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CLIENT MEMORANDUM

May 8, 2012

SEC Reopens Comment Period for Proposed Amendments to Financial Responsibility Rules for Broker-Dealers

On May 3, 2012, the SEC reopened the comment period on a long-dormant proposal to amend the financial responsibility rules for broker-dealers. Proposed in March 2007 but never acted on by the SEC, the proposal would make various amendments to the SEC's net capital, customer protection, books and records and notification rules for registered broker-dealers.[1]

Reopening the comment period indicates that the SEC likely plans to take action on at least some of the proposed rule changes in the near future. Because it was originally proposed before the 2008 financial crisis, we expect that the SEC will reconsider and decline to adopt some of the proposed changes that could be seen as reducing broker-dealer customer protection requirements or allowing increased leverage.

Among other things, if adopted, the Proposal would:

- Codify, broaden and mandate an existing staff no-action position relating to reserve account requirements for registered broker-dealers holding proprietary accounts of other brokers or dealers ("**PAB accounts**");
- Prohibit registered broker-dealers from maintaining reserve accounts at affiliated banks, and limit the amount of reserve account funds that a registered broker-dealer may maintain at any single bank;
- Permit holding of shares of eligible money market funds in reserve accounts;
- Adopt restrictions on "sweeping" customer free credit balances into money market funds and bank deposits, and changing sweep arrangements;
- Create a presumption, for net capital purposes, that securities loans by a registered broker-dealer are effected as principal, rather than as an agent, unless specified procedures are followed;
- Require new SEC reporting by registered broker-dealers having significant positions in securities loans and repurchase agreements on non-government securities;
- Require large firms to document their risk management controls; and
- Clarify the treatment, for net capital purposes, of liabilities of a registered broker-dealer assumed by third parties (such as those under expense sharing arrangements) and certain short-term capital contribution arrangements.

The comment period will be reopened for 30 days from the date the notice is published in the Federal Register.

[1] Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 34-55431 (March 9, 2007); 72 Fed. Reg. 12862 (March 19, 2007), *available at* http://sec.gov/rules/proposed/2007/34-55431.pdf (the "**Proposal**").

Amendments to the Customer Protection Rule

PAB Accounts

Under Rule 15c3-3 under the Exchange Act (the "**Customer Protection Rule**"), registered broker-dealers that hold customer funds or securities are generally required to (i) maintain possession or control of certain customer securities (which limits the firm's ability to lend or rehypothecate the securities), and (ii) deposit cash or specified securities into a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (the "**reserve account**") based upon a formula that is set forth in the Customer Protection Rule. The possession and reserve account provisions are intended to allow for the prompt return of customer assets in the event of a registered broker-dealer's insolvency, provide for an orderly liquidation process, and reduce the need for the Securities Investor Protection Commission ("**SIPC**") to advance funds to satisfy insolvent firms' customers under the Securities Investor Protection Act of 1970 ("**SIPA**").

Domestic and foreign broker-dealers are generally not "customers" for purposes of the Customer Protection Rule. Therefore, registered broker-dealers ("**carrying broker-dealers**") carrying proprietary accounts of other broker-dealers do not have to include such accounts in the rule's reserve and possession and control requirements. However, they may be "customers" for the purposes of SIPA and the proceedings thereunder. Thus, in the SEC's view, there is a risk that in the event of the insolvency of a carrying broker-dealer, SIPA would have exposure in respect of accounts of a domestic or foreign broker-dealer which were held by the failed carrying broker-dealer, but the carrying broker-dealer would not have separately reserved assets against the securities and funds of its domestic or foreign broker-dealer customer.

In a no-action letter (the "**PAIB Letter**"), the SEC staff previously addressed the treatment of proprietary accounts of registered broker-dealers held by carrying broker-dealers.[2] In the PAIB Letter, the SEC stated that a registered broker-dealer whose proprietary account was held by a carrying broker-dealer would have to take certain capital deductions unless the carrying broker-dealer holding such proprietary account agreed to: (i) perform a reserve computation; (ii) establish a separate special reserve bank account (a "**PAIB Account**"); and (iii) maintain cash or qualified securities in the reserve account equal to the computed reserve requirement. According to the Proposal, however, the PAIB Letter is not a complete solution to the concern of SIPC exposure, because PAIB Account arrangements are essentially voluntary (since the registered broker-dealer that maintains a proprietary account with the carrying broker-dealer may elect to take a capital charge, or the carrying broker-dealer may decline to enter into the arrangement), and because foreign broker-dealers have no incentive to establish such accounts (because they are not subject to the net capital rule).

