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Expert Analysis

Broker-Dealer Licensing: Understanding the Role and Limitations Of the Series 6 License

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Broker registration is the “keystone” of broker-dealer regulation.¹ The registration requirements are designed to ensure that “securities are [only] sold by a salesman who understands and appreciates both the nature of the securities he sells and his responsibilities to the investor to whom he sells.”²

Despite the importance of registration, it is a subject that causes confusion among investors and even some financial advisers. Further, the securities law surrounding broker registration is confusing and in some ways contradictory.

Brokers are only permitted to conduct business and sell securities covered by the licenses the broker maintains. This article explores the conflicts in the licensing system and whether the system achieves its primary goal: to instill public confidence that brokers are properly trained and qualified to recommend securities to investors.

THE REGISTRATION REQUIREMENT

The Securities Exchange Act of 1934 creates an expansive broker-dealer registration requirement that requires all people who interact with the public regarding securities to register, not just people who actually recommend securities transactions.³ Accordingly, the registration requirement ensures that all people who deal with the public concerning the sale of securities meet minimum competency requirements.

Courts examining the registration requirement under the Exchange Act have cited strong policy considerations for requiring broker registration. In *Eastside Church of Christ v. National Plan* the 5th U.S. Circuit Court of Appeals explained:

The requirements that brokers and dealers register is of the utmost importance in effecting the purposes of the [Exchange] Act. It is through

the registration requirement that some discipline may be exercised over those who may engage in the securities business and by which necessary standards may be established with respect to training, experience, and records.⁴

In addition, courts have stated that even minimum and ancillary contacts with the investing public require registration. For example, in *Exchange Services v. Securities and Exchange Commission*, the 4th Circuit upheld an SEC order and the National Association of Securities Dealers⁵ decision that required discount brokerage employees to register. The court found that any employee interactions with the public regarding the purchase of securities required registration even though those interactions represented only a small fraction of the employees' responsibilities.⁶

"The regular and continuous contact order takers have with the public is reasonable rationale for the policy," the court said. "These personnel may stray from their limited duties during public contact, resulting in harm to investors. Such risk and the overriding concern for protection of public interest are sound bases for the SEC's reliance on the policy denying exemption status for the order takers."⁷

It is clear the Exchange Act broadly requires people to register when communicating with the public and conducting brokerage activity.

However, the creation of various registration license types, each covering only certain products, complicates regulatory and compliance requirements and creates a conflict between limiting broker qualifications by product type and ensuring that brokers are minimally competent to deal with the public.

REGISTRATION LIMITATIONS

Congress delegated authority to the self-regulatory agencies under the auspices of the SEC to develop the criteria for broker-dealer registration.⁸ The Financial Industry Regulatory Authority (formerly NASD) has created and continues to update the licensing requirements for all registered representatives, compliance officers and securities principles.

The most common and encompassing license is a general securities registered representative, or the Series 7 license, which allows a broker to sell nearly all types of securities⁹ such as stocks, bonds, mutual funds and private placements.¹⁰ In contrast to a Series 7 broker's broad license, a Series 6 broker is qualified to sell only two types of products.¹¹

A Series 6 licensed broker can recommend certain investment companies, more commonly known as mutual funds, and variable contract products, such as annuities.¹² More specifically, a Series 6 can offer and sell open-end mutual funds and closed-end mutual funds during the initial offering period only — a significant limitation.¹³

SERIES 6: THE 'LIMITED' REPRESENTATIVE LICENSE

A Series 6 licensed broker faces several unique challenges in attempting to adhere to FINRA rules and regulations, while also abiding by the Series 6 licensing limitations. First, a Series 6 broker can only discuss two types of securities but will invariably be asked about securities outside the scope of the broker's qualifications.

FINRA's only guidance to Series 6 brokers is not to function outside the scope the limited license.¹⁴ Consequently, the responsibility to create communication guidelines for Series 6 brokers falls upon brokerage firms and the brokers themselves.

Brokerage firms often create internal compliance rules to prevent Series 6 brokers from attempting to sell or even discuss securities products outside the scope of the broker's license with clients. Yet, even with these procedures in place, the line between what Series 6 holders can and cannot discuss with their clients is blurred at best.

