

## Banking & Securities Spotlight

### SEC Issues Final Amendments to FRRs

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#### The Bottom Line

Many of the amendments to the FRRs incorporate into the rules items that were the subject of SEC interpretive letters or for which compliance with draft guidance was expected by regulatory examiners. The amendments to the FRRs also introduce new requirements.

- The SEC issued a [final rule](#)<sup>1</sup> amending certain FRRs<sup>2</sup> related to the protection of customer assets held by broker-dealers under the Securities Exchange Act of 1934. Many of the amendments to the FRRs incorporate into the rules items that were the subject of SEC interpretive letters or for which compliance with draft guidance was expected by regulatory examiners. The amendments to the FRRs also introduced new requirements.
- The following key requirements were added to the customer protection rule:<sup>3</sup>
  - Broker-dealers are prohibited from using cash accounts at affiliated banks to maintain reserves of customer funds.
  - Broker-dealers are restricted in their ability to maintain cash reserve deposits at U.S. branches of foreign banks.
  - Firms must obtain specific authorization from their customers for money movements.
  - Foreign broker-dealers will be protected as a separate class of customer, and their accounts will be treated the same as those of U.S. broker-dealers.
  - Carrying broker-dealers that use securities held in proprietary accounts of other broker-dealers (PAB accounts) must include the securities' market value as a credit in the reserve formula.
- The amended books and records rules<sup>4</sup> introduce a new requirement that broker-dealers meeting certain thresholds must document the controls they use to manage credit, market, and liquidity risks.
- The amended notification rule<sup>5</sup> introduces new notification requirements for broker-dealers whose repurchase and securities lending activities exceed a certain threshold. Since most broker-dealers are members of FINRA, they will not be affected by these requirements.

<sup>1</sup> SEC Final Rule Release No. 34-70072, *Financial Responsibility Rules for Broker-Dealers*.

<sup>2</sup> Financial responsibility rules.

<sup>3</sup> SEC Rule 15c3-3, "Customer Protection — Reserves and Custody of Securities."

<sup>4</sup> SEC Rule 17a-3, "Records to Be Made by Certain Exchange Members, Brokers and Dealers," and SEC Rule 17a-4, "Records to Be Preserved by Certain Exchange Members, Brokers and Dealers."

<sup>5</sup> SEC Rule 17a-11, "Notification Provisions for Brokers and Dealers."

# Beyond the Bottom Line

On July 30, 2013, the SEC issued a final rule amending the following FRRs: the net capital rule,<sup>6</sup> the customer protection rule, the books and records rules, and the notification rule. The amendments, which are effective October 21, 2013, were issued in conjunction with the SEC's [final rule](#)<sup>7</sup> amending Exchange Act Rule 17a-5.<sup>8</sup> These amendments are discussed in detail below.

## Amendments to the Net Capital Rule

The net capital rule, which requires broker-dealers to maintain minimum amounts of liquid assets, is designed to ensure that broker-dealers have sufficient liquid assets to pay customer liabilities in the event that their business fails. Many of the amendments to the net capital rule are based on previous SEC guidance, including interpretive letters from the SEC to the DEA.<sup>9</sup> In addition to codifying this guidance in the FRRs, the final rule introduces the following new requirements:

- The SEC has the authority to issue an order prohibiting the withdrawal of capital in any amount. Previously, the SEC's authority was limited to prohibiting withdrawals greater than 30 percent of excess net capital.
- Broker-dealers that claim insolvency and seek bankruptcy protection will be deemed to be not in compliance with the net capital rule. Accordingly, they will be required to cease conducting a securities business and to file a notice under the notification rule.<sup>10</sup>

The amendments to the rule codify the following requirements, which were contained in SEC interpretive letters and other guidance:

- A liability that is subject to an expense-sharing agreement with an affiliate must be recorded unless the broker-dealer can demonstrate (e.g., by producing the affiliate's financial statements) that the affiliate has the financial resources to pay the liability.<sup>11</sup>
- Contributed capital that can be withdrawn at the option of the investor should be treated as a liability.
- A broker-dealer that intends to withdraw capital within one year must obtain permission from its DEA before doing so.
- A capital charge will be added for an excess deductible on fidelity bond coverage (as the self-regulatory organizations (SROs) have required).
- Immediate counterparties to stock borrow and stock loan transactions are presumed to be acting in a principal capacity unless they have entered into a contract that clearly specifies their respective roles in the transaction.<sup>12</sup>

Under the amended net capital rule, the SEC has the authority to issue an order prohibiting the withdrawal of capital in any amount.

<sup>6</sup> SEC Rule 15c3-1, "Net Capital Requirements for Brokers or Dealers."

<sup>7</sup> SEC Final Rule Release No. 34-70073, *Broker-Dealer Reports*.