The Proposal would instead require carrying broker-dealers to establish bank accounts for PAB accounts, including accounts of domestic and foreign broker-dealers and foreign banks acting in a broker-dealer capacity, and conduct reserve account calculations with respect to PAB accounts. Deposit and withdrawal requirements, similar to those applicable to customer reserve accounts, would also be required.

Carrying broker-dealers maintaining PAB accounts would also be required to notify the banks holding such accounts of the status of the PAB accounts and confirm with the banks that such accounts are maintained for the benefit of the PAB accountholders. In essence, the amendment would codify and

[2] Letter from Michael A. Macchiaroli, Associate Director, SEC Division of Market Regulation, to Raymond J. Hennessy, Vice President, New York Stock Exchange, Inc., and Thomas Cassella, Vice President, NASD Regulation, Inc. (Nov. 10, 1998).

render mandatory the reserve and segregation requirements currently established by the PAIB Letter, and extend them to proprietary accounts of foreign broker-dealers.[3]

There are several differences between the requirements applicable to PAB accounts and the requirements for ordinary customer securities and funds held by a registered broker-dealer. Carrying broker-dealers would be able to use excess debits in their regular customer reserve accounts to offset deposit requirements in PAB accounts, but not the other way around. Moreover, carrying broker-dealers would not be required to maintain physical possession or control of fully paid and excess margin securities carried for PAB accounts, provided that certain written consents are obtained.

If adopted, this amendment would decrease the liquid funding available at carrying broker-dealers, particularly those carrying accounts of unregistered foreign broker-dealers. Revisions to accounting and operational procedures would also be required.

Banks Holding Reserve Accounts

The Proposal would limit the banks at which registered broker-dealers may hold their reserve accounts by: (i) excluding cash deposits at parent or affiliate banks for the purposes of meeting reserve requirements, and (ii) limiting the amount of cash a registered broker-dealer may maintain in a reserve bank account at any single unaffiliated bank to the lower of (A) 50% of the broker-dealer's excess net capital and (B) 10% of the unaffiliated bank's equity capital.

If this amendment is adopted, registered broker-dealers holding customer funds may be required to move their reserve accounts if currently held at affiliated banks. Further, registered broker-dealers may need to enter into new or additional banking relationships, which may increase the cost and administrative burden of cash management regarding reserve account funds.

Qualifying Money Market Funds as Eligible Reserve Account Assets

Under the Customer Protection Rule, reserve account deposits must be made either in cash or "qualified securities."[4] The Proposal would expand the definition of qualified securities to include money market securities that only invest in qualified securities, provided that the money market funds meet other criteria, including not being affiliated with the firm, and not having the ability to require multi-day redemption notification or delay redemption for more than one day.

This amendment is potentially beneficial to registered broker-dealers and reflects a long-standing request by the mutual fund industry. However, since the Proposal was originally issued in March 2007, there has been an increased focus on the level of risk presented by money market funds, which may cause the SEC to reconsider this aspect of the Proposal.[5]

[3] Under the Proposal, if a carrying broker-dealer fails to comply with the proposed requirements, the broker-dealer holding proprietary assets at that carrying broker-dealer would be required to take a net capital deduction.

[4] "Qualified securities" is currently defined to mean securities issued by the United States or guaranteed by the United States with respect to principal and interest.

[5] For example, in September 2008, the Reserve Primary Fund "broke the buck" (meaning its net asset value fell below $1.00 per share), leading the U.S. Treasury to temporarily guaranteed money market fund deposits. More recently, the Chairman of the SEC has suggested significantly reforming the structure of money market funds to reduce the risk of future losses. *See* Chairman Mary L. Schapiro, Remarks at SIFMA's 2011 Annual Meeting, *available at* http://www.sec.gov/news/speech/2011/spch110711mls.htm.

Sweep Accounts

The Proposal would introduce explicit requirements on the manner in which registered broker-dealers offer to "sweep" funds (referred to as "free credit balances") that are payable to customers on demand into money market funds, bank deposits or other instruments, and the requirements for changing sweep options that they make available to customers.

In sweep arrangements, registered broker-dealers may offer to sweep free cash balances into a specific money market fund or interest bearing bank account. The customer earns dividends on the money market fund or interest on the bank account until such time as the customer chooses to withdraw or otherwise invest the cash.

