SEC Amends Financial Responsibility Rules, Customer Asset Protection, the Early Notification Rule and the Books and Records Rules for Broker-Dealers*

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On October 17, 2013, the SEC Extended the Effective Date for a Number of the Rules in the Following Article

On October 17, 2013, the SEC entered an order providing BDs a temporary exemption from the effective date of October 21, 2013 to March 3, 2014 for most of the amendments and position statements that are discussed in the following article.[1] The article was in the process of being published when the SEC's Release was published. The SEC did *not* extend the effective dates for all of the amendments, all of which were to be effective October 21, 2013. The SEC is *not* granting a temporary exemption from all amendments and changes adopted in Release No. 70072, on July 30, 2013, in particular:

> (1) The requirement in paragraph (j)(1) of Rule 15c3-3; (2) the new requirements in Rule 15c3-1 (other than the requirement in paragraph (c)(2)(iv)(E)(*2*) of Rule 15c3-1); (3) and the new requirements in Rule 17a-11.

The SEC extended the effective date because of the significant amount of changes, including significant operational and system changes necessary to comply with the final rule amendments. The temporary exemption will sunset on March 3, 2014. The SEC hopes that this will facilitate an orderly transition to the new requirements by providing BDs with time to make the necessary operational and system changes.

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I. Introduction

During the last five years, the securities and futures industry has been rocked by highly publicized insolvencies of several major broker-dealers and futures commission merchants. These events have highlighted deficiencies in the customer asset protection schemes of both the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). On July 31, 2013, in two separate 300 page rule making releases,[2] the SEC announced the adoption of amendments to its:

1. broker-dealer ("BD") customer asset protection scheme and related rules (the "Adopting Release"), effective October 21, 2013; and
2. financial reporting scheme for BDs, enhanced auditing requirements, form custody, the new Compliance Report and the new Exemption Report (the "Reports Adopting Release") (various effective dates between December 1, 2013 and June 15, 2014).

The Adopting Release is based upon a 2007 rule proposal referred to in this article as the "Proposing Release".[3] The Reports Adopting Release is based on a 2011 rule proposal referred to as the "Reports Proposing Release".[4] In addition to new rules, both

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Releases also codified a number of staff interpretations and clarified certain rules which, in some cases, revised interpretations and added additional conditions and/or exceptions to prior interpretations.

[SEC] Rule 15c3-3 has been amended to codify and clarify that proprietary assets of an [Introducing Broker-Dealer] (both foreign and domestic) carried at a [Clearing Broker-Dealer] will be treated similarly to customer assets in the event of insolvency of the CBD.

This article will discuss the (i) revisions to customer asset protection rules, including the codification of the protection of assets of an introducing broker-dealer ("IBD") carried at a broker-dealer clearing firm ("CBD"), (ii) amendments to the financial responsibility rules (Rules 15c3-1, 15c3-2 and 15c3-3), (iii) revisions to the books and records rules (Rules 17a-3 and 17a-4), and (iv) revisions to the early notification rule (Rule 17a-11).[5] A second article, appearing in an upcoming issue of *Practical Compliance and Risk Management for the Security Industry*, will focus on the Reports Adopting Release.

II. Proprietary Accounts of Broker Dealers; 15c3-3 Changes

A. Broker-Dealer Proprietary Account Asset Protection Scheme Rule Changes

Rule 15c3-3[6] has been amended to codify and clarify that proprietary assets of an IBD (both foreign and domestic) carried at a CBD will be treated similarly to customer assets in the event of insolvency of the CBD. As a result of the amendments to the rule, IBD assets held or carried at a CBD will be covered by the Rule 15c3-3 IBD protection scheme unless the IBD subordinates any claims to the creditors of the CBD.[7] This IBD asset protection scheme lessens the possibility of a shortfall of assets owed to IBDs in the event of a CBD insolvency. Since any such shortfall would also have led to a shortfall of customer assets which SIPA would have been required to cover, this is a worthwhile change.

To understand the SEC rule changes, it is necessary to understand Rule 15c3-3 and how it protects customer assets. Rule 15c3-3 was adopted in 1972 "in response to Congressional directive to improve financial responsibility of broker-dealers that carry customer assets."[8] The purpose of the rule is to enable prompt return of funds and securities to customers in the event of a CBD insolvency.[9] Rule 15c3-3 is complex, but in essence requires CBDs carrying customer assets to segregate the net amount due customers in a "Reserve Account" and to maintain, in "control locations," fully paid excess margin securities held by the CBD for customers.

The required amount of customer funds to be segregated for customers (the "Reserve Calculation") is calculated pursuant to a formula set forth in Exhibit A to the Rule. The SEC in the Proposing Release explained the process as follows:

> Under the formula, the broker-dealer adds up various credit and debit line items. The credit items include cash balances in customer accounts and funds obtained through the use of customer securities. The debit items include money owed by customers (*e.g.,* from margin lending), securities borrowed by the broker-dealer to effectuate customer short sales, and required margin posted to certain clearing agencies as a consequence of customer securities transactions. If, under the formula, customer credit items exceed customer debit items, the broker-dealer must maintain *cash or qualified securities* in that net amount in a 'Special Reserve Bank Account for the Exclusive Benefit of Customers.' This account must be segregated from any other bank account of the broker-dealer.[10] (Emphasis added.)

