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Client Alert

Current Issues Relevant to Our Clients

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SEC Amends Broker-Dealer Net Capital and Customer Protection Rules

The Securities and Exchange Commission (the "SEC") recently adopted amendments to the broker-dealer net capital rule, customer protection rule and related rules under the Securities Exchange Act of 1934 ("Exchange Act"). These rules include Rules 15c3-1 (Net Capital Rule), 15c3-3 (Customer Protection Rule), 17a-3 and 17a-4 (Books and Records Rules), and 17a-11 (Notification Rule). A copy of the related SEC release is available here. The amended rules will be effective 60 days after publication in the Federal Register, which has not yet occurred as of the date of this Client Alert.

Background

The SEC originally proposed the rule amendments in March 2007 and reopened the public comment period in May 2012. The SEC modified certain portions of the originally-proposed amendments and determined to defer consideration of other portions until a later date. This Client Alert summarizes a selection of the final amended rules.

Net Capital Rule Amendments

Liabilities Assumed by Third Parties
In the original amendment proposal, the SEC expressed concern that some broker-dealers were excluding from net capital calculations certain expenses and debts that have been assumed by third parties (typically a parent or other affiliate). The modified rule now requires a broker-dealer to take into account any liabilities that are assumed by a third party if the broker-dealer cannot demonstrate that the third party has the resources (independent of the broker-dealer) to pay the liabilities. A broker-dealer can demonstrate the adequacy of the third party's finances by maintaining records, such as the entity's most recent audited financial statements, tax returns, or regulatory financial filings.

Non-Permanent Capital Contributions
Consistent with SEC staff positions that capital is not temporary, the modified rule requires broker-dealers to treat as a liability (i) any capital that is contributed under an agreement giving the investor the option of withdrawal, and (ii) any capital contribution that is intended to be withdrawn within one year of contribution. The rule also provides that capital withdrawn within one year is deemed to have been intended to be so-withdrawn unless the broker-dealer receives written permission for the withdrawal from its designated examining authority ("DEA").

Fidelity Bonding Requirements
With respect to the fidelity bonding requirements prescribed by a broker-dealer's self regulatory organization ("SRO"), the revised net capital rule requires broker-dealers to deduct from net capital the excess of any deductible amount over the amount permitted by the SRO's rules.

Solvency Requirements
The amended rule requires a broker-dealer to cease conducting a securities business if the broker-dealer becomes "insolvent," as defined in new subsection 15c3-1(c)(16). The definition is intended to be broad enough to cover any type of insolvency proceeding or condition of insolvency. A companion amendment to Rule 17a-11 (notification rule) also requires that a broker-dealer meeting the definition of "insolvent" provide immediate notice to the SEC, its DEA and, if applicable, the Commodity Futures Trading Commission.

Customer Protection Rule Amendments

Proprietary Accounts of Broker-Dealers
The customer protection rule requires broker-dealers which maintain custody of customer securities (so-called "carrying" broker-dealers) to (i) maintain physical possession or control over such customers' fully-paid and excess margin securities, and (ii) maintain a reserve of cash or qualified securities in certain bank accounts that is at least equal in value to the net cash owed to customers, including cash obtained from the use of customers' securities. Carrying broker-dealers are permitted to carry accounts of other broker-dealers ("PAB" accounts), but such other broker-dealers are not within the current definition of "customer" for purposes of the rule. As a

result, carrying broker-dealers are not currently required to maintain possession or control of the securities in PAB accounts or include them in reserves calculations. Under the Securities Investor Protection Act of 1970 ("SIPA"), however, the definition of "customer" does not exclude broker-dealers. The SEC originally proposed to close this gap in coverage by requiring carrying broker-dealers to maintain sufficient reserves with respect to the PAB accounts. Commenters to the proposed rule noted several practical limitations to closing the gap in coverage, including certain inconsistencies with a no-action letter issued by the SEC staff in 1998. In response, the SEC modified the proposed rule. As adopted, the amendments require carrying broker-dealers to:

1. Perform a separate reserve computation for PAB accounts (in addition to the customer reserve computation currently required for Rule 15c3-3 customer accounts);

2. Establish and fund a separate reserve account for the benefit of PAB account holders; and

3. Obtain and maintain physical possession or control of non-margin securities carried for PAB accounts, unless the carrying broker-dealer has provided written notice to the PAB account holders that it will use those securities in the ordinary course of its securities business, and has provided opportunity for the PAB account holder to object to such use.