The Proposal would allow sweep arrangements only under three specific circumstances:

- With regard to sweep arrangements ***other than*** those involving money market funds and bank deposits, the Proposal would only permit a registered broker-dealer to sweep customer free credit balances upon a specific order, authorization, or draft from the customer, and under the terms and conditions specified by the customer.
- With regard to sweep arrangements involving money market funds and bank deposits for ***new customers***, the Proposal would permit a registered broker-dealer to begin sweeping the customer's free credit balance into either money market funds or bank deposits only if: (i) the customer previously agreed to permit sweeping of free credit balances (*e.g.*, in the account opening agreement) after being notified of the different types of money market funds and bank account products in which the broker-dealer may sweep free credit balances; (ii) the firm provides the customer with all notices and disclosures regarding the investment and deposit of free credit balances required by the self-regulatory organizations ("**SROs**") of which the firm is a member;[6] (iii) the firm provides the customer with notice in the customer's quarterly statement that the money market fund or bank deposit account can be liquidated on the customer's demand and converted back into free credit balances held in the customer's securities account; and (iv) the firm provides the customer with notice at least 30 calendar days before changing the product, the product type, or the terms and conditions under which the free credit balances are swept, and the notice must describe the change and explain how the customer could opt out.
- With regard to sweep arrangements involving money market funds and bank deposits for ***customers whose accounts were opened before the effective date of the rule***, the Proposal would permit a registered broker-dealer to sweep the customer's free credit balance into either money market funds or bank deposits only if all of the conditions specified for new accounts specified in the preceding paragraph is satisfied ***other than*** the requirement that the customer previously agreed to permit sweeps. According to the Proposal, this would avoid the need to amend each existing customer account agreement.

The Proposal is the first significant formal SEC guidance regarding sweep arrangements, and would impose additional requirements on registered broker-dealers offering to sweep customers' funds in addition to existing SRO guidance.

[6] *E.g.*, NYSE Information Memo 05-11 (February 15, 2005).

Other Proposed Amendments

The Proposal would make additional amendments to the Customer Protection Rule of a more technical nature, including:

- The elimination of an exception that permits firms that have sold securities short to customers who have paid for the securities and are holding them as long positions to account for such positions as adjustments in the firms' reserve calculation, rather than obtaining possession and control of the securities.[7]
- The elimination of a discrepancy between the method for calculating the reserve formula for registered broker-dealers computing net capital under the "basic method" (which requires such firms to deduct 1% from the total debits for debit balances in customers' cash and margin accounts), and those using the "alternative method" (which requires a 3% deduction). The Proposal would lower the debit reduction for firms using the "alternative standard" to the same level as that of firms using the "basic method." As this proposed amendment would reduce the amount of funds that firms using the alternative method are required set aside for the benefit of customers, the SEC may reconsider this proposal in light of renewed concerns over capital and leverage levels following the financial crisis.
- Clarification that where a firm is duly registered with the CFTC as a futures commission merchant, "free credit balances" for purposes of the reserve account formula would not include either (i) segregated funds carried in a commodities account, or (ii) funds exempt from the segregation requirement under CFTC rules.[8]
- Modifications to the Customer Protection Rule that are designed to provide the protections of Rule 15c3-3 and SIPA to futures positions held in a securities account under SRO portfolio margin rules.[9]

Amendments to the Net Capital Rule

Rule 15c3-1 (the "**Net Capital Rule**") requires registered broker-dealers to maintain a minimum amount of net capital, limits firms' leverage and prohibits rapid withdrawals of capital. The proposed amendments to Rule 15c3-1 are essentially incremental changes that address particular technical issues, rather than

[7] The proposed amendment would require registered broker-dealers to generally obtain physical possession and control of securities included in its books and records as a proprietary short position or a short position for another person within ten business days (or 30 calendar days if the registered broker-dealer is a market maker in the securities).

[8] The Customer Protection Rule already excludes funds held in a segregated account under the Commodity Exchange Act. However, under CFTC rules, accounts maintained for persons that have an ownership interest in the futures commission merchant may be designated as "proprietary accounts." Cash held in such an account is not subject to segregation requirements applicable to other customer accounts.