> With respect to customer securities:

> …Rule 15c3-3 also requires a broker-dealer to maintain physical possession or control of all fully paid and excess margin securities carried for customers. As a result, the broker-dealer cannot lend or hypothecate these securities and must hold them itself or, as is more common, in a satisfactory control location.[11] If a shortfall exists, the broker-dealer must remove liens on securities collateralizing a bank loan; recall securities loaned to a bank or

> clearing corporation; buy-in securities that have been failed to receive over thirty days; or buy-in securities receivable as a result of dividends, stock splits or similar distributions that are outstanding over forty-five days. (Citations omitted).[12]

Reserve calculations must be made weekly as of the close of the last day of business of the week. Deposits of cash and/or qualified securities sufficient to maintain the formula net credit amount must be made no later than one hour after the opening of banking business on the second following business day.[13] However, a small BD which has an aggregate indebtedness not in excess of 800% of net capital and which carries aggregate customer funds as computed at the last computation not exceeding $1 million may, in the alternative, make the customer reserve calculations monthly as of the close of the last business day of the month. Any IBD using this alternative method must deposit in the reserve account not less than 105% of the reserve calculation amount no later than one hour after opening of banking business on the following business day.[14]

B. Why the Change Was Necessary – the SIPA Coverage Anomaly.

The Securities Investors Protection Act of 1970 ("SIPA")[15] does not provide SIPC insurance with respect to proprietary accounts of IBDs. SIPA provides *customers* up to $500,000 insurance coverage (of which no more than $100,000 may be in cash) in the event of a shortfall in customer assets. Under Rule 15c3-3's definitions, the term "customer" specifically does not include a BD.[16] As a result, there is no reserve or segregated fund for IBDs in the event of the insolvency of a CBD. However, under SIPA, IBDs that maintain proprietary accounts at a CBD are entitled to share pro rata in the customer assets of the CBD (including the reserve account, securities and other customer assets[17]) potentially leading to a shortfall of readily available funds and securities for customers in the event of insolvency. In a worst case, a shortfall of assets for the IBDs could result in some IBDs not having enough capital to continue in business, which could lead to a chain reaction of BD insolvencies. In addition, since customers' assets would be part of the customer asset pool, if BDs participate in the pool pro rata, this also decreases the amount available for customers, thereby increasing the amount SIPC must cover.[18] In order to lessen the possibility of a shortfall, the SEC staff developed a regime, by interpretation and no-action letter, regarding how to address Proprietary Accounts of Introducing Brokers ("PAIB").

C. The PAIB Regime

To partially fill this gap between Rule 15c3-3 and the insolvency treatment under SIPA, in 1998, SEC staff issued a no-action letter[19] providing that assets in a proprietary account of an IBD at a CBD were *not* good assets of the IBD for net capital purposes under Rule 15c3-1 *unless* the proprietary assets of an IBD at a CBD were held pursuant to an agreement between the CBD and the IBD under which the CBD agrees to:

1. Maintain at an unaffiliated bank a PAIB Reserve Account pursuant to an agreement with the bank that the funds and securities in the reserve account are the property of IBDs, not the property of the CBD or the bank.
2. Make weekly computations pursuant to the reserve formula and deposit the amount of free credit balance from the PAIB reserve computation in the PAIB bank account in cash or qualified securities.
3. In the case of securities, hold them in appropriate control locations so that they are readily available to a trustee in the event of liquidation.

The PAIB scheme developed by the SEC staff seems to have worked smoothly to date, but there was concern that, as a staff interpretation implemented by contract, it may be questioned in an insolvency proceeding. The recent amendment to Rule 15c3-3 adopted by the SEC codifies and expands the SEC staff's PAIB letter scheme.

D. The PAB Rule Codification.

New paragraph (a)(16) of Rule 15c3-3 defines a Proprietary Account of Broker-Dealers ("PAB") account as follows:

> (16) The term *PAB account* means 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 account or a receipt-versus-payment account. The term *does not include an account that has been subordinated* to the claims of creditors of the carrying broker or *dealer.*[20] (Emphasis added.)

Rule 15c3-1 (the Capital Rule) has been amended to provide that an IBD need not deduct from capital under Rule 15c3-1 the amount held in its proprietary account at a CBD provided the carrying arrangement between the CBD and the IBD meets the requirements of amended Rule 15c3-3,[21] which provide, among other things, the following.

