# Financial Responsibility Rules for Broker-Dealers – Final Revisions

## Executive Summary

The Securities and Exchange Commission (SEC) has issued its long awaited revisions to the Financial Responsibility Rules for Broker-Dealers under the *Securities Exchange Act of 1934* (SEA). The rule changes were first proposed in 2007 and reissued for comment in 2012. In final form, the revisions primarily affect SEA Rule 15c3-3, *Customer Protection – Reserves and Custody of Securities*, and SEA Rule 15c3-1, *Net Capital Requirements for Brokers or Dealers*. In addition, SEA Rule 15c3-2 has been eliminated though portions of that Rule have been imported to Rule 15c3-3. The revisions also include numerous technical adjustments and changes to the wording of the rules that have no other impact.

The major changes to the broker-dealer financial responsibility rules are:

- SEA Rule 15c3-3
  - Codify the Proprietary Account of Broker-Dealers (PAB) requirements, including requirements to maintain possession or control
  - Require buy in short trades allocating to customer longs
  - Import SEA Rule 15c3-2 regarding free credit balances as well as establish sweep guidelines
  - Define criteria for using affiliated and unaffiliated banks for Reserve Bank accounts
- SEA Rule 15c3-1
  - Adjust net worth, in certain situations, for liabilities or expenses assumed by third parties
  - Reduce net worth for nonpermanent capital
  - Clarify when a firm is considered principle to lending transactions
  - Define "insolvency"
  - Strengthen capital withdrawal rules
- SEA Rules 17a3 and 17a4
  - Require broker dealers that meet certain minimum requirements to maintain records documenting the credit, market and liquidity risk management controls
- SEA Rule 17a-11
  - Require notification when lending liabilities or assets exceed prescribed leverage limits

The rules become effective on October 21, 2013 and compliance is expected as of that date.

# Background

The SEC's changes to the Financial Responsibility Rules for Broker-Dealers were proposed prior to the financial crisis of 2008 and are finally being implemented, although not all of the proposed revisions have been included in the final release. In particular, the SEC has deferred final consideration of certain proposed revisions related to money market funds (due to its current money market reform initiative), including revisions that would:

- Expand the definition of a "qualified security" under Rule 15c3-3; and
- Reduce the haircut for money market funds under Rule 15c3-1.

In addition, the SEC has deferred a proposal that would have eliminated a reduction to aggregate debit items (ADI) that certain broker-dealers must take when computing their reserve requirements under Rule 15c3-3. The SEC cited the adverse market environment for deferring consideration of this provision.

Lastly, the final rule contains numerous technical changes that have been made primarily to update the wording in the rule for consistency or to agree to current terminology.

# Description

## SEA Rule 15c3-3, Customer Protection – Reserves and Custody of Securities

The most significant aspects of the revisions pertain to the customer protection rules (SEA Rule 15c3-3). The revisions center primarily on four aspects, the most significant of which is the codification of provisions in the SEC's 1998 no action letter for Proprietary Assets of Introducing Brokers (PAIB). The codification of the no-action letter guidance will basically require all carrying brokers who clear transactions of broker-dealers to establish a Special Reserve Bank Account for Brokers and Dealers and perform a separate reserve calculation for these accounts on a weekly basis. Excess debits in the Customer Reserve Calculation can be used to reduce the PAB requirement, but excess PAB debits cannot reduce the Customer Reserve requirement.

A Proprietary Account of Broker-Dealers is defined as 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.*

The requirement to include all broker-dealers, including foreign broker-dealers was primarily designed to align the customer protection aspects more closely to the SIPA (*Securities Investor Protection Act*) definitions. In many instances, SIPA classifies broker-dealer accounts as customers and if these assets are not segregated, there is a risk of a shortfall in the assets set aside for the benefit of customers vs. the claims approved in a SIPA liquidation. The requirement to include affiliated broker-dealers in this calculation was not well received when the requirements were first proposed, but issues noted during the financial crisis, especially during the SIPA liquidation of

Lehman Brothers, Inc., have raised added concerns on the part of the regulators. The SEC has addressed this by allowing introducing firms to "opt out" as long as they subordinate their claims, i.e. stand behind other creditors in liquidation. In this situation, however, U.S. broker-dealers that choose to subordinate their claims to the claims of other creditors will not be able to include those assets as allowable for their own net capital computations. In addition, foreign regulatory rules may also prohibit the foreign firms from the "opt out" provision.

