



For Your Information

Revision to Net Capital Treatment of Clearing Agreement Penalty Clauses

In the Regulatory Short Takes section of the Spring 2000 *Regulatory & Compliance Alert*, Volume 14-1, NASD indicated that all or a portion of the amount specified in a clearing agreement as a termination fee would be treated as a charge to the introducing firm's net capital. The Question and Answer included in the Regulatory Short Take was as follows:

Q: Is the penalty amount in a penalty clause contained in a clearing agreement a charge to net capital?

A: Yes. A penalty contained as a provision in a clearing agreement is a charge to the introducing firm's net capital. NASD has generally viewed these as early termination penalties.

For example: a clearing agreement requires a \$100,000 deposit, no fixed expiration date. There is a clause in the agreement that states; "If during the first year of the agreement it is terminated the introducing firm would forfeit \$25,000, during the second year \$15,000, and during the third year \$10,000." In this example, if the introducing firm were to terminate its clearing agreement in the first year it would only receive \$75,000 from the clearing firm, in the second year, \$85,000, and in the third year, \$90,000. Consequently, a charge to net capital would have to be taken equal to the total amount that would be forfeited at the date of the net capital computation, or in this example, a charge of \$25,000 in the first year, \$15,000 in the second year, \$10,000 in the third, and no charge thereafter.

In May 2002, the staff of the SEC's Division of Market Regulation informed NASD that the introducing firm would not be subject to the net capital charge discussed in the preceding paragraph, if the clearing agreement provides explicitly that the clearing firm **will not** enforce the penalty clause or otherwise attempt to collect the penalty amount if the introducing firm becomes the subject of a proceeding under SIPA (the Securities Investor Protection Act). The clearing firm is not required to forfeit any rights it would have as a general creditor of the failed broker/dealer.



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To facilitate this change, clearing firms may revise their clearing agreements to include the following language:

"In the event that [the Introducing Broker] is the subject of the issuance of a protective decree pursuant to the Securities Investor Protection Act of 1970 (15 USC 78aaa-III), [the Clearing Firm's] claim for payment of a termination fee under this Agreement shall be subordinate to claims of [the Introducing Broker's] customers that have been approved by the Trustee appointed by the Securities Investor Protection Corporation pursuant to the issuance of such protective decree."

Questions about this item may be directed to the NASD Member Regulation Department at (202) 728-8221.