NASD
National Association of Securities Dealers, Inc.
1735 K St., N.W. • Washington, D.C. 20006 • (202) 728-8000
notice to members 84-7

January 30, 1984

IMPORTANT

OFFICERS, PARTNERS AND PROPRIETORS

TO: All NASD Members and Other Interested Persons

RE: SEC Staff Interpretations of Rule 15c2-4

SUMMARY

In response to a request by the Association, the staff of the SEC's Division of Market Regulation has recently issued its views on frequently raised interpretive questions regarding Rules 15c2-4 (the "Rule") under the Securities Exchange Act of 1934 (the "Act"). The SEC staff's views are set forth in a question and answer format and are presented to assist Association members who are involved in best efforts, "all or none" or other contingency underwritings.

The Rule applies to best efforts distributions of securities. The Rule prescribes procedures for such distributions conducted on an "all-or-none" basis, or on any other basis on which payment will not be made to the issuer until some further event or contingency occurs (e.g., a "minimum-maximum" offering). It requires a broker-dealer participant either to promptly deposit investors' funds received into a separate bank account, as agent or trustee for those investors, or to promptly transmit such funds to a bank escrow agent, pending the occurrence of the contingency. The purpose of the Rule is to insulate offering proceeds from unlawful activities by, or the financial reverses of, the broker-dealer participating in the offering and thus to ensure that the issuer will receive the full proceeds promptly if the contingency occurs or that investors will receive a prompt reimbursement of all of their funds if the contingency does not occur. Under the Rule, a broker's obligation with regard to funds received depends on whether it is a "$5,000 broker-dealer" or a "$25,000 broker-dealer" under the SEC's net capital rules. Upon receipt of an investor's funds, a "$25,000 broker-dealer" has two options:

(1) To act as agent or trustee for a separate bank account until the contingency occurs; or

(2) To transmit the monies to an unaffiliated bank to hold in escrow for the investors until the contingency occurs.

Pursuant to Rule 15c3-1(a)(2) under the Act, a "$5,000 broker-dealer" may only receive and promptly transmit investors' checks which are payable to an unaffiliated bank escrow agent.

QUESTIONS AND ANSWERS

The SEC staff has prepared the following answers to a list of questions raised by the NASD concerning Rule 15c2-4.

(1) **Question:** Where a customer's check is payable to the issuer or the bank escrow agent, but is physically received by the broker-dealer, is money "received" within the meaning of the Rule?

Answer: Yes, this situation is governed by the provisions of the Rule. A check constitutes "money" under the Rule, and in the above situation money has been "received" for the purposes of the Rule. 1/ A "$5,000 broker-dealer" may only physically receive and promptly transmit checks payable to an unaffiliated bank escrow agent.

(2) **Question:** Where a customer's check is payable to the issuer (or an affiliate of the issuer) but a broker-dealer does not physically receive the check, is money "received" within the meaning of the Rule?

Answer: Direct receipt of an investor's funds by an issuer (or an affiliate of the issuer) is not a circumstance addressed by the Rule. 2/ Although a narrow construction of the Rule's provisions might arguably lead to the conclusion that direct receipt by the issuer does not violate the Rule, direct receipt by

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1/ Broker-dealers are also required by Rules 17a-3 under the Act to record by memorandum any receipt of customer funds for the purchase of a security even if the customer's check is payable to the issuer or bank escrow account.

2/ Direct receipt of investors' funds by the issuer in a best efforts contingent underwriting was not anticipated or addressed by the Commission when it adopted the Rule in 1962. See Securities Exchange Act No. 6737 (February 21, 1962) and Securities Exchange Act Release No. 6689 (December 21, 1961).

the issuer could result in difficulties with respect to the maintenance of required books and records by the broker-dealer. In addition, if funds are sent directly to the issuer, and the issuer converts the funds or goes bankrupt, the broker may expose itself to liability. The Commission's staff, therefore, believes that the better practice is to have investors' funds sent directly to the broker-dealer. 3/

(3) **Question:** Is the Rule complied with if an investor's check is made payable to the broker-dealer with the understanding that it will be held or not deposited in a separate bank account or transmitted into escrow until some later date (such as until shortly before the termination of the offering)?