[9] The Customer Protection Rule would be amended to include as "credit items," for purposes of the reserve calculation, funds resulting from margin deposits and marks to market related to and proceeds from the liquidation of futures contract and related options carried in a portfolio margin account. As a consequence, such futures-related funds would be treated as "cash" for the purposes of determining a customer's "net equity" in a SIPA liquidation. The rule would be further amended to include as a debit item the amount of customer margin on deposit with futures clearing organizations relating to the portfolio margin account, and define "customer property" for purposes of SIPA to include these amounts. It should be noted that in its comment letter to the SEC when the Proposal was originally released in 2007, SIPC argued that the these amendments would be inconsistent with SIPA and, if they were to be made, would require legislative amendment to SIPA rather than SEC rulemaking. *See* Comment Letter, Josephine Wang, SIPC (May 17, 2007), *available at* http://sec.gov/comments/s7-08-07/s70807-16.pdf. Since that time, Section 983 of the Dodd-Frank Act amended the definition of "customer" and "customer property" to include references to futures contracts and options on futures contracts held in a portfolio margin account carried as a securities account.

sweeping changes to the structure of the Net Capital Rule. Nonetheless, they may in some cases impose additional compliance burdens.

Liabilities Assumed by Third Parties

Parents or other affiliates of a registered broker-dealer often choose to assist their affiliated registered broker-dealer by assuming the registered broker-dealer's obligations in respect of services or goods, such as office space or utilities. The staff of the SEC has expressed concerns that some registered broker-dealers may be incorrectly omitting expenses and liabilities subject to these agreements from the firm's books and records, resulting in inaccurate disclosure of the firm's performance and financial condition.[10] The staff's concern was that the omission may artificially inflate the firm's profitability, causing it to appear to be in full capital compliance when, in some cases, it may not be in compliance after giving effect to the actual value of expenses that are technically assumed by third parties. SROs have also issued guidance concerning expense sharing agreements.[11]

The Proposal would amend the Net Capital Rule to require registered broker-dealers to decrease their net worth (and therefore their net capital) by treating as a liability of the firm any liability assumed by third parties, unless the firm can demonstrate that the third parties have the resources independent of the broker-dealer's income and assets to pay the liability. To evidence a third party's financial capacity, the firm could maintain as a record the third party's most recent and current audited financial statements, tax return or regulatory filing containing financial reports.

Because FINRA member firms are already required to comply with SEC staff and FINRA guidance on expense sharing agreements, formally adopting this position into the Net Capital Rule should have minimal impact on firms.

Treatment of Short-Term Capital Investments

A further capital-related issue addressed by the Proposal is the treatment of short-term capital investments in registered broker-dealers. In some cases, capital may be contributed under an agreement giving the investor the option to withdraw the capital at the investor's discretion. The SEC has previously stated that a capital contribution should be treated as a liability if it is made with the understanding that the contribution can be withdrawn at the option of the investor. The Proposal would require a registered broker-dealer to treat as a liability (rather than as part of net worth) (i) any capital that is contributed under an agreement giving the investor the option to withdraw it, or (ii) any capital contribution that is intended to be withdrawn within one year (unless permission is granted by the registered broker-dealer's SRO). Any withdrawal of capital made within one year of its contribution to the registered broker-dealer would be presumed to have been intended to be withdrawn within a year and must treated as a liability.[12]

Other Proposed Amendments

The Proposal contains a number of other proposed changes to the Net Capital Rule, including:

[10] Letter from Michael Macchiaroli, Associate Director, SEC Division of Market Regulation, to Elaine Michitsch, New York Stock Exchange, Inc., and Susan Demando, NASD Regulation, Inc. (July 11, 2003).

[11] *See*, *e.g*., NASD Notice to Members 03-63 (October 2003).

[12] FINRA Rule 4110(c)(1) already prohibits FINRA members from allowing withdrawals of equity capital within one year of contribution; incorporating this requirement into the Net Capital Rule should not create any new restriction.

- A revision to the Net Capital Rule that would conform its treatment of excess deductibles on SRO-required fidelity bonds to the capital deductions required by SRO rules.[13]
- An expansion of the SEC's authority to issue orders to prevent significant rapid withdrawals of capital.
- A reduction of the "haircuts" required to be taken on money market funds (from 2% to 1%) when calculating their value for net capital purposes. At the time of the original Proposal, the SEC noted "the historical stability of money market funds as investments" as one of the reasons for reducing the required haircut. Given the greater risks now viewed as present in money market funds, particularly after the collapse of the Reserve Primary Fund, the SEC may reconsider this aspect of the Proposal.
- A requirement that registered broker-dealers cease securities business if any "insolvency" event occurs.
- An amendment to make permanent existing temporary relief concerning the haircuts applied by registered broker-dealers carrying accounts of non-clearing option specialists and market makers.

