

**INFORMATIONAL**

---

## FOCUS Reporting

---

### Changes To FOCUS Resulting From Certain Disclosure And Asset Recognition Requirements Under FASB 140

**SUGGESTED ROUTING**

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Executive Representative
- Internal Audit
- Legal & Compliance
- Operations
- Senior Management

**KEY TOPICS**

- Financial Accounting Standards Board
- FOCUS Reports

**Executive Summary**

The National Association of Securities Dealers, Inc. (NASD®) has modified the FOCUS Report to include disclosure, pursuant to Financial Accounting Standards Board Statement 140 (Statement 140), of amounts of inventory pledged, non-cash collateral received in secured financing transactions, and residual interests carried as a result of asset-collateralized securitizations. Beginning with the December 2001 FOCUS Report, members, who are required to file FOCUS Report, Part II, need to disclose:

- (1) the dollar value of inventory pledged to secure a bank loan, or a security lending or re-purchase transaction, *to the extent that the third party receiving the collateral has the right to sell or re-pledge such collateral;*
- (2) the market value of securities received as collateral, which were pledged by a counter-party as a result of a securities lending or repurchase arrangement, as well as an offsetting amount representing the obligation to return pledged securities; and
- (3) the fair value of residual interests, over which the firm has retained control, in a special purpose entity (SPE), and an offsetting amount representing contingent obligations to the beneficial owners of interests in the SPE.

**Questions/Further Information**

Members should initially direct any questions on the applicability of the disclosure requirements of Statement 140 to their outside auditors. Questions concerning the disclosure reported on the FOCUS Statement of Financial Condition

("Balance Sheet") may be directed to Andrew Labadie, Member Regulation, NASD Regulation, at (202) 728-8397.

**Background**

In September 2000, the Financial Accounting Standards Board (FASB) issued Statement 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." While the primary focus of Statement 140 is to provide guidance for, and facilitate consistent treatment of, transfers of financial assets and settlements of financial liabilities, it also requires firms to disclose the extent to which they have (1) encumbered (that is, permitted third parties to sell or re-pledge) inventory that has been pledged to obtain financing, and (2) received non-cash financial assets as collateral in secured lending transactions. In addition, firms need to disclose the fair value of any residual interests retained in an SPE. (SPEs are often a vehicle for the issuance of asset-collateralized securities, such as interests in the cash flows obtained from credit card receivables).<sup>1</sup>

The Securities and Exchange Commission requested the New York Stock Exchange (NYSE) and the NASD to determine the extent to which broker/dealers encumber pledged inventory, engage in secured financing transactions, or originate securitizations in which they retain residual interests. The NYSE and the NASD have included additional fields in the Balance Sheet of the FOCUS Report to capture such information. Accordingly, beginning with the December 2001 FOCUS Report, members will need to disclose the market value of proprietary securities that are not under their control as encumbered

assets, and recognize, as assets and liabilities, non-cash collateral received in certain secured transactions, as well as indirect interests in certain securitized assets that do not qualify for sale treatment under Statement 140.

### **Application: FOCUS Report Part II Filers**

Pages 2 and 3 of the FOCUS Report have been revised to accommodate the new disclosure and recognition Items; the specific line item fields are currently reflected in Web FOCUS.

1. Under Section 7, *Securities and Spot Commodities owned at market value*, we have added Line 7J: "Total Inventory – includes encumbered securities of" – (FOCUS Item 120). The dollar value of proprietary securities that are encumbered is a *subset* of the combined value of the preceding inventory categories (that is, it *cannot exceed* the amount reported in Item 850). As a subset of the total of the preceding inventory categories, the amount reported in Item 120 does not carry forward to Item 850, and thus has no effect on total assets. Encumbered securities primarily consist of securities not in the control of the broker/dealer as a result of a secured transaction such as a bank loan, or a security lending or re-purchase transaction, *to the extent that the third party receiving the collateral has the right to sell or re-pledge such collateral*. The amount reported on this line may be reported on a settlement-date basis, even if inventory is reported on a trade-date basis.

2. Under Section 15, *Other Assets*, we have added Line 15E, "Collateral accepted under Statement 140" – (FOCUS Item 536), and under Section 23, *Accounts payable and accrued liabilities and expenses*, Line 23G, "Obligation to return securities" – (FOCUS Item 1386). Collateral accepted under Statement 140 refers to the market value of non-cash collateral received in exchange for securities loaned. The *offsetting* liability on Line 23G represents the obligation to return such securities. The amounts reported in Item 536, and in Item 1386 in a basic filing, or Item 1686 in an alternate filing, should be *equal*. The amount included in Item 536 should be carried forward to Item 930, and the amount included in 1386 in a basic filing should be carried forward to Item 1686. Since the amounts on Lines 15E and 23G offset, they do not effect net worth.<sup>2</sup>

3. Again under Section 15, *Other Assets*, we have added Line 15F, "SPE Assets" – (FOCUS Item 537) and under Section 23, *Accounts payable and accrued liabilities and expenses*, Line 23H, "SPE Liabilities" – (FOCUS Item 1387). SPE assets represent residual interests, over which the issuer has retained control, in an SPE (that is, effectively residual interests in the cash flows obtained from the underlying securitized assets held by the SPE). The fair value of such retained residual interests is reported in Item 537. The offsetting liability reported on Line 23H represents the contingent obligations to the beneficial owners of interests in the SPE. The amounts reported in Item 537,

and in Item 1387 in a basic filing, or Item 1687 in an alternate filing, should be equal. The amount included in Item 537 should be carried forward to Item 930, and the amount included in 1387 in a basic filing should be carried forward to Item 1687. Since the amounts on Lines 15F and 23H offset, they do not effect net worth.

Assets and liabilities reported on FOCUS solely to provide disclosure pursuant to Statement 140 will have no impact on the computation of net capital or the customer reserve calculation. Haircut charges will continue to apply unchanged to the inventory categories in Lines 7A through 7I. The amount reported in Item 120 on Line 7J will not be subject to an additional haircut charge. The amounts reported in Items 536 and 537 are included in allowable assets and the amounts in 1386 and 1387 are excluded from aggregate indebtedness.

**Endnotes:**

- 1 Statement 140 became effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. The collateral re-classification and recognition requirements became effective for financial statements for fiscal years ending after December 15, 2000. Statement 140 replaces, and yet is essentially a refinement of, Statement 125, which was released in June 1996.
- 2 Members are responsible for determining how Statement 140 applies to the member's use of customer securities, e.g., bank loan versus customer margin securities. Members should consult with their independent public accountants as to the recognition of such securities on the FOCUS Balance Sheet. If so recognized, the market value of these securities would also be disclosed on Line 15E, Item 536, and Line 23G, Items 1386 or 1686 on the FOCUS Balance Sheet.

*© 2002 National Association of Securities Dealers, Inc. (NASD). All rights reserved. Notices to Members attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.*