have the power to arrest anyone, he may apply to the appropriate authorities in his state for the issuance of an arrest warrant. The appropriate state prosecutor, usually the State Attorney General, may decide whether to bring a criminal action under the USA, another statute, or, when applicable, common law. In certain states, the Administrator has full or limited criminal enforcement powers. To be convicted of fraud, the violation must be willful and the registrant must know that the activity is fraudulent.

TAKE NOTE

Fraud is the deliberate or willful concealment, misrepresentation, or omission of material information or the truth to deceive or manipulate another person for unlawful or unfair gain. Under the USA, fraud is not limited to common-law deceit.

Statute of Limitations (Criminal)

The statute of limitations for criminal offenses under the USA is five years from the date of the offense.

Judicial Review of Orders (Appeal)

Any person affected by an order of the Administrator may obtain a review of the order in an appropriate court by filing a written petition within 60 days. In general, filing an appeal does not automatically act as a stay of the penalty. The order will go into effect as issued unless the court rules otherwise.

What about the SEC's powers? As mentioned previously, the SEC has no jurisdiction over state securities laws (although federal law always supersedes state law). However, this exam deals with many areas of federal law, so we need to know about those powers.

SEC Enforcement Powers

Enforcement and administration of the federal securities laws, such as the Investment Advisers Act of 1940 (our focus here), is the responsibility of the SEC. As of the date of publication, there is no self-regulatory organization (SRO) for investment advisers. If that situation should change and become testable, it will be posted in the Content Updates. In other words, FINRA, the NYSE, and the like have no jurisdiction over federal covered investment advisers; only the SEC does. If the SEC suspects a violation of the law or its rules, it may take the following actions:

- Subpoena witnesses
- Acquire evidence
- Subpoena books and records
- Administer oaths

- Go to a competent court of jurisdiction to obtain an injunction enjoining a person from continued activity until the results of a hearing
- Refer to the appropriate court for criminal prosecution

The SEC has the power to censure; place limitations on the activities, functions, or operations of; suspend for a period not exceeding 12 months; or revoke the registration of any investment adviser if it finds, after a hearing, that the penalty is appropriate. If it is necessary to go to court, all hearings are held in the federal court system. If a defendant is found guilty, he may appeal an SEC order against him by filing that appeal in the U.S. Court of Appeals with jurisdiction where the violation occurred.

If the violation is one in which the SEC seeks criminal penalties, the act provides for a fine of no more than $10,000, imprisonment for no more than five years, or both.

There is nothing in the USA that specifies a maximum suspension as there is in the federal law. Another difference is that, in the case of an appeal, it is made through the state court system, not the federal one. In both cases, the appeal must be filed within 60 days of the court's decision.

Another difference is in the level of penalties. Under the USA, the maximum penalties for a criminal infraction are a fine of up to $5,000 or a prison sentence not to exceed three years, or both. However, imprisonment is only an option when the violation is committed knowingly.

TEST TOPIC ALERT

You may be asked about either or both of these penalties on your exam and must be able to keep them straight. Federal law is $10,000 and five years. State law is $5,000 and three years.

TAKE NOTE

Remember the sequence 5-5-3 for the application of criminal penalties: 5-year statute of limitations, $5,000 maximum fine, and/or imprisonment of no more than 3 years.

Under the civil provisions, the statute of limitations runs for two years from the discovery of the offense or to three years after the act occurred, whichever occurs first.

KNOWLEDGE CHECK 12.3

1. Aaron is a client of XYZ Financial Services. Over the past several years, Aaron has been suspicious of possible churning of his account but has taken no action because account performance has been outstanding. After reviewing his most recent statement, Aaron suspects that excessive transactions have occurred. He consults his attorney, who informs him that under the Uniform Securities Act, any lawsuit for recovery of damages under the act must commence within
   A. one year of occurrence.
   B. two years of occurrence.
   C. three years of occurrence or two years of discovery, whichever occurs first.
   D. two years of occurrence or three years of discovery, whichever occurs last.
2. If an agent chooses to appeal an Administrator's order, when must the agent file for review of the order with the appropriate court?
   A. Immediately
   B. Within 30 days after the entry of the order
   C. Within 60 days after the entry of the order
   D. Within 180 days after the entry of the order

KNOWLEDGE CHECK ANSWERS

Knowledge Check 12.1

1. **C** The Administrator of this state has jurisdiction over an offer to buy or sell as follows. An offer to sell or to buy is made in this state, whether or not either party is then present in this state, when the offer *originates* from this state. An offer to buy or to sell is accepted in this state when acceptance is communicated to the offeror in the state. The security may be registered in dozens of states, including this state, or the security might be exempt from registration. That means it would not be registered in this state. However, the Administrator has jurisdiction only when the offer is made or accepted in this state. Likewise, the broker-dealer may be registered in many states, but unless the BD is involved in an offer or acceptance in this state, this state's Administrator does not have jurisdiction.

   LO 12.a

2. **C** A state Administrator has jurisdiction over a securities offering made in a bona fide newspaper published within the state with no more than two-thirds of its circulation outside the state.

   LO 12.a

Knowledge Check 12.2

1. **B** A cease and desist order is a directive from an administrative agency to immediately stop a particular action. Administrators may issue cease and desist orders with or without a prior hearing. Brokerage houses cannot issue cease and desist orders to each other.

   LO 12.b

2. **D** You must know the difference between cancellation of a registration (which requires no hearing) and revocation (which does). Cancellation is nonpunitive (the registrant is not guilty of a violation).

   LO 12.c

Knowledge Check 12.3

1. **C** Under the USA, the lawsuit for recovery of damages must commence within three years after occurrence of the offense or two years after its discovery, whichever happens earlier.

   LO 12.d

2. **C** Under the USA, a registered person has up to 60 days to appeal any order issued against him by the state Administrator.

   LO 12.e