1. Establishing a special PAB reserve bank account at an unaffiliated bank with specific requirements including an agreement with the bank that the assets held in the PAB account are property of the IBD and not the property of the CBD nor the bank at which the PAB account is held.
2. Performing a weekly (monthly for small BDs) PAB reserve computation for assets carried in IBD proprietary accounts.
3. Maintaining cash or qualified securities in the PAB reserve account equal to the computed reserve requirement (i.e., the net credit balance to due to the IBDs).[22]

Reserve calculations must be made weekly as of the close of the last day of business of the week. A small BD which has an aggregate indebtedness not in excess of 800% of net capital and which carries aggregate customer funds as computed at the last computation not exceeding $1 million may, in the alternative, make the customer reserve calculations monthly as of the close of the last business day of the month.

Paragraph (g) of Rule 15c3-3 provides that the CBD can make withdrawals from the PAB reserve account, but only in accordance with the rule, similar to the current customer reserve account withdrawal provisions. The new PAB amendments also permit the CBD to use PAB credits to finance "customer" debits but prohibits the use of credits in the customer reserve account to finance debits in the PAB reserve account.[23]

The new PAB scheme, like the PAIB scheme, requires the CBD to make a computation weekly of the credits (owed to IBD) and debits (owed to CBD) pursuant to the reserve formula of Appendix A to Rule 15c3-3.[24] The net of the credits and debits is the amount of the PAB reserve that must be maintained in cash or qualified securities in a separate segregated account at an unaffiliated bank. Under the PAB regime (like the PAIB regime), the CBD must make a computation weekly (or monthly for small BDs) and deposit within 2 business days of the weekly computation the net amount owed to IBDs by the CBD in cash or qualified securities in the PAB reserve account.[25] As with the customer reserve formula net amount, the PAB reserve account net amount must be maintained at a non-affiliated bank. The CBD must have an agreement with the bank acknowledging that the PAB account is for the exclusive benefit of the IBDs and is kept separate from any other account of the CBD maintained at the bank and confirming that the bank may not have any direct or indirect lien, security interest or otherwise use the account to secure obligations of the CBD to the bank or any other party claiming through the bank.[26]

Under the amended Rule 15c3-3(b)(5), the CBD is not required to maintain physical possession or control of non-margin securities carried for a PAB account provided that the CBD provides adequate written notice to the account holder that the CBD may use the securities in the CBD's ordinary business.[27] In the event that the IBD does not object, the CBD may use the IBD's securities in its business but the CBD will need to include the market value of the securities as a credit in the reserve formula when performing the PAB reserve computation. It should be noted that there is no debit to offset this credit, so it will in effect require the CBD to fund the PAB reserve account. It should also be noted that securities not being used by the CBD must be maintained in accordance with the possession and control requirements of Rule 15c3-3.

E. Exclusions From Definition of PAB Account.

An IBD's account is excluded from the definition of PAB account if the introduced account has been subordinated by agreement to the claims of creditors of the CBD. Likewise, the definition of PAB account also excludes a delivery-versus-payment ("DVP") account or receipt-versus-payment ("RVP") account. [28]

F. Foreign Broker-Dealers and Banks Acting as Broker-Dealers.

Under the changes to Rules 15c3-1, 15c3-2 and 15c3-3(a), CBDs carrying proprietary accounts of foreign BDs, including foreign banks that are operating as BDs, are required to include such proprietary accounts in the CBD's PAB reserve computation. As noted above, however, the definition of PAB account does not include any IBD account that has been subordinated by agreement to the claims of creditors. [29]

G. Banks Where Special Reserve Accounts May Be Held.

Amended Rule 15c3-3(e)(5) will make it difficult to maintain a reserve account at a bank affiliate of the CBD since cash held in a reserve account held at an affiliated bank may not be counted in determining the required minimum PAB reserve funds deposit. The exclusion does not apply to deposits of securities (as opposed to cash) in a segregated reserve account at an affiliated bank of a CBD. With respect to *unaffiliated* banks, a CBD is required to exclude from its net capital amounts deposited to the extent the balance of the account exceeds (i) 50% of the BD's excess net capital based on its most recent FOCUS report; or (ii) 15% of the bank's equity based on the bank's most recent financial reports.[30]

H. SEC Declined to Expand the Definition of "Qualified Securities" for a Reserve Account to Include Certain Money Market Funds.

Rule 15c3-3(a)(6)'s definition of "qualified securities" specifies the securities (essentially limited to U.S. government securities) that may be held in the reserve account or PAB account in lieu of cash. The SEC had originally proposed that "qualified securities" also include certain "Government Securities" money market mutual funds. The SEC did not adopt the proposed expansion of "qualified securities" for 15c3-3 reserve accounts because of its ongoing study with respect to money market funds.[31]

I. Aggregate Debit Item Charge.

Note E(3) to the reserve formula of SEC Rule 15c3-3a requires that BDs using the *basic method* of computing net capital under Rule 15c3-1 reduce total debits by 1% of item 10 (customer debit balances) of the reserve formula. However, for BDs using the *alternative standard* to compute its minimum net capital requirements, aggregate debit items are required to be reduced by 3% in lieu of the 1% otherwise required by Note E(3). The SEC decided not to revise this charge to 1% (in lieu of the 3%) of aggregate debit items for BDs using the alternative standard to compute capital.[32]

