

NASD Notice to Members 99-44

SEC Approves Interpretations And Allocation Chart For Proprietary Accounts Of Introducing Broker/Dealers

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Executive Summary

On November 3, 1998, the Securities and Exchange Commission (SEC) issued a No-Action Letter to clarify its position under SEC Rule 15c3-1 (Net Capital Rule) regarding the capital treatment of assets in the proprietary account of an introducing broker/dealer (PAIB) held by a clearing broker/dealer. National Association of Securities Dealers, Inc. (NASD®) *Notice to Members 98-99* discusses PAIB in greater detail and also provides a copy of the SEC's No-Action Letter.

The letter allows introducing broker/dealers to include PAIB assets as allowable assets in their net capital computations, provided the clearing broker/dealer adheres to the provisions, procedures, and interpretations set forth in the letter including the establishment of a separate reserve account for PAIB assets in accordance with SEC Rule 15c3-3 (Customer Protection Rule). The effective date of the No-Action Letter is June 1, 1999.

The SEC has approved six interpretations and an allocation chart relative to PAIB which are contained in this *Notice to Members*. Questions concerning this *Notice* may be directed to Samuel Luque, Jr., Associate Director, Member Regulation, NASD Regulation, Inc. (NASD Regulation®), (202) 728-8472; or Susan DeMando, Regional Compliance Supervisor, Member Regulation, NASD Regulation, (202) 728-8411.

SEC Interpretations On PAIB

- The PAIB letter applies to all broker/dealers with cash and/or securities on deposit in a proprietary account at another broker/dealer.
- Clearing deposits held by clearing brokers are to be included as credit items in the PAIB reserve formula computation.
- If an introducing firm does not have a proprietary trading account, it still must enter into a PAIB agreement with its clearing firm in order to treat its deposit at the clearing firm as a good asset for capital purposes.
- A U.S. broker/dealer's deposit held by a foreign entity is not affected by the PAIB letter. However, the deposit would be subject to the net capital treatment as is normally accorded to such deposits.
- A proprietary account of a foreign broker/dealer is not included in the PAIB calculation.
- If a clearing firm will not enter into a PAIB agreement, the introducing broker/dealer would need to take a non-allowable capital charge only on its net equity at the clearing firm.

PROPRIETARY ACCOUNTS OF INTRODUCING BROKERS (PAIB) ALLOCATION CHART

This allocation chart shows the relationship between the various allocable items and may be used in conjunction with the interpretations when an allocation is required to determine the debit and credit values includible in the PAIB reserve formula computation.

A. CREDITS

<u>Short Location:</u>	<u>Long Allocation</u>	<u>Include Credit</u>	<u>Debit</u>
Customer Bank Loan vs:			
	Customer Long	No	No
	Proprietary Long	No	No
	Non-Customer Long	No	No
	PAIB Accounts Long	No	Yes
	Stock Borrowed	No	No
	Fail to Deliver	No	No
Non-Customer Bank Loan vs:			
	Customer Long, Stock Borrowed, or Fail to Deliver	No	No
	Non-Purpose Loan Accounts	No	No
	Proprietary and Non-Customer Accounts	No	No
	PAIB Accounts Long	Yes	Yes (see Note 1)
Proprietary Bank Loan vs:			
	Customer Account Long	No	No
	Fail to Deliver or Stock Borrowed	No	No
	Proprietary, Subordinated, General Partners, Directors, and Principal Officers Accounts Long	No	No
	PAIB Accounts Long	No	Yes
	All Other Long Allocations	No	No
Any Bank or Custody Location with Cross Lien Provisions vs:			
	Customer Account Long	No	No
	PAIB Accounts Long	Yes	Yes (see Note 2)
Collateral to Letter of Credit (LOC) or Collateral Pledged for OCC Customer Margin Requirement vs:			
	Customer Accounts Long	No	No
	Proprietary Qualified Sec.	No	No
	Non-Customer or Proprietary Accounts	No	No
	PAIB Accounts Long	Yes	Yes (see Notes 8 & 9)
Collateral to Letter of Credit or Collateral Pledged for OCC PAIB Margin Requirement vs.			
	Customer Accounts Long	No	No
	Proprietary Qualified Sec.	No	Yes
	Non-Customer or Proprietary Accounts	No	No
	PAIB Accounts	Yes	Yes (see Notes 6,7,8,9)

A. CREDITS *(continued)*

<u>Short Location:</u>	<u>Long Allocation</u>	<u>Include Credit</u>	<u>Debit</u>
Collateral Pledged to Letter of Credit for Securities Borrowed vs:			
Customer Accounts Long		No	No
Non-Customer or Non-Purpose Loan Accounts		No	No
PAIB Accounts Long		Yes	Yes (see Note 3)
Proprietary Accounts		No	No
Collateral Pledged for Securities Borrowed vs:			
Customer Accounts Long		No	No
Non-Customer and Non-Purpose Loan Accounts		No	No
PAIB Accounts Long		Yes	Yes (see Note 4)
Proprietary Accounts		No	No
Securities Loaned vs:			
Customer Accounts Long		No	No
Fails to Deliver		No	No
Securities Borrowed		No	No
Non-Customer and Proprietary Accounts Long		No	No
PAIB Accounts Long		Yes	Yes
Fails to Receive vs:			
Customer Accounts Long		No	No
Fails to Deliver		No	No
Non-Customer Accounts Long		No	No
PAIB Accounts Long		Yes	Yes
Proprietary Accounts Long		No	No
Securities Borrowed		No	No
Proprietary and Non-Customer Shorts vs:			
Customer Accounts Long		No	No
Non-Customer Accounts Long		No	No
PAIB Accounts Long		Yes	Yes (see Note 5)
Customer Short Position vs:			
Customer Long		No	No
Proprietary and Non-Customer Accounts Long		No	No
PAIB Accounts Long		Yes	Yes
PAIB Short Position vs:			
Customer Long		No	No
Proprietary and Non-Customer Accounts Long		No	No
PAIB Accounts Long		Yes	Yes