<sup>8</sup> SEC Rule 17a-5, "Reports to Be Made by Certain Brokers and Dealers." See Deloitte's [Issue 4, September 2013, Banking & Securities Spotlight](#) for additional information about the final rule amending Rule 17a-5.

<sup>9</sup> Designated examining authority, such as FINRA.

<sup>10</sup> The notification rule requires broker-dealers to notify the SEC and their DEA if they are experiencing certain difficulties. The rule also requires notification if certain minimum net capital requirements are not met.

<sup>11</sup> See NASD Notice to Members 03-63, *SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers*: "On July 11, 2003, the [SEC] Division of Market Regulation (DMR) issued a letter (the 'Letter') to clarify its position under SEC Rules 15c3-1, 17a-3, 17a-4, and 17a-5 (collectively, the 'financial responsibility rules') regarding the treatment of broker/dealer expenses and liabilities. The Letter addresses situations in which another party has agreed to pay expenses related to the business of the broker/dealer. The Letter's requirements became effective when it was issued." NASD members were required to comply with the requirements of the Letter no later than December 1, 2003.

<sup>12</sup> In a March, 20, 2007, [draft letter](#) to Michael Macchiaroli, associate director of the SEC's Division of Market Regulation, the Securities Industry and Financial Markets Association discussed the problem that would ultimately give rise to this amendment. The letter stated that "[b]roker-dealers frequently borrow securities through an intermediary (the 'Agent Lender') that acts as agent on behalf of one or more lenders (the 'Principals'). [U]nder long-standing securities industry practices for these transactions broker-dealers historically obtained little or no information from the Agent Lender regarding the specific Principal(s) involved in each transaction. Accordingly, broker-dealers would record such transactions on their books and records only on an aggregate basis (i.e., reflecting the Agent Lender as the counterparty), and were unable to determine their credit exposures to individual Principals."

- Broker-dealers may use theoretical option pricing models to calculate haircuts for listed options and related positions (as previously allowed under a temporary amendment to the net capital rule).

## Amendments to the Customer Protection Rule

The customer protection rule requires segregation of customer securities and funds from a broker-dealer's proprietary securities and funds. It thereby ensures that customer assets are readily available to be returned to customers in the event that the broker-dealer fails.

As amended, the rule requires broker-dealers that choose to maintain cash deposits in a reserve account to do so at an unaffiliated bank. The amended rule further provides that cash deposits in a reserve account may not exceed 15 percent of the unaffiliated bank's equity capital. Under the amended rule, broker-dealers are also restricted in their ability to maintain cash reserve deposits at U.S. branches of foreign banks.

Other key amendments to the customer protection rule are discussed below.

### PAB Accounts

The amended rule eliminates the reference to "introducing"<sup>13</sup> broker-dealers in the definition of PAIB accounts (i.e., proprietary accounts of introducing broker-dealers) and uses the term "PAB accounts" to clarify that the amended rule applies to securities accounts of **all** broker-dealers. The amended rule thus reconciles its definition of "customer" with the definition of the same term as used in the Securities Investor Protection Act.

New requirements related to PAB accounts include the following:

- Capital charges related to PAB accounts need not be taken for positions held at the clearing broker-dealer since all PAB accounts are protected by the clearing broker-dealer.
- Any PAB reserve bank account that is established after the amended rule's effective date should be named "special reserve bank account for brokers and dealers"; however, broker-dealers will not be required to retitle **current** PAIB reserve bank accounts.

PAB accounts as defined by the amended customer protection rule include accounts of foreign broker-dealers and accounts of foreign banks acting as broker-dealers. However, PAB accounts would not include:

- Deliver-versus-payment or receipt-versus-payment (DVP/RVP) accounts.
- Accounts owned by a guaranteed subsidiary of the carrying broker-dealer.
- Accounts whose owner guarantees all liabilities and obligations of the broker-dealer.

Before the rule was amended, the SEC staff's "PAIB letter"<sup>14</sup> gave introducing broker-dealers that wanted to protect their assets at the clearing broker-dealer and avoid 100 percent capital charges related to those assets the option to enter into a PAIB agreement with the clearing firm. Now that the rule requires broker-dealers that carry the accounts of other broker-dealers to comply with PAB account requirements, PAIB agreements are no longer needed. Further, clearing agreements may still be required under FINRA rules.

The amended rule eliminates the reference to "introducing" broker-dealers in the definition of PAIB accounts and uses the term "PAB accounts" to clarify that the amended rule applies to securities accounts of all broker-dealers.

<sup>13</sup> According to the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, an "introducing broker" is a broker-dealer firm that accepts customer orders but elects to clear the orders through another broker for cost efficiencies (for example, not having to perform all the clearance functions on a small volume of business, thereby eliminating many fixed costs)."

<sup>14</sup> November 3, 1998, letter to the NYSE and NASD from Michael Macchiaroli, associate director of the SEC's Division of Market Regulation.