III. Allocation of Customer Fully Paid and Excess Margin of Securities to Short Positions

Rule 15c3-3 was amended to require that a BD retrieve from any non-control location, within thirty business days of settlement, securities of the same issue and class of those included on the BD's books as a proprietary short position or a short position for another person. Previously, this time period was ten business days, with the thirty-day time frame applied only to market makers. The rule change makes the time frame uniform – thirty business days regardless of whether the person is a market maker.[33]

IV. Treatment of Free Credit Balances and Sweep Programs

New subsection (j)(1) of Rule 15c3-3 makes it unlawful for a BD to convert, invest or otherwise transfer to another account or institution, free credit balances held in a customer's account except as provided in subsection (j)(2). Subsection (j)(2) provides that a BD is permitted to convert, invest or otherwise transfer to another account or institution free credit balances in a customer's account on the customer's specific order, authorization or draft *but only* in the manner and terms and conditions specified in the order, authorization or draft.[34] New paragraph subsection (j)(2)(ii) provides that a BD is permitted to transfer free credit balances held in a new account of a customer to a product in its Sweep Program or to transfer the customer's interest in one product in a Sweep Program to another in a Sweep Program subject to the conditions discussed below.

Commentators mentioned that Rule 15c3-3(j)[35] proposed revisions did not clearly cover mass transfers. Therefore, the SEC revised paragraph (j), and now paragraph (j)(2)(ii) clarifies that the conditions for operating a Sweep Program will apply to (1) the transfer of free credit balances from a customer's securities account to a product in a Sweep Program and (2) the transfer of customers' interest in one Sweep

Program to another Sweep Program. These provisions will also cover bulk transfers of customer positions from one product – for example a money market fund – to another bank deposit product and transfers of individual positions from one product to another.

The Adopting Release described the new amendments as follows:

> As adopted, paragraphs (j)(2)(ii)(A) and (B) establish four conditions that must be met … to transfer a customer's interest directly from one product in a Sweep program to another product in a Sweep Program….[P]aragraph (j)(2)(ii)(A) – applies only with respect to accounts opened on or after the effective date of the rule….[36]The remaining three conditions – set forth in paragraph (j)(2)(ii)(B)(*1*) through (*3*) – apply to both existing and new accounts.
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> Paragraph (j)(2)(ii)(A), as adopted, provides that for an account opened on or after the effective date of the rule, the customer *must give prior written affirmative consent to having free credit balances in the customer's securities* account included in the Sweep Program after being notified: (1) of the general terms and conditions of the products available through the Sweep Program; and (2) that the broker or dealer may change the products available under the Sweep Program.[37] (Emphasis added.)

The Commission has modified paragraph (j)(2)(ii)(A) in the final rule to read 'the customer gives prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified….'[38] The Commission modified this paragraph to incorporate the term *Sweep Program* as defined in paragraph (a)(17) of the rule and the reference to the 'customer's securities account' to make this paragraph consistent with other modifications to paragraph (j)(2) of the final rule. Additionally, the Commission modified this paragraph to clarify that the *customer's consent must be written*, consistent with the discussion in the proposing release, which noted customer consent could be given in an account opening agreement.[39] As noted above, subsection (j)(2)(ii)(A) applies only to accounts opened after the effective date (October 20, 2013).

Paragraph (j)(2)(ii)(B), as adopted, prescribes the following conditions to sweeping customer free credit balances in all accounts (new or existing):

> (*1*) The broker-dealer provides the customer with the disclosures and notices regarding the Sweep Program required by each SRO of which the broker-dealer is a member;
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> (*2*) The broker-dealer provides notice to the customer, as part of the customer's quarterly statement of account, that the balance in the bank deposit account or shares of the money market mutual fund in which the customer has a beneficial interest can be liquidated on the customer's order and the proceeds returned to the securities account or remitted to the customer; and
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> (*3*)(*i*) The broker-dealer provides the customer with written notice *at least 30 calendar days before:*
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> (*A*) making changes to the terms and conditions of the Sweep Program;
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> (*B*) making changes to the terms and conditions of a product currently available through the Sweep Program;
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> (*C*) changing, adding or deleting products available through the Sweep Program; or
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> (*D*) changing the customer's investment through the Sweep Program from one product to another;
>
> (*ii*) the notice describes the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product.[40] (Emphasis added.)

These amendments present a number of issues for BDs. The SEC staff (as well as the SROs) have, under the general anti-fraud and fair dealing provisions, advised BDs to give customers adequate disclosure and notice. Firms should review their procedures to confirm on-going disclosures are made with respect to money market mutual funds or other Sweep Programs. While many customer agreements include provisions similar to those required, firms would be well advised to review customer agreements and amend as necessary.