The amended rule defines "PAB account" to mean "a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer) other than a delivery-versus-payment or a receipt-versus-payment account." The adopted definition excludes an account that has been subordinated to the claims of creditors of the carrying broker-dealer. The SEC believes that this provision provides certain operational efficiencies sought by some carrying broker-dealers (i.e. the ability to exclude such accounts from PAB reserve computations), while still closing the coverage gap between the customer protection rule and SIPA.

Banks Where Reserve Deposits May be Held
Amended Rule 15c3-3(e) requires a broker-dealer to deposit cash or qualified securities into a customer or PAB reserve account, which must be maintained at a bank. Paragraph (f) of the rule requires that the broker-dealer obtain written agreement from the bank not to re-lend or hypothecate securities deposited into such reserve accounts. The amended rule also requires carrying broker-dealers to exclude from the minimum deposit requirements any cash deposited into reserve accounts at affiliated banks, and limits the amount of cash that can be included at non-affiliated banks to an amount not greater than 15% of the bank's equity capital, as reported by the bank in its most recent call report.

Treatment of Free Credit Balances
Carrying broker-dealers frequently transfer or "sweep" their customers' free credit balances into a money market fund or interest-bearing bank account. Because the different types of sweep accounts afford different levels of interest payments and protection, the amended rule prohibits a carrying broker-dealer from converting, investing, or otherwise transferring free credit balances from one account to another unless it complies with the following four conditions:

1. For any account opened after the effective date of the rule, the customer must give prior written affirmative consent to having free credit balances included in a sweep program after being notified of the general terms and conditions of the products available through the sweep program and that the broker-dealer may change the products available under the sweep program;

2. For any new or existing account, the broker-dealer must provide customers with sweep program disclosures and notices required by each self-regulatory organization of which the broker-dealer is a member;

3. For any new or existing account, the broker-dealer must provide notice, as part of the customer's quarterly statement of account, that the balance in the account can be liquidated on the customer's order; and

4. For any new or existing account, the broker-dealer must provide written notice at least 30 calendar days before making certain changes to the sweep program's terms, conditions, products, or investment.

Notification Rule Amendments

The amendments to Rule 17a-11 establish new notification requirements for broker-dealers' repurchase and securities lending activities when they exceed certain thresholds. As adopted, the notification rule now requires broker-dealers to notify the SEC whenever the total amount of money payable against, or the total contract value of, all securities loaned or subject to a repurchase agreement, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement, exceeds 2,500% of tentative net capital, excluding certain government securities transactions. A broker-dealer is exempted from the notice requirement if it reports its securities lending, borrowing, repurchase, and reverse repurchase activities to its DEA on a monthly basis.

Books and Records Amendments

Amended Rules 17a-3 and 17a-4 require broker-dealers which have more than $1 million in aggregate credit items (as computed under the customer protection rule reserve formula) or more than $20 million in capital to make and keep current records documenting its credit, market, and liquidity risk management controls. The SEC notes that most broker-dealers subject to the rules already have such controls in place, and the purpose of the amendment is not to change any such policies. Instead, the SEC emphasizes that such policies need to be adequately documented. The amendments also require broker-dealers to retain the documented risk management controls or procedures for three years after their use is terminated.

For More Information

For more information on any of the topics covered in this client alert, please contact an attorney in our Corporate Securities Group or visit us online at chapman.com.

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