

Notice to Members

APRIL 2004

SUGGESTED ROUTING

Accounting
Financial Compliance
Operations
Senior Management

KEY TOPICS

Financial Accounting
FOCUS Reporting
Net Capital

ACTION REQUIRED

Financial Accounting

Limited Net Capital Relief from the Reclassification of Certain Equity as Liabilities in Accordance with Statement of Financial Accounting Standards No. 150

Executive Summary

In May 2003, the Financial Accounting Standards Board (FASB) released Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* (the "Statement" or "Statement 150") as part of a broad effort to ensure that entities recognize as liabilities contractual obligations to transfer cash, other assets, or equity interests to other parties. One of the primary requirements of the Statement is the need to reclassify *mandatorily redeemable* financial instruments, generally defined as ownership interests in the issuing entity with mandatory redemption features, as liabilities.¹

This reclassification requirement is applicable to non-public entities beginning with the commencement of the first fiscal year starting after December 15, 2003.² Because of the effect of these requirements on non-public entities, particularly since many non-public companies are capitalized solely with stock that may be redeemed upon the death or retirement of a shareholder, many non-public companies requested an extension of the Statement's effective date. In a November 7, 2003, Staff Position Release (Release 150-3), the FASB decided that it *would not* revise the effective date of the Statement for non-public entities that are required to file financial statements with the Securities and Exchange Commission (SEC). As a result, the Statement provisions remain applicable to non-public broker-dealers at the start of the fiscal year that begins after December 15, 2003.

In response to a request from the Securities Industry Association (SIA), the SEC Division of Market Regulation (DMR) concluded in a February 19, 2004, No-Action Letter (No-Action Letter) that it "will not recommend enforcement action to the Commission if a broker-dealer that is a non-public entity, in calculating net capital under [Securities Exchange Act] Rule 15c3-1, adds to its regulatory net worth the carrying value of mandatorily redeemable financial instruments that FAS [Statement] 150 excludes from the firm's GAAP equity." *The No-Action Letter only provides relief from the net capital ramifications of the Statement's treatment of mandatorily redeemable financial instruments and does not extend to the accounting treatment of financial instruments (whether or not mandatorily redeemable) as set forth in the Statement. (See Exhibit A for a copy of the No-Action Letter.)* The No-Action Letter further requires that "a broker-dealer that wishes to take advantage of this relief must advise its designated examining authority of its intent." Consequently, to take advantage of the relief granted by the No-Action Letter, a member must advise NASD of its intent to rely on the No-Action Letter by **May 10, 2004**, and *prior to applying the relief.*

Questions/Further Information

Questions or comments regarding this *Notice* may be addressed to Andrew Labadie, Financial Analyst, Member Regulation, Regulatory Policy and Oversight (RPO), at (202) 728-8397; or Susan DeMando, Director, Financial Operations, Member Regulation, RPO, at (202) 728-8411.

Background and Discussion

(The following discussion serves primarily to summarize the portions of Statement 150 that pertain to mandatorily redeemable financial instruments. NASD strongly encourages firms to review Statement 150 along with this Notice in order to have a frame of reference from which to discuss the issues in Statement 150 with their outside accountants/auditors, and to determine how the firm needs to comply with the Statement's material provisions regarding mandatorily redeemable financial instruments.)

Statement 150 represents the completion of the first phase of the FASB's consideration of how best to account for financial instruments that have the characteristics of liabilities and equity, and that obligate the entity to transfer cash or other assets, or to issue equity, to the instrument holders. The FASB concluded that if an entity issues a financial instrument that requires, or may require, the issuing entity to transfer cash, assets, and/or shares of its stock to the holder of the instrument, and if the value or amount of the assets or shares are fixed upon the issuance of the instrument, or based on an index whose value is determined independently of, or inversely to, the successful operations of the entity, that entity must classify the instrument as a liability. The FASB believes that reclassification is necessary because the instrument imposes a cost on the

issuing entity to the benefit of the instrument holder, and the holder's interest in the issuing entity is contrary to those of an owner (e.g., common shareholder) exposed solely to the potential benefits and risks derived from the operation of the business.

As such, Statement 150 requires that financial instruments that are mandatorily redeemable and issued in the form of shares or other ownership interests be classified as liabilities. Ownership interests are considered mandatorily redeemable if they require the issuer to redeem the instrument by transferring its cash, assets, or other equity interests to the holder at a specified or determinable date (or dates), or upon an event certain to occur.³ However, ownership interests that are redeemable only upon the liquidation or termination of the issuing entity continue to be classified as equity.