Importantly, the SEC recognized in the Adopting Release that there may be instances where an unusual emergency requires a waiver of the thirty day written notice. In such cases the Adopting Release states:

> "A broker-dealer could request exemptive relief from the Rule in unusual or emergency cases where it may be

impractical or contrary to investor protection for a broker-dealer to first provide customers thirty days written notice under the rule before taking one of these actions."[41]

V. Incorporation of Rule 15c3-2 into Rule 15c3-3(j)(1)

The SEC eliminated Rule 15c3-2, incorporating its substance into SEC Rule 15c3-3(j). Rule 15c3-3(j), as amended, will require that BDs inform each customer *at least quarterly* of the amount of free credit balance due the customer and that such amount is payable upon demand. Most BDs already show free credit balances, if any, in their monthly or quarterly customer account statements with the required statement that free credit balances are payable on demand. As such, Rule 15c3-2 was redundant.

VI. Certain Accounts Under the Commodities Exchange Act

The SEC amended paragraphs (a)(8) and (9) of Rule 15c3-3 to clarify its position that funds held in a customer commodity futures account of a BD that is also a futures commission merchant ("FCM") are not to be included in "free credit balances" or "other credit balances"[42] if the funds are segregated in accordance with the Commodity Exchange Act, as amended ("CEA") or in a similar manner.[43] Likewise, funds held in a "proprietary"[44] commodity futures account are not to be included in "free credit balances" or "other credit balances" whether or not segregated.[45] Under the CEA and CFTC rules, customer funds and securities held at a FCM must be segregated and carried in a segregated account at a bank.[46] This amendment is a helpful clarification, as the SEC and SRO interpretations on this subject were not particularly clear, creating unnecessary uncertainty.

VII. Futures Positions in Securities Portfolio Margin Accounts

Under the SRO portfolio margin rules, a BD may combine securities and futures positions in a portfolio securities account to compute margin requirements based on the net of all positions in the account. The Dodd-Frank Act[47] amended and expanded the SIPA insurance for customer claims to cover futures contracts held in a customer portfolio margin account at a BD. The SEC amended Rule 15c3-3 in light of the fact that futures positions in a portfolio margin account would be covered by SIPA in a SIPA liquidation. To facilitate the securities and futures portfolio margining, the SEC proposed several amendments. After reviewing the comments the SEC adopted the following changes:

> …the text in paragraphs (a)(8) and (a)(9) of Rule 15c3-3 expands the terms *free credit balance* and *other credit balances* to include 'funds carried in a securities account pursuant to a self-regulatory organization portfolio margin rule approved by the Commission…including variation margin or initial margin, marks to market, and proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon.' The amendments, as adopted, more precisely capture the Commission's intent in terms of identifying the types of futures-related cash balances that may be held in a portfolio margin account than the language in the proposed rule.
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> On the debit side of the customer reserve formula, the Commission is adopting, substantially as proposed, an amendment to Rule 15c3-3a Item 14 that permits a broker-dealer to include as a debit item the amount of customer margin required and on deposit at a derivatives clearing organization related to futures positions carried in a portfolio margin account. Under SIPA, the term *customer property* includes, 'resources provided through the use or realization of customers' debit cash balances and other customer-related debit items as defined by the Commission by rule,' as well as, 'in the case of a portfolio margining account of a customer that is carried as a securities account pursuant to a portfolio margining program approved by the Commission, a futures contract or an option on a futures contract received, acquired, or held by or for the account of a debtor from or for such portfolio margining account, and the proceeds thereof.' Under this provision of SIPA, this amendment to Rule 15c3-3 makes the margin required and on deposit at a derivatives clearing organization part of the 'customer property' in the event the broker-dealer is placed in a SIPA liquidation. Thus, it would be available for distribution to the failed firm's customers. (Emphasis in original.) (Citations omitted.)[48]

The amendments to Rule 15c3-3 are designed to provide the same treatment to futures related cash balances in a portfolio account as it applies to securities related cash balances.[49]

VIII. The Regulatory Oversight of Securities Lending and Repo Transactions

Subparagraph (c)(2)(iv)(B) to Rule 15c3-1, *as amended*, provides that BDs lending and borrowing securities are presumed, for purposes of the rule, to be acting as principal and therefore subject to applicable capital deduction under the capital rule. However, these deductions do not come into play if the BD takes certain steps to disclaim principal liability by disclosing the identities of the borrower and lender to each other and obtaining agreements from each of the borrower and lender stating the BD is acting exclusively as agent and assumes no principal liability in connection with the transactions.[50] This is consistent with the Standard Master Securities Loan Agreement, including Annex I, commonly used by parties for securities borrowing and lending transactions, as it contains similar provisions for establishing agency as opposed to principal status.[51]

In addition, paragraph (c)(5) of Rule 17a-11[52] was amended to require monthly notification and reporting to the SEC, SROs, and other regulators whenever, if the BD is acting as a *principal* (1) the total amount payable against all loaned securities, (2) the total amount subject to repurchase agreements or (3) the total contract value of all securities borrowed subject to a reverse purchase agreement exceeds 2,500 percent of tentative net capital. However, transactions in government securities as defined under Section 3(a)(42) of the Securities Exchange Act[53] are excluded from the new leverage threshold.