Amendments With Respect to Securities Lending and Borrowing and Repurchase Transactions

Presumption of Principal Capacity

The Proposal would amend the Net Capital Rule to provide that registered broker-dealers would be presumed to be acting as principals and be subjected to applicable capital deductions in relation to securities lending transactions, unless they take certain steps to disclaim principal status. In effect, the Proposal would require registered broker-dealers in a securities lending or borrowing transactions to take the applicable capital deductions as if they were the principals for such transactions, unless they take the enumerated steps.[14]

New Reporting Requirements

The Proposal would amend Rule 17a-11 to require registered broker-dealers to notify the SEC whenever money payable against all non-government securities loaned or subject to a repurchase agreement, or the total contract value of all such securities borrowed or subject to a reverse repurchase agreement, exceeds 2,500% of tentative net capital. The SEC believes this requirement would help identify firms with significant non-government securities lending and borrowing or repo business and expedite regulators' responses in the event that such firms have financial difficulties. In lieu of this requirement, the Proposal would allow firms engaging predominantly in securities lending and repo transactions involving non-government securities to elect to submit monthly reports to their designated examining authority.

[13] For example, under FINRA Rule 4360(c), if the deductible on a fidelity bond exceeds 10% of the coverage, that excess must be deducted from the firms' net capital.

[14] In particular, to be considered as acting as agent, rather than principal, (i) the firm must fully disclose the identity of each party to the other, and (ii) each party must expressly agree in writing that the obligations of the firm shall not include a guarantee of performance by the other party and that such party's remedies in the event of a default by the other party shall not include a right of setoff against obligations, if any, of the firm.

If the Proposal is adopted, firms engaging to a significant degree in securities lending and borrowing business or repo business involving non-government securities would need to revise their recordkeeping, reporting and internal control procedures to ensure compliance with this new reporting requirement.

Documentation of Risk Management Procedures

The Proposal would amend Rule 17a-3 to require relatively large registered broker-dealers[15] to document any implemented internal risk management control designed to assist in analyzing and managing the market, credit, liquidity, operational and other risks. These firms would also be required to maintain these records for three years after the termination of use of such system of controls.

In the Proposal, the SEC underscored the need for internal controls as a means for registered broker-dealers, especially the largest and most diversified firms, to manage the risks inherent in their business activities and to prevent significant losses. Nevertheless, the SEC emphasized that it is not proposing any minimum requirements in firms' internal controls. Rather, this requirement would only apply to risk management control that has been ***implemented*** by the particular firms, but would not technically require the creation of new policies when not otherwise implemented.[16]

According to the Proposal, as of March 2007, this proposed requirement would have apply to approximately 500 firms.

Other Matters on Which the SEC Requests Comments

In addition to the general request for comments under each of the proposals summarized above, the SEC also requested comment on the following specific issues:

- Rule 17a-11 under the Exchange Act requires registered broker-dealers to promptly notify the SEC if, among other things, the net capital level for firms using the alternative standard falls below 5% of aggregate debit items. The SEC requests comments on the use of a tiered approach to lower this early warning threshold for registered broker-dealers with debit items exceeding $10 billion.
- Under the Net Capital Rule, haircuts for securities lending and borrowing transactions are different from those for repo transactions. The SEC is seeking comment on whether and how the net capital treatment for these types of transactions should be harmonized, given the economic similarity between the transactions.
- Special insolvency-related issues may arise when customer securities held at a registered broker-dealer are subject to third-party liens. In particular, in some instances, the customer securities may be held in the name of the customer unless they are moved to pledge accounts. In such cases, upon the registered broker-dealer's insolvency, both the customers and the third-party lien-holders may have claims for the securities. In respect of customer securities subject to third-party liens, the SEC is seeking comments on whether registered broker-dealers should: (i) include customers' obligations to third-parties as a credit item in the reserve formula; (ii) move such securities into separate pledge accounts in the name of the pledgees; or (iii) record and disclose the liens.

[15] The requirement would only apply to registered broker-dealers that have more than (i) $1,000,000 in aggregate credit items as computed under the customer reserve formula of Rule 15c3-3, or (ii) $20,000,000 in total capital including subordinated debt.

[16] Note that firms that provide market access subject to Rule 15c3-5 are already separately required to maintain a written system of risk management policies and procedures relating to the risks arising from that activity.

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