In addition, the amended rule codifies requirements that broker-dealers already complied with under PAIB agreements; namely, the rule requires 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 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.

## **Reserve Formula**

In an effort to protect customer securities and funds, the amended rule requires a broker-dealer to obtain authorization from a customer before converting a free credit balance into a specific investment on the customer's behalf. This provision and other amendments related to the reserve formula are discussed in detail below.

### ***Sweeps of Free Credit Balances***

A broker-dealer cannot convert, invest, or transfer to another account or institution credit balances held in a customer's account unless one of the following criteria is satisfied:

- The broker-dealer has a specific order, authorization, or draft from the customer.
- The broker-dealer is transferring the free credits held in a customer's securities account to a product in its sweep program or transferring interest from one product in a sweep program to another product in a sweep program. If so, the broker-dealer must satisfy four conditions:
  - Obtain written affirmative consent to include free credits in the sweep program from each new customer.
  - Provide notices required by the applicable SRO.
  - Provide information on the customer's balance on a quarterly basis.
  - Give the customer 30 days' notice of a change in sweep options.

Broker-dealers will need to obtain written affirmative consent to include free credits in the sweep program from each new customer.

The SEC and FINRA continue to expect compliance with the draft guidance that they have provided to firms.

### ***Futures Transactions and Accounts***

An amendment to the definition of "free credit balances" in paragraph (a)(8) of the customer protection rule clarifies that funds held in proprietary futures accounts should not be treated as free credit balances in the customer reserve formula.

This amendment rescinds the interpretation in Securities Exchange Act Release No. 9922 that required credit balances in "non-regulated" commodity accounts to be included in the reserve formula of the customer protection rule.

### ***Portfolio Margining***

Other amendments to the definition of "free credit balances" in paragraph (a)(8) of the customer protection rule clarify that funds held in a commodities account that qualifies as a proprietary account under Commodity Exchange Act regulations should not be included as free credit balances in the reserve formula. The amendments include the following:

- The amount of margin required and on deposit at a futures clearing organization related to positions in a portfolio margin account will be treated as a debit item in the reserve formula.

- Initial and variation margin deposits, mark-to-market adjustments, and proceeds resulting from closing out, settling, or exercising futures contracts and options in portfolio margin accounts will be treated as free credit balances.

### Requirement to Possess or Control Customers' Fully Paid and Excess Margin Securities (Free of Any Lien)

Under an amendment to the customer protection rule, a broker-dealer that sold a security short to a customer will have 30 days to obtain possession or control of the security.

This amendment rescinds a [rule interpretation](#) under which a broker-dealer that sold a security short to a customer could include the security's market value as a credit in the reserve formula rather than obtaining possession of the security.

### Amendments to the Books and Records Rules

The books and records rules require broker-dealers to create and maintain certain books and records. As amended, the rules will also require broker-dealers that meet certain thresholds to document the controls they use to manage credit, market, and liquidity risks.<sup>15</sup> Specifically, the risk management documentation requirement will apply to broker-dealers that have (1) \$1 million in aggregate credit items under the customer protection rule or (2) \$20 million in total capital, including subordinated debt that conforms to Appendix D of the net capital rule.

In addition, the amended rules require broker-dealers that no longer use a particular risk management control to maintain documentation related to that control for three years after terminating it.<sup>16</sup>

### Amendments to the Notification Rule

The notification rule helps ensure that broker-dealers make certain notices when their financial condition or other specific circumstances raise concern.

The rule's amendments establish new notification requirements for broker-dealers whose repurchase and securities lending activities meet certain thresholds. A broker-dealer to which the amendments apply will be required to notify its DEA and the SEC when balances related to borrowed and loaned securities that are subject to repurchase agreements or reverse repurchase agreements exceed 25 times the broker-dealer's tentative net capital.<sup>17</sup> However, the amendments exempt (1) borrowed government securities that are subject to repurchase agreements and (2) loaned government securities that are subject to reverse repurchase agreements.

Broker-dealers that are subject to FINRA's notification requirements will not be affected by the notification requirements under the amended rule.

Alternatively, a broker-dealer whose repurchase and securities activities **regularly meet the established thresholds** can report its stock loan and repurchase activity to its DEA monthly, in a manner the DEA deems acceptable.

### Next Steps

Broker-dealers can begin to ensure their compliance with the amended FRRs by considering the data requirements of the amended rules and determining whether their existing infrastructure will be adequate or whether system enhancements will be necessary.

As amended, the books and records rules will require broker-dealers that meet certain thresholds to document the controls they use to manage credit, market, and liquidity risks.

<sup>15</sup> See SEC Rule 17a-3(a)(23).

<sup>16</sup> See SEC Rule 17a-4(e)(9).

<sup>17</sup> Tentative net capital represents the broker-dealer's net capital before securities haircuts are applied.



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