Firms will have to set up specific procedures to review account documentation for each counterparty if the broker wishes to act as an agent, as opposed to a principal, in connection with the lending or borrowing of securities. Likewise, any BD engaged in securities lending will need to be certain that it is taking the applicable capital deduction unless it can demonstrate it is acting as an agent. With respect to the new thresholds under Rule 17a-11, the leverage thresholds will have to be built into a firm's procedures and controls to provide for such notification if the threshold is tripped. While not specified, it is likely the SEC will require continuous compliance with this rule at all times during the day, not just at the end of the day. Consequently, a firm should set thresholds and procedures so that any trades that would take it above the threshold level at any time during the day are rejected.

IX. Documentation of Risk Management Procedures

Paragraph (a)(23) to Rule 17a-3 was amended to require certain BDs to document and implement risk management controls designed to assess and manage risk arising from the business activities engaged in.[54] Risks include, but are not limited to, credit, liquidity and operational risks. This requirement will apply only to BDs that have (1) more than $1 million in aggregate credit items as computed under the customer reserve formula or (2) $20 million in total capital, including debt subordinated in accordance with Appendix D of Rule 15c3-1. Under Rule 17a-4, the holding period of such records would be for three years after the BD ceases to use a particular system of controls.[55]

X. Requirement to Subtract Certain Liabilities and Expenses Assumed by Third Parties from Net Worth for Net Capital Purposes under the Net Capital Rule

These changes essentially codify the SEC's staff positions and SRO interpretive positions that have been in place for some time. Rule 15c3-1 was amended to add a new paragraph (c)(2)(i)(F) that requires a BD to adjust its net worth when computing net capital by including any liabilities assumed by third parties if the BD cannot demonstrate that the third party has resources independent of the BD's income and assets to pay the liabilities.[56] This requires BDs to maintain records of affiliates or other third parties that assume obligations, including the detailed up-to-date financial statements from such parties. It has been the practice of the FINRA examiners in recent years to ask for this detailed financial information regarding any entity assuming the obligations of a BD. Consequently, most firms where this is a potential issue likely already have in place procedures with respect to the required records to show the ability of a third party assuming liabilities to make payment as required.

XI. Non-Permanent Capital

The SEC also amended paragraph (c)(2)(i)(G) of Rule 15c3-1 to require a BD to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it within one year or that is intended to be withdrawn within one year *unless* the BD first receives permission in writing from its designated examining authority (usually FINRA but potentially CBOE). This is a codification of the SEC staff position of many years. This requirement would not apply to withdrawals covered by paragraph (e)(4)(iii) of 15c3-1.[57] While this is not a new development, as a reminder, to avoid the dilemma of retroactive application, all contributions of capital should be structured so that they may not be withdrawn for a one year period of time absent regulatory permission.

XII. Requirement to Deduct Amount of Fidelity Bond Limits as Set by Broker-Dealer's SRO

The SEC proposed an amendment of Rule 15c3-1(c)(2) by adding a new subparagraph (c)(2)(xiv) that requires a BD to deduct the excess of any deductible amount of its fidelity bond requirement over the maximum deductible amount prescribed by the BD's SRO examining authority. The SEC changed the wording of the final rule to provide that the BD must deduct "the amount specified by the rule of the BD's examining authority with respect to a requirement to maintain the fidelity bond coverage."[58]

XIII. Broker-Dealer Solvency Requirement

The SEC amended Rule 15c3-1(a) to provide that a BD shall not continue to conduct business if the firm is "insolvent" as that term is defined in new paragraph (c)(16). "Insolvency", among other things, would include voluntary or involuntary bankruptcy or a similar proceeding by a trustee, receiver or similar official, a general assignment by the BD for the benefit of its creditors, an admission of insolvency or an *inability to make a computation to establish compliance with Rule 15c3-1*.[59] In other words, if the BD is "insolvent" within the meaning of paragraph (c)(16), it would have to immediately stop effecting any transactions or attempting to enter or induce the purchase or sale of any security. Further, the SEC also amended Rule 17a-11 to require that a BD meeting the definition of "insolvent" to provide immediate notice to the SEC, SIPC, appropriate SROs, and the CFTC, if applicable.

It should be noted that among the conditions that cause a BD to be deemed "insolvent" is the inability to make a capital computation. This may be problematic in certain situations. It will be interesting to see how the SEC treats this from a practical standpoint. For example, a BD could have substantial excess net capital but be unable to determine its exact net capital due to difficulty obtaining price data, international disruption or similar events. In the past, the SEC staff has allowed the BD to continue operations albeit with conditions.