Second, the limited nature of the Series 6 license raises the issue of whether a Series 6 broker can adequately meet FINRA's suitability rule. FINRA Rule 2111, the updated rule governing a broker's suitability obligations, requires all brokers to understand the client's "other investments" as well as the client's "financial situation and needs."¹⁵

However, the FINRA rules state that a Series 6 broker is not qualified to function as a representative for products outside the scope of the license.¹⁶ Consequently, a conflict exists between a Series 6 broker's ability to satisfy the suitability requirements under the FINRA rules and the limited scope of the broker's license.

Even though a Series 6 broker's ability to perform a complete suitability analysis appears questionable given the limitations of the license, FINRA does not require Series 6 brokers to disclose their restrictions to clients.

Third, a potential compliance issue exists when a Series 6 broker recommends closed-end mutual funds during the offering period and then continues to service the client's account holding the closed-end mutual funds. Since a Series 6 broker can only make a recommendation at the initial offering, the broker cannot recommend that a client sell or hold the closed-end fund after the initial recommendation because any further communication or discussion of the merits of the closed-end mutual fund would violate the Exchange Act.

It is difficult to understand the reasoning behind allowing brokers to recommend the purchase of a product that they could not later recommend the client sell or hold. FINRA has not provided guidance to Series 6 brokers that would assist the representatives in trading closed-end mutual funds in client accounts.

Finally, an argument can be made that a Series 6 broker is not fully qualified to sell the products that the Series 6 license allows the representative to sell. Even a limited representative is expected to understand the underlining products contained in the mutual funds they recommend to clients.

For example, FINRA's Notice to Members 04-30 requires that brokers understand the characteristics, risks and rewards of bonds and bond mutual funds before the broker recommends the product to investors.¹⁷ While a Series 6 representative cannot sell bonds, the Series 6 broker can sell bond mutual funds. Since a mutual fund can hold almost any type of investment product, none of which a Series 6 broker is otherwise qualified to offer and sell, it is difficult to understand how the Series 6 is qualified to describe the risks associated with mutual funds.

Presumably, FINRA allows Series 6 brokers to sell mutual funds because the funds are managed by a fund manager and are usually diversified through investments in many asset types and sectors. While diversification and a separate management

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structure reduce some risk, they have never been found to negate a broker's obligation to understand the nature and qualities of the mutual fund's properties.

Further, many mutual funds hold concentrated positions in complex products such as embedded swaps, structured assets and various hedging instruments. The presence of complex products in a mutual fund can dramatically affect the fund's volatility and risk profile depending upon prevailing market conditions. Series 6 brokers are not licensed to explain to their clients the nuanced risks of the specific underlining products and specialized instruments contained in some mutual funds.

As discussed above, there are at least four areas in which a Series 6 broker's responsibilities are unclear and come into conflict with the broader purposes of broker-dealer registration. Because Series 6 representatives are limited in the types of securities they can sell, there is substantial doubt whether the Series 6 holder can meet all of its obligations to its clients.

FINRA DISCIPLINARY ACTIONS AGAINST SERIES 6 BROKERS

FINRA has disciplined brokers for conducting securities business beyond the scope of their Series 6 license qualifications. For example, the NASD, now FINRA, brought a disciplinary proceeding against Majied Alzid for placing equity trades outside the scope of his Series 6 license and in violation of Rule 1032(b).¹⁸

Alzid's "activities in the investment banking and securities business were limited" and did not allow for equity trading.¹⁹ As a result of this and other violations, FINRA barred Alzid from association with any member firm in any capacity.

In another example, FINRA brought an action against Brookstone Securities and David W. Locy for failing to supervise the activities of Series 6 brokers at the firm.²⁰ Brookstone and Locy conducted a private placement offering through Series 6 licensed brokers without proper due diligence.

Brookstone allegedly allowed Series 6 brokers to conduct the due diligence on the private placement offering and recommend the investments to clients, even though the brokers were not qualified to perform either duty.

CONCLUSION

The registration requirements are designed to ensure that a broker who recommends and sells securities understands both the properties of the securities being sold and the broker's responsibilities to the investor. Despite the importance of registration, the current system fails to allow limited license holders to properly serve their clients and to abide by the letter of the FINRA rules.

The first step FINRA could take to rectify the issues discussed is to provide greater guidance and standards in order to prevent a Series 6 broker from performing broker duties outside the scope of the broker's qualifications.