The revised rules also require carrying brokers to maintain possession or control of securities of PAB accounts, unless the carrying broker notifies the PAB account holders in writing and in advance that they will use the securities. The PAB account holder can object and the carrying broker cannot use that account holder's securities if it receives such an objection. If no objection is made and the securities are used by the carrying broker, the carrying broker will need to include a credit in the PAB reserve formula for the value of the securities used.

Additional revisions made with respect to PAB accounts provide that a carrying broker:

- Establish and maintain a PAB reserve account for PAB accounts, perform a separate PAB reserve computation for PAB accounts, and maintain cash or qualified securities in the PAB reserve account in an amount equal to the PAB reserve requirement.
- Notify the bank about the status of the PAB reserve account and obtain an agreement and notification from the bank that the PAB reserve account will be maintained for the benefit of the PAB account holder.
- Can make withdrawals from a PAB reserve account in accordance with terms specified in the rule.
- May use credits related to PAB accounts to finance Rule 15c3-3 customer debits, but may not use customer credits to finance PAB debits.

In addition to the PAB requirements, the revisions to SEA Rule 15c3-3:

- Add a requirement to reduce securities to possession or control where customer longs allocate to firm or other shorts for more than 30 calendar days. This requirement does not include customer long sales under paragraph (m) of SEA Rule 15c3-3. Also the 30-day period does not start for syndicate shorts until the completion of the underwriters' participation in the distribution.
- Establish a new paragraph (e)(5) that prohibits the use of cash deposits into special reserve bank accounts for customer or PAB accounts in affiliated banks, and limits the amount of cash on deposit with unaffiliated banks to 15 percent of equity capital of the bank (up from the proposed 10 percent) as reported on its most recent Call Report (Reports of Condition and Income) when determining whether the broker-dealer maintains the minimum deposits required. The proposed provision that would have excluded the amount of cash on deposit at any one institution that exceeded 50 percent of the broker-dealer's excess net capital has been eliminated.
  - The requirement to use the equity from the Call Report eliminates the ability to establish reserve bank accounts at U.S. branches of foreign banks.
- Import provisions of SEA Rule 15c3-2, which has been removed, into a new paragraph (j) *Treatment of Free Credit Balances*. This paragraph also further defines the disclosure requirements and terms for the use of sweep accounts at broker dealers.
- Enhance certain definitions, including:

- A revised definition of free credit balances and other credit balances that includes clarification that funds in proprietary futures accounts are not considered free or other credit balances.
- Expanding the definitions to include funds carried in a securities account pursuant to portfolio margining. In addition, item 14 in the reserve formula has been expanded to include as a debit in the reserve formula customer margin required and on deposit at a derivatives clearing organization for futures positions in portfolio margining accounts.

## SEA Rule 15c3-1, Net Capital Requirements

In general, the changes to SEA Rule 15c3-1, *Net Capital Requirements*, provide that:

- The requirement to obtain a PAIB clearing agreement is no longer required. Specifically, the rules now state that cash and securities held in a securities account at a clearing broker need not be deducted from capital, except where the account has been subordinated to the claims of creditors.
- Any liabilities or expenses which have been assumed by a third party must be accounted for when calculating net capital, unless the broker-dealer can demonstrate that the third-party has adequate resources.
- Any capital that the investor has the option to withdraw within one year or was returned within one year will not count as good capital and must be subtracted from net worth. If a withdrawal is made prior to one year without regulatory approval a broker dealer will need to ensure that it had adequate capital without this investment from the time of the investment.
- The broker-dealer must deduct from capital any excess fidelity bond deductible as specified by its Examining Authority or Designated Self Regulatory Organization (DSRO).
- A broker-dealer must not be insolvent, as defined in the rule, including but not limited to when the broker-dealer:
  - Is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate the broker or dealer or its property;
  - Has made a general assignment for the benefit of creditors;
  - Is insolvent within the meaning of Title 11 of the United States Code, or is unable to meet its obligations as they mature; or
  - Is unable to make such computations as may be necessary to establish compliance with this section.