Effective Date, Measurement, and Disclosure

Entities need to recognize mandatorily redeemable financial instruments as liabilities upon the effective date of the Statement for the particular entity, or following the effective date, upon the issuance of a mandatorily redeemable instrument. The amount to be recognized, if fixed, is the present value of the cash or assets to be exchanged. If the amount is variable, the issuer recognizes the value of the cash, other assets, or shares to be delivered as derived from the underlying index today. For example, if the financial instruments were redeemable for a number of shares determined by the value of a separate index, the amount reported as a liability would be the book value of such shares. (If the index, initially valued at \$100, increases to \$200 as of the reporting date, and during this period the book value of the entity's stock remains at \$10 per share, the reported liability would be equal to the book value of 20 shares.) If all of an entity's shares were mandatorily redeemable, the recorded value would be equal to the entity's net worth. In this case, since the entity would no longer recognize any equity, the mandatorily redeemable securities would represent the residual interest to which income or loss would be allocated and, therefore, retained earnings and other comprehensive income would be included as components of the liability balance representing such shares.

Issuers of mandatorily redeemable financial instruments are required to describe such instruments as *shares subject to mandatory redemption* on the face of the balance sheet to distinguish those instruments from other liabilities. In addition, issuers must disclose, in the notes to the financial statements, the nature and terms of, and the rights and obligations embodied in, such instruments, including information about settlement alternatives.

Application of Statement 150 to Non-Public Broker-Dealers

Because Statement 150 applies to entities that are required to file financial statements with the SEC, non-public broker-dealers are subject to Statement 150 (including the provisions regarding the reclassification of mandatorily redeemable financial instruments as liabilities) beginning with the commencement of the first fiscal year starting after December 15, 2003. In the net capital context, the reclassification of these financial instruments as liabilities reduces net worth, and without any offsetting adjustment, decreases the amount of regulatory capital. While non-public entities had requested a modification of the Statement, or at least an extension of its effective date, the FASB concluded in Release 150-3 that any entity that files financial statements with the SEC, which includes all broker-dealers, would be required to adopt the Statement in accordance with the initial "effective date" provisions.

In January 2004, the SIA submitted a letter to the DMR of the SEC requesting temporary relief for non-public broker-dealers from the effect on net capital of reclassifying mandatorily redeemable ownership interests as liabilities. In its No-Action Letter, the DMR decided that it would not recommend enforcement action to the SEC if

"...a broker-dealer that is a non-public entity, in calculating net capital under Rule 15c3-1, adds to its regulatory net worth the carrying value of mandatorily redeemable financial instruments that FAS [Statement] 150 excludes from the firm's GAAP equity."

The No-Action Letter states that "[t]he limitations on withdrawal of equity capital contained in paragraph (e) of Rule 15c3-1 still would apply."⁴ In addition, "[t]he amount added back to net worth also could be treated as equity in determining a broker-dealer's compliance with the debt to debt-equity total in paragraph (d) of Rule 15c3-1, provided it otherwise meets requirements of that paragraph." Further, this relief "would not affect the treatment of properly subordinated debt under Appendix D to Rule 15c3-1." Finally, the No-Action Letter states that a broker-dealer that wishes to take advantage of this relief must advise its designated examining authority of its intent. The procedures for notifying NASD are described in the following "Action Required" section.

The relief provided by the No-Action Letter is temporary and is available only during the *first* fiscal year beginning after December 15, 2003. With the commencement of the fiscal year beginning after December 15, 2004, the effects of any reclassification of mandatorily redeemable financial instruments will flow through, without adjustment, to the computation of net capital.⁵ In essence, the No-Action Letter gives non-public broker-dealers twelve months to revise the elements of their underlying capitalization that result in an unavoidable redemption obligation.

Importantly, the No-Action Letter only provides relief in the net capital context to the requirement to treat mandatorily redeemable financial instruments as liabilities, and does not relieve any broker-dealer from complying with all of the provisions of the Statement, including those that address financial instruments which, although not mandatorily redeemable, are considered liabilities as opposed to equity. Accordingly, broker-dealers must reflect mandatorily redeemable ownership interests and, if appropriate, certain other financial instruments as liabilities in their financial statements included in the FOCUS Report.