XIV. Amendments to the Capital Rule Governing Orders Restricting Withdrawal of Capital from a Broker-Dealer

Currently, paragraph (e)(3)(i) of Rule 15c3-1 restricts a BD when it is withdrawing capital or making loans or advances to stockholders, insiders or affiliates under certain circumstances ("Withdrawals"). The BD must give the SEC notice of Withdrawals above certain moving thresholds. The SEC may issue a temporary order prohibiting Withdrawals above certain moving percentage triggers set forth in Rule 15c3-1(e). The SEC removed percentage triggers which were difficult to compute. The paragraph now provides that the SEC may restrict Withdrawals with no monetary limit for up to twenty business days.[60] In the final rule the SEC added the following additional language that the orders will be issued:

> …under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with protection of investors if the Commission, based on the information available, concludes that such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection act of 1970.[61]

XV. Adjusted Net Capital Requirements (Amendment to Appendix A of Rule 15c3-1)

The SEC amended paragraph (b)(1)(iv) of Appendix A to Rule 15c3-1 to make permanent previously granted relief permitting a reduced range of pricing inputs to the theoretical model provided in Appendix A. This effectively reduces the haircuts applied by the clearing firm with respect to non-clearing options specialists and market makers.[62]

XVI. Money Market Funds under the Capital Rule

The SEC did not change Rule 15c3-1(c)(2)(vi)(D)(1) which provides for a 2% haircut for money market funds when computing net capital.[63] The definition of money market fund is defined as a money market fund qualifying under Rule 2a-7 under the Investment Company Act of 1940.[64]

XVII. Miscellaneous

A. Harmonizing Securities Lending and Repo Capital Charges

The SEC considered whether to harmonize the net capital deductions required under paragraph (c)(2)(iv)(B) of Rule 15c3-1 for securities lending and borrowing transactions with the deductions required under paragraph (c)(2)(iv)(F) for securities repo transactions.[65] Since these transactions are essentially the same from an economic standpoint, the difference in capital treatment has always been a mismatch. However, the SEC did not act on this proposal due to concerns about possible negative impact on market structure which the SEC felt merited additional study.

B. Accounting for Third Party Liens on Customer Securities Held at a Broker-Dealer

In its proposing release, the SEC requested comment on how third party liens against customer fully paid securities carried by a BD should be treated under the Financial Responsibility Rules.[66] Specifically, the SEC asked if a BD should be required to (1) include the amount of a customer's obligation to third parties as a credit item in the reserve formula, (2) remove the securities subject to the lien into a separate pledge account in the name of pledgee or pledgees, or (3) record it on books and records and disclose to the customer the existence of the lien, the identity of the pledgee obligation and the amount of security subject to the lien or a combination of these. The SEC was concerned that conflicting liens would increase the cost of SIPC liquidation and the fund administered by SIPC. The SEC did not take action with this issue at this time, choosing to further investigate and study the issues.[67]

XVIII. Conclusion

In this article, the authors have attempted to identify, discuss and briefly comment on the major changes and amendments to the rules and interpretations by the SEC staff. Although the Adopting Release is over 300 pages, it is worth reading because the SEC discusses its thinking on many of the changes and amendments which may not be clear on their face. In addition, the SEC in the Release responds to the many comments by the industry and industry service providers, including discussion of revisions implemented or rejected due to such comments. This provides further insight into the SEC thinking on the amendments. Given the scope of these amendments (and the sheer size of the Adopting Release), that additional insight can be helpful.

ENDNOTES

* The contributions of Suzanne Hennessey, Legal Assistant are gratefully recognized.

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1 34 Act Rel. 34-70701 (Oct. 17, 2013)

2 34 Act Rel. No. 34-70072 (July 31, 2013); 17 CFR 240.15c3-1, 240.15c3-2, 240.15c3-3, 240.17a-3, 240.17a-4, 240.17a-11 (Adopting Release). 34 Act Rel. No. 34-70073 (July 31, 2013); 17 CFR 240.17a-5, 17a-11; (June 15, 2011) (Reports Adopting Release) (collectively, the "Releases").