Answer: Under the Rule, such a delay is inappropriate. The monies must be deposited or transmitted "promptly" (as defined in Answer 6). The broker-dealer may not delay depositing or transmitting checks.

(4) **Question:** In a contingent offering of limited partnership interests, is money "received" within the meaning of the Rule under the following arrangement?

> A broker-dealer receives an investor's check accompanied by a signed subscription, which it forwards to the general partner for acceptance. Pending acceptance, the broker-dealer is authorized by the investor to invest his funds in a money market fund registered under the Investment Company Act of 1940. Upon acceptance of the subscription by the general partner, the broker-dealer, pursuant to a revocable letter of authorization, will sell a number of shares of the money market fund equal in value to the subscription price and forward the proceeds to the general partner.

Answer: In this situation, because the customer's check is accompanied by a signed subscription agreement,

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3/ However, a "$5,000 broker-dealer" may not receive customer funds unless the customer's check is payable to a bank escrow agent. See Rule 15c3-1(a)(2).

money is "received" within the meaning of the Rule and the broker-dealer must "promptly deposit" it in a separate bank account or "promptly transmit" it to a bank to be held in escrow. The broker-dealer is not permitted to temporarily invest the funds in a money market fund.

(5) **Question:** Is the Rule complied with if an investor writes a check payable to a "$25,000 broker-dealer" who, in turn, promptly writes its own check or wires funds to a separate bank account or escrow account?

Answer: Yes, this complies with Rule 15c2-4. However, Rule 10b-9 would also have to be considered. 4/ In "all-or-none" or minimum-maximum" offerings, investors' funds may not be forwarded to the issuer until the required minimum number of securities has been sold and fully paid for in customer funds that have cleared the banking system. A broker-dealer may not substitute its own good check for the check of a customer that has insufficient funds in order to satisfy the contingency. See SEC No-Action Letter issued to Brodis Securities Incorporated (November 14,1983).

(6) **Question:** What do the terms "promptly deposited in a separate bank account" and "promptly transmitted" mean under the Rule?

Answer: Absent unusual circumstances, funds should be deposited or transmitted as soon as practicable after receipt. In contingent offerings not requiring suitability determinations by the issuer or the general partner, funds should be deposited or transmitted by noon of the next business day. In contingent offerings requiring suitability determinations by the issuer or general partner (for example, most direct participation programs) where investors' checks are made payable solely to the bank escrow agent but delivered to the broker-dealer, prompt transmittal may be accomplished by forwarding the checks to the escrow agent either by noon of the

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4/ Under Rule 10b-9 a representation that an offering is on an "all or none" or "minimum-maximum" basis constitutes a manipulative or deceptive device prohibited by Section 10(b) unless prompt refunds are made to purchasers if the represented number of securities are not sold in bona fide transactions at the specified price within the specified time and if the total amount due the seller is not received by it by the specified date.

next business day or by noon of the second business day after receipt of the subscription by the issuer or general partner. If the latter option is used, the subscription must be forwarded to the issuer or general partner by noon of the next business day after receipt of the funds. See SEC Interpretive Letter issued to Lowell H. Listrom & Company, Inc. (April 27, 1983).

(7) **Question:** How is compliance with the Rule affected where the issuer (or general partner of the issuer) and a broker-dealer participating in the distribution are affiliated?

Answer: Where an investor sends his check directly to an issuer that is affiliated with a participating broker-dealer, "receipt" of the funds is considered to be made by the broker-dealer when the issuer receives the check. Therefore, the Rule applies and the broker-dealer is responsible for ensuring that the issuer promptly transmits the funds to an independent escrow account.

Since the Rule imposes an obligation on a broker-dealer to ensure that funds received by it are not dissipated in any fashion and not disbursed to the issuer unless the contingency has been fully satisfied, where an issuer and a broker-dealer are affiliated, the broker-dealer should not act as agent or trustee for the funds. See Securities Exchange Act Release No. 11532 (July 11, 1975). Instead, an escrow agent should be used that is a bank unaffiliated with both the issuer (or the general partner of the issuer) and the broker-dealer.

(8) **Question:** In an offering of securities (such as limited partnership interests) where an "all-or-none" or "minimum-maximum" is involved, how does a requirement that the issuer or general partner personally approve each prospective investor or limited partner for suitability affect compliance with either Rule 15c2-4 or Rule 10b-9?