Action Required

Firms that are designated to NASD for financial surveillance purposes and that wish to avail themselves of the relief set forth in the No-Action Letter must inform NASD of this action in an e-mail from an officer of the firm. **NASD must receive this e-mail by Monday, May 10, 2004.** The reference line of the e-mail should indicate, in the following order, "Statement 150," the name of the firm, and its Central Registration Depository (CRD®) number. In addition to communicating the request, the e-mail must include the following information:

- ◆ The value and number of units of mandatorily redeemable equity securities or ownership interests as of March 31, 2004, which *would be* required to be reflected as liabilities in accordance with Statement 150, even if March 31st precedes the required Statement adoption date.
- ◆ The designation of such securities or interests (e.g., common stock, preferred stock, or partnership interests).
- ◆ The identity and respective values of the equity components included in the liability related to shareholders' interests subject to a redemption feature. For example, the par value and other paid-in amounts of mandatorily redeemable instruments and the amount of retained earnings or accumulated deficit and their respective recorded values as of March 31, 2004.
- ◆ A brief description of the rights and obligations embodied in these securities or ownership interests, including information concerning settlement alternatives, and the identity of the entity that controls the settlement alternatives.
- ◆ The amount that would be paid, or the number of shares that would be issued and their fair value, determined under the conditions specified in the contract if the conditions for redemption had been fulfilled as of March 31, 2004.
- ◆ The general identity of the holders of the mandatorily redeemable securities (e.g., principals of the firm, employees, registered personnel, family members of the principals, third-party investors, and/or consultants).
- ◆ The name, position, and telephone number of the officer communicating the request.

The purpose of obtaining this information is to determine the extent to which Statement 150 affects firms and to provide NASD with a benchmark in tracking the adjustments included in the FOCUS Reports.

NASD will conclude that information is properly provided through this notification once a member firm has submitted an e-mail and has completely and accurately addressed each of the above points. E-mails must be submitted to *andrew.labadie@nasd.com*. E-mails to other addresses will not constitute proper notice to NASD. The notification to NASD and the requested information does not constitute NASD's approval of a firm's compliance with Statement 150 or provide assurance that the firm has complied with the requirements of the No-Action Letter.

FOCUS Report Disclosure Instructions

Regardless of whether firms avail themselves of the limited relief provided by the No-Action Letter, firms must reflect the recorded amounts of mandatorily redeemable ownership interests classified as liabilities in "Notes & Mortgages Payable: B Secured" of the statement of financial condition in the FOCUS Report (Line 24 of FOCUS Form II or Line 18 of FOCUS Form IIA). The value of those ownership interests that would be redeemed for cash should be included in aggregate indebtedness and reported in field 1211, and the value of interests redeemable for other assets or other equity interests should be included in field 1390, of either the Part II or IIA FOCUS filing. *(Please note that, if the entire balance of equity capital must be reclassified as liabilities in accordance with Statement 150, firms will need to record a nominal amount, such as \$1.00, in the equity section when completing the FOCUS electronically to be able to submit the filing.)* Those firms that choose to record an addition to net worth in computing net capital should reflect the amount and description of the add-back as an allowable credit on line 4 B, field 3525 in the computation of net capital.

Endnotes

- 1 For purposes of the Statement, “financial instruments” are essentially ownership interests in the issuing entity, which range from those that impose or could impose future obligations on the issuer to the benefit of the holder, to those that place the risk of the enterprise entirely on the holder (e.g., shares of common stock). “Mandatorily redeemable” means that the issuing entity will need to give cash, other assets, or other equity interests in the entity to the holder in exchange for the financial instruments upon the occurrence of an event certain to occur.
- 2 The reclassification of mandatorily redeemable financial instruments is applicable to publicly traded companies, including publicly traded broker-dealers, beginning with the commencement of the first interim period starting after June 15, 2003.
- 3 One needs to consider all provisions of a redeemable instrument in determining whether the instrument is mandatorily redeemable. A term extension option—a provision that defers redemption until a specified liquidity level is reached—or a similar provision that may delay or accelerate the timing of a mandatory redemption does not affect the classification of a mandatorily redeemable financial instrument as a liability. In addition, in Release 150-3, the FASB asserts that ownership interests that are required to be redeemed in accordance with a related agreement are to be viewed as mandatorily redeemable if the ownership interests are issued with the redemption agreement and the agreement addresses the redemption of the specific ownership interests.
- 4 For purposes of paragraph (e) of Rule 15c3-1, equity capital would include the amount of any add-back to net worth as well as the balances of the components described in subparagraph (e)(4)(ii).
- 5 For example, if a broker-dealer has a fiscal year end of July 31, it would not be required to adopt Statement 150 until August 1, 2004, and then could apply the addition to net worth from the period beginning August 1, 2004 through July 31, 2005. Those broker-dealers with a fiscal year ending November 30, and which would not be required to adopt Statement 150 until December 1, 2004, would then be able to apply the addition to net worth in accordance with the No-Action Letter from December 1, 2004, through November 30, 2005.

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