**B. OTHER CREDITS OR VALUES INCLUDIBLE
- REGARDLESS OF ALLOCATION**

Include Credit

Securities Borrowed Secured by an Irrevocable Letter of Credit Secured by Customer Margin Securities	No
Securities Borrowed Secured by an Irrevocable Letter of Credit Secured by PAIB Securities	Yes (see Note 3)
Stock Dividends Receivable, Stock Splits, and Other Distributions Over 30 Calendar Days Old	No
Suspense Account Credits and Short Security Count, Unverified Short and Suspense Security Differences:	
Over seven business days old	No
Over 30 calendar days old	No
Transfer over 40 calendar days old	No
Prepaid Fails to Receive	No
Unclaimed Dividends and Interest Payable	No
All outstanding drafts payable to customers which have been applied against free or other credit balances and checks drawn in excess of bank balances (per firm records)	No
Drafts Payable to PAIB	Yes
TEFRA Accounts Payable	No
Accrued Interest Payable on Customer Credit Balances	No
Accrued Interest Payable on PAIB Credit Balances	Yes

C. DEBITS

<u>Long Position:</u>	<u>Short Allocation</u>	<u>Include Debit</u>	<u>Credit</u>
Securities Borrowed Collateralized By Cash, U.S. Treasury Bills, Notes, LOC's Secured by Proprietary Qualified Securities, or any other Acceptable Collateral as per (b)(3) vs:			
	Customer Accounts Short	No	No
	Non-Customer or Proprietary Accounts Short	No	No
	PAIB Accounts Short	Yes	Yes
	Fails to Receive	No	No
	Customer Bank Loan	No	No
	Non-Customer or Proprietary Bank Loan	No	No
	Securities Loan	No	No
	Stock Dividend Receivable	No	No
	Transfer	No	No
	All Other Physical Control Locations	No	No
Securities Borrowed Secured By an Unsecured Irrevocable Letter of Credit, Unacceptable Collateral as per (b)(3) or Unsecured Borrows			
		No	
Fails to Deliver Not Over 30 Calendar Days Old vs:			
	Customer Accounts Short	No	No
	Non-Customer and Proprietary Accounts Short	No	No
	PAIB Accounts Short	Yes	Yes
	Fails to Receive	No	No
	Customer Bank Loan	No	No
	Proprietary and Non-Customer Bank Loan	No	No
	Securities Loaned	No	No
	Transfer	No	No
	Other Physical Control Location for Not More Than Three Business Days	No	No

NOTES FOR PAIB ALLOCATION

Note 1 Include market value of the collateral up to the amount borrowed as a credit.

Note 2 When a broker/dealer pledges PAIB securities to a non-customer loan and also has proprietary and/or customer loans with the same pledgee, it must assure itself that the pledgee does not have a lien upon non-customer collateral for any loan other than for PAIB non-customers.

If a cross lien exists and could place PAIB securities at risk, there shall be included in the PAIB formula the amount of the PAIB loan, **plus** the lower of the value of PAIB collateral in excess of the loan or the amount of loans for other than PAIB.

Note 3 Include the market value of the borrowed securities as a credit.

Note 4 Include the market value of the pledged securities.

Note 5 Include the market value of the short securities.

Note 6 Letters of Credit Secured by Customer and Non-Customer Securities

When a letter of credit, collateralized by both customer and non-customer securities, is deposited with OCC as margin, only the amount required for customers' margin is included as a debit in the customer reserve formula. Therefore, the amount of margin required for Market-Maker accounts is included as a debit in the PAIB reserve formula to the extent it is collateralized by customer and PAIB securities. (The combined customer and non-customer margin requirement, up to the amount of the letter of credit, must be included as a credit in the customer's reserve formula only.)

Note 7 OCC Margin Requirement Met by PAIB Securities

When PAIB collateral is deposited with OCC to satisfy Market-Maker margin requirements, the actual amount of margin required is included in the formula as a debit and a credit.

Note 8 Letters of Credit Secured by PAIB Securities

Include as a credit, the amount of letters of credit which are collateralized by PAIB securities and deposited with OCC, to the extent of the margin requirement at OCC, which is covered by such letters of credit.

Note 9 Commingled Collateral as OCC Margin Deposit

When customer, non-customer, and qualified proprietary securities are commingled as margin on deposit with OCC, the customer margin requirement should be included in the customer reserve formula computation as a credit and the lesser of the customers' margin required or the total of the collateral value, less the amount representing the non-customer should be included as a debit in that formula.

Any amount not allowed as a debit in the customer reserve formula because the margin requirement was satisfied with PAIB securities should be included as a debit in the PAIB reserve formula and no credit need be included to the extent the credit is included in the customer reserve formula.