  Broker-dealers meeting the definition of insolvent must provide immediate notice to the SEC.
- The SEC may restrict any withdrawal of capital, unsecured loans or advances to parent or affiliate for up to 20 days if the SEC deems it would be detrimental.
- If a broker dealer participates in a loan of securities by one party to another party it will be deemed to be a principal unless the identity of each party is disclosed and each party agrees, in writing, not to hold the broker-dealer responsible for the performance of the other party. This requirement is intended to remove any ambiguity about a broker-dealers' status as agent or principal to each transaction.

## Other Revisions

In addition to the revisions to SEA Rules 15c3-3 and 15c3-1 the SEC has revised SEA Rules 17a3, 17a4, and 17a11. In particular, SEA Rule 17a3, *Records to be Made*, has

been amended to require broker-dealers who have regulatory capital in excess of $20 million or aggregate credit items in their reserve formula in excess of $1million to establish and maintain documented management controls with respect to credit, market and liquidity risks. SEA Rule 17a4, *Records to be Preserved,* has been revised to include a requirement to maintain these records for three years after the termination of these controls. And, SEA Rule 17a11, *Notification Provisions*, has been revised to include a leverage requirement to notify the SEC if at any time its total amount, excluding transactions in Government Securities, of money payable against all securities loaned or subject to a repurchase agreement or the total contract value of all securities borrowed or subject to a reverse repurchase agreement is in excess of 2500 percent of its tentative net capital. Notification is not required if the broker dealer provides leverage transaction information to its DSRO on a monthly basis.

## Commentary

Although widely and long anticipated, these revisions will require changes to firms' procedures and disclosures as well as system enhancements. With the very short time frame prior to the effective date, firms will need to address these issues immediately.

Broker-dealers that currently clear other broker-dealer proprietary accounts, including foreign broker-dealers and foreign banks acting as broker-dealers and do not currently prepare a PAB calculation will need to establish procedures and develop processes to comply with the revisions.

Firms will need to revise their current system specifications, particularly with respect to the Possession or Control Requirements. They will need to ensure that their systems designs can incorporate the requirement to segregate PAB fully paid for securities and have the ability to differentiate those accounts that do not require segregation. In addition, these systems will need to determine which short sales need to be brought into possession or control. .

Disclosures will also need to be enhanced, and there may be a need to establish additional disclosures for PAB clients regarding the use of their securities as well as expanded disclosures with regard to sweep accounts. In addition, broker-dealers will need to establish a new on-boarding process with respect to sweep account affirmations which will likely be challenging. Firms will need to be able to differentiate those new accounts that have provided the affirmation from those accounts that have not. And, firms will need to enhance their ongoing process to monitor changes in the programs offered and to provide customers the ability to "opt out."

Even new requirements that appear to be simple, such as including language in the customer statements indicating that free credit balances can be returned to the customer on demand and that sweep balances can be liquidated and returned to the account or remitted to the customer, may be problematic in the time frames outlined by the rules.

Broker dealers will also need to establish procedures to ensure that all deposits in Special Reserve Bank Accounts for The Exclusive Benefit of Customers and PAB Accounts meet the new restrictions. Firms will need to ensure that they review all current arrangements, establish ongoing review procedures with respect to banks utilized and enhance their process for entering into new agreements. Current relationships need to be reviewed and new accounts will need to be opened, which may lead to operational risk issues as well as the potential for regulatory violations if firms are not careful with the timing of moving deposits among banks.

There may be some ambiguity with regard to the use of affiliated banks or with unaffiliated banks where the deposit may exceed the 15 percent level. For example, it is not clear if firms can deposit cash before 10AM with these banks and then substitute the deposit with securities before the end of the day. Also current processes may require the return of collateral and deposit of cash in the morning followed by a deposit of new securities later in the day. These long established operational and cash management processes may be difficult for firms to adjust.

Those firms required to maintain a record of the market, credit and liquidity risk management controls should review their current recordkeeping procedures to ensure that the controls are clearly identified and are appropriately incorporated into the firm's record requirement and retention controls. This will require firms to review their current procedures to ensure that they address the control requirements, or if needed, to prepare the documentation, and establish an ongoing control over all changes or enhancements made.

Finally, although most firms do not currently meet, or have plans to increase their financing business to a level that would reach the thresh old established by the leverage notification requirements of under Rule 17a-11, all firms should consider and establish escalation procedures to ensure that they will be able to meet the requirements if necessary.

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