[3] Originally Proposed in SEC Rel. No. 34-55431, 72 FR 12862 (Mar. 9, 2007) ("Proposing Release").
[4] 34 Act Rel. No. 34-64676, 76 FR 37572 (June 27, 2011) ("Reports Proposing Release").
[5] SEC Rules may be found at 17 CFR 240 *et seq.*; 17 CFR 240.15c3-3. The CFR cites in this article will be omitted and SEC Rules cited by their SEC Rule number.
[6] SEC Rule 15c3-3.
[7] Adopting Release, p. 16; Rule 15c3-3(a)(16).
[8] *See* 34 Act Rel. No. 9856 (Nov. 10, 1972).
[9] Adopting Release, p. 16; Rule 15c3-3.
[10] Proposing Release, pp. 3, 4.
[11] Under the rule, satisfactory control locations include regulated securities clearing agencies, US banks, and, with the approval of the Commission, certain foreign financial institutions. In order to meet the possession or control requirement, a broker-dealer must determine on a daily basis the amount of customer fully paid and excess margin securities (by issuer and class) it holds for customers. It then compares that amount with the amount of securities it holds free of lien in its own possession or at one of the satisfactory control locations. Proposing Release, pp. 3-4.
[12] Proposing Release, p. 4.
[13] SEC Rule 15c3-3e.
[14] In the event a BD on a monthly basis has aggregate indebtedness in excess of 800% of net capital, the BD must thereafter compute weekly for four weeks, during none of which the aggregate indebtedness exceeded 800% of net capital. BDs that do not carry customer accounts and have only proprietary accounts may compute monthly rather than weekly. Computations also may be made at any time as of the close of any business day and the deposit so computed made one hour after opening of banking business on the second following day. If a BD performing the computation with respect to PAB accounts on a monthly basis is at any time required to deposit additional cash or qualified securities in the PAB reserve bank account, the BD must thereafter perform computations required on a weekly basis for four consecutive weeks. None of which is made at a time when the BD is required to deposit additional cash or qualified securities in the PAB reserve account. 15c3-3(a)(1).
[15] 15 U.S.C. 78aaa *et seq.*
[16] SEC Rule 15c3-3(a)(i).
[17] 15 U.S.C. 78iii(2).
[18] Adopting Release, pp. 13-14.
[19] *See* Adopting Release, p. 15; Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation Commission to Raymond J. Hennessy, Vice President of NYSE and Thomas Cansella, Vice President of NASD Regulation, Inc. (Nov. 10, 1998).
[20] Adopting Release, p. 16; SEC Rule 15c3-3(a)(16).
[21] Adopting Release, p. 24, *et seq*.
[22] Amended SEC Rule 15c3-3(e).
[23] Adopting Release, p. 25.
[24] Adopting Release, pp. 10-14.
[25] Adopting Release, pp. 15-16.
[26] Adopting Release, pp. 24-25.
[27] Adopting Release, pp. 21-23.
[28] Adopting Release, p. 16.
[29] SEC Rule 15c3-3(a)(16); Adopting Release, p. 20.
[30] Adopting Release, pp. 29-41.
[31] Adopting Release, p. 73
[32] Adopting Release, p. 126.
[33] Adopting Release, pp. 41-46.
[34] Adopting Release, pp. 61-63.
[35] Adopting Release pp. 61-63; SEC Rule 15c3-3(j).
[36] Effective date September 30, 2013.
[37] Adopting Release, p. 59; *see* SEC Rule 15c3-3(j)(2)(ii)(A), as adopted.
[38] *Id*. Adopting Release, pp. 60-61. The proposed rule stated the "customer has previously affirmatively consented to such treatment of the free credit balances after being notified of…." In addition, as noted above, the phrase "accounts opened on or after the effective date of this paragraph" was deleted from proposed paragraph (j)(2)(ii) and moved to paragraph (j)(2)(ii)(A), with the reference to specific paragraph (j)(2)(ii) inserted after the word "paragraph." Moving this phrase to paragraph (j)(2)(ii)(A) simplifies the final rule by eliminating the necessity of codifying two largely overlapping sets of conditions, with three of the conditions being repeated in both paragraphs. The effect of this change is to make the first condition only applicable to new accounts and the remaining conditions (paragraph (j)(2)(ii)(B)(*1*) through (*3*)) applicable to both new and existing accounts. The word "accounts" also has been replaced with the phrase "an account." Adopting Release, p. 61 FN 199.
[39] *See* Adopting Release, pp. 59-61 ("[T]he customer would need to agree prior to the change (*e.g.,* in the account opening agreement) that the broker-dealer could switch the sweep option between those two types of products.").
[40] *See* paragraph (j)(2)(ii)(A)(*2*) of SEC Rule 15c3-3, as adopted.
[41] Adopting Release, p. 65, FN 111.
[42] Adopting Release, p. 67, *et seq*.
[43] *See* 17 U.S.C. §4d(a); CFTC Rule 1.20-e.
[44] *See* CFTC Rule 1.3(y); 17 CFR 1.3(y).
[45] Adopting Release, p. 69.
[46] *See* 17 U.S.C. §4d(a); CFTC Rule 1.20-e.
[47] *See* Pub. L. No. 111-203 §983.
[48] Adopting Release, pp. 80-82.
[49] Adopting Release, p. 79.
[50] Adopting Release, pp. 82-89.
[51] *See* 2000 Master Securities Loan Agreement, Annex 1, published by the Bond Market Association, now the Securities Industry and Financial Markets Association.
[52] SEC Rule 17a-11(c)(5).
[53] 15 U.S.C. 78a(42).
[54] Adopting Release, pp. 89-92.
[55] *See* SEC Rule 17a-4(e)(9).
[56] Adopting Release, p. 97, *et seq.*
[57] Adopting Release, p. 101, *et seq.*
[58] Adopting Release, p. 111.
[59] Adopting Release, p. 112, *et seq*.
[60] Adopting Release, p. 121, *et seq*.
[61] Adopting Release, p. 121; SEC Rule 15c3-1(e)(3)(i).
[62] Adopting Release, p. 122.
[63] Adopting Release, p. 124.
[64] 15 U.S.C. 80(a), *et seq.*
[65] Adopting Release, p. 130.
[66] Adopting Release, p. 82.
[67] Adopting Release, p. 130.

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