Answer: In an "all-or-none" or "minimum-maximum" offering, Rule 10b-9 must be considered if the issuer or general partner is required to approve the investor for suitability or otherwise. The specified minimum or total will be not be considered "sold" in bona fide transactions until such minimum or total has been accepted for subscription by the issuer or general partner.

(9) **Question:** Does the Rule apply to private placements done on a best efforts basis in light of the use of the term "distribution" in the Rule?

Answer: Yes, the Rule does apply to such private placements. This issue was addressed by the SEC in a recent decision. See Baikie & Alcantara, Inc., Securities Exchange Act Release No. 19410 (January 6, 1983). To the extent a private placement meets the definition of a distribution under Rule 10b-6, a private placement would be a distribution under Rule 10b-6(c)(5) under the Act, which defines the term "distribution."

(10) **Question:** May some person other than a bank (e.g., an attorney for the broker-dealer) act as an escrow agent within the meaning of the Rule?

Answer: No, the escrow agent must be a bank that is unaffiliated with either the issuer or the broker-dealer.

(11) **Question:** May the lawyer for the broker-dealer be the "agent or trustee" for the separate bank account established pursuant to paragraph (b)(1) of the Rule?

Answer: No, the lawyer of the broker-dealer or some other person could not act as agent or trustee of the separate bank account. The phrase "as agent or trustee" in the Rule refers to the broker-dealer. Among other things, this affords the SEC and the NASD clear examination authority of the separate bank account. Also, only a "$25,000 broker-dealer" may be the agent or trustee of the separate bank account.

(12) **Question:** If a "$25,000 broker-dealer" establishes an escrow account or separate bank account to hold customer funds received in connection with an "all-or-none" or other contingency-type offering in accordance with Rule 15c2-4(b)(1) or (2), must the broker-dealer include the customer funds so held as "Item 1" credits for purposes of computing the reserve formula requirements under Exhibit A to Rule 15c3-3 under the Act?

Answer: No.

(13) **Question:** What are the permissible investments that may be made by an agent, trustee or bank escrow agent under Rule 15c2-4?

Answer: Rule 15c2-4(b)(1) and (2) specify that funds must be deposited in, or transmitted to, a bank by such persons. Therefore, bank accounts, including saving

accounts and bank money market accounts, are the types of investments permitted under Rule 15c2-4. [5/] The monies must be held in a bank account that enables the agent, trustee, or escrow agent to "promptly" or "directly" transmit or return such funds to the person entitled thereto when the appropriate event or contingency has occurred or failed to occur. The definition of a "bank" is contained in Section 3(a)(6) of the Act and does not, for example, include a savings and loan association. [6/]

In addition, with respect to offering proceeds transmitted to a bank escrow account pursuant to Rule 15c2-4(b)(2), the staff of the Division of Market Regulation will not recommend that the SEC take enforcement action under the Rule if the bank escrow agent invests offering proceeds in either short-term certificates of deposit issued by a bank, or short-term securities issued or guaranteed by the United States Government.

Any such investment in time deposits, short term bank certificates of deposit, or short term U. S. Goverment-backed securities must be made in recognition of the Rule's requirement that offering proceeds held in a separate bank account or escrow be transmitted promptly to the issuer or the investor once the contingency has or has not occurred. Thus, it would be inappropriate for a bank escrow agent to invest in an otherwise permissible instrument under the Rule if that instrument's maturity date extends beyond the anticipated contingency occurence date, unless such instrument can be readily sold or otherwise disposed of for cash by the time the contingency occurs without any dissipation of the offering proceeds invested.

The following securities are not permissible investments within the meaning of Rule 15c2-4:

(a) money market funds;
(b) corporate equity or debt securities;
(c) repurchase agreements;

5/ A trustee may also be restricted to certain investments by the fiduciary laws of a particular state.

6/ But cf., Investment Company Act Release No. 13666 (December 12, 1983).

(d) banker's acceptances;
(e) commercial paper; and
(f) municipal securities.

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Questions or comments with regard to the interpretations in this Notice should be addressed to William Schief, Director of Regional Attorneys, Surveillance Department at (202) 728-8229 or the SEC's Division of Market Regulation (Office of Trading Practices) at (202) 272-2848.

Sincerely,

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Vice President
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