FINRA can better protect investors by requiring customers to be informed as to the qualifications of their broker. A more informed investing public will ultimately lead to a better investor decision-making process. To this end, FINRA should require brokers to provide clear disclosures concerning a Series 6 broker's limitations and their ability to provide complete investing services and advice.

Unfortunately, broker-dealer licensing was not a topic included in the recent Dodd-Frank Act. As a consequence, the SEC is not currently studying the potential impact on investors in maintaining securities qualification distinctions amongst brokers.

However, FINRA published a notice June 28 that the organization is seeking input to update the Series 6 license, among other licenses.²¹ The information gathered by FINRA will be used to update the qualification exams.

The notice says, "FINRA encourages survey recipients to participate to help ensure that examination content accurately reflects the jobs they perform."²² While FINRA is not examining major changes to the Series 6 license, the organization should take this opportunity to examine the role and obligations of the Series 6 broker and update the training requirements and exam accordingly.

NOTES

- ¹ Frank W. Leonesio, Exchange Act Release No. 23,524, 36 SEC Docket 457, 464 (Aug. 11, 1986).
- ² Persons Deemed Not to be Brokers, Exchange Act Release No. 20,943 (May 9, 1984), 49 Fed. Reg. 20,512, 20,515 (1984).
- ³ Section 15(a)(1) of the Exchange Act states, "It shall be unlawful for any broker or dealer ... to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security ... unless such broker or dealer is registered." 15 U.S.C.A. § 78o(a)(1).
- ⁴ *Eastside Church of Christ v. Nat'l Plan*, 391 F.2d 357, 362 (5th Cir. 1968).
- ⁵ Now known as the Financial Industry Regulatory Authority.
- ⁶ 797 F.2d 188 (4th Cir. 1986).
- ⁷ *Id.* at 190.
- ⁸ FINRA is the current SRO with authority to implement securities related registration requirements.
- ⁹ A Series 7 cannot sell commodities and futures.
- ¹⁰ FINRA, Content outline for the General Securities Registered Representative Examination: Series 7 (2011).
- ¹¹ FINRA, Investment Company Products/Variable Contracts Limited Representative Qualifications Examination: Series 6 (2005).
- ¹² Under FINRA Rule 1022(d)(1) a registered representatives who holds a Series 6 is permitted to transact a member's business in redeemable securities of companies registered pursuant to the Investment Company Act of 1940, securities of closed-end companies registered pursuant to the Investment Company Act of 1940 during the period of original distribution only, and variable contracts and insurance premium funding programs and other contracts issued by an insurance company except contracts that are exempt securities pursuant to Section 3(a)(8) of the Securities Act of 1933.
- ¹³ Closed-end funds differ from open-end funds because they raise money only once in a single offering period, similar to the way a stock issue raises money for the company only once, at its initial public offering. After the shares are initially sold, a closed-end fund uses the money to buy a portfolio of underlying investments, and any further growth in the size of the fund depends on the return on the closed-end fund investments, not new investment dollars. Open-end mutual funds, on the other hand, can buy and sell shares at any time. The open-end fund can sell new shares to meet increased demands. FINRA, Mutual Funds, <http://www.finra.org/Investors/SmartInvesting/ChoosingInvestments/MutualFunds/>.
- ¹⁴ FINRA Rule 1032(b)(1)(A) only states that a Series 6 broker's "investment banking or securities business are limited solely to those activities enumerated in Rule 1022(d)(1)." Further, under Rule 1032(b)(2) a Series 6 broker "shall not be qualified to function as a representative in any area not described in paragraph (b)(1)(A)."
- ¹⁵ Formally FINRA Rule 2310. Rule 2310 also required brokers to take into account an investor's holdings and financial needs.
- ¹⁶ See *supra* note 14.

¹⁷ FINRA NTM 04-30, pg. 4 (April 2004).

¹⁸ *Dep't of Enforcement v. Alzid*, NASD Disciplinary Proceeding No. C8A050041 (Apr. 18, 2006).

¹⁹ *Id.* at 6.

²⁰ *Dep't of Enforcement v. Brookstone Sec.*, FINRA AWC No. 2009019837303 (May 20, 2011).

²¹ Information Notice: FINRA Surveys to Update the Series 6, 16, 24 and 26 Exams (June 28, 2011).

²² *Id.*



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