

NASD Notice to Members 98-99

SEC Issues No-Action Letter On 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. The letter allows introducing broker/dealers to include PAIB assets as allowable assets in their net capital computations, provided the clearing broker/dealer establishes a separate reserve account for PAIB assets in accordance with SEC Rule 15c3-3 (Customer Protection Rule) and both the introducing broker/dealer and the clearing broker/dealer enter into a written agreement whereby the clearing broker/dealer will perform the PAIB calculation in accordance with the provisions, procedures, and interpretations set forth in the letter. Firms must begin adhering to the requirements stated in the No-Action Letter on June 1, 1999; until then introducing broker/dealers may continue their current practice of treating PAIB assets as allowable.

A copy of the No-Action Letter is attached. Questions concerning this *Notice* may be directed to Samuel Luque, Jr., Associate Director, Member Regulation, NASD Regulation, Inc. (NASD RegulationSM), (202) 728-8472, or Susan DeMando, Regional Compliance Supervisor, Member Regulation, NASD Regulation, (202) 728-8411.

Background

The Net Capital Rule requires broker/dealers to have sufficient liquid capital to protect the assets of customers and to meet their obligations to other broker/dealers. In calculating net capital, broker/dealers begin with their net worth and then make various positive and negative adjustments. The Customer Protection Rule requires broker/dealers that carry customer accounts to maintain

physical possession or control of all customer fully paid and excess margin securities, and periodically to compute and set aside in a special reserve bank account a certain amount of money that is customer money or money obtained from using customer securities.

Introducing broker/dealers typically include their proprietary cash and securities held by their clearing firms as allowable assets in calculating their net capital. However, clearing broker/dealers are not required to maintain physical possession or control of these PAIB assets, or include them as customer credits in their customer reserve formula calculation, because the Customer Protection Rule specifically excludes broker/dealers from the definition of "customer." Therefore, since clearing broker/dealers are free of these customer-protection restrictions, it is possible for them to treat PAIB assets as their own. In fact, clearing broker/dealers have never been precluded from using PAIB assets in the normal course of their business. However, this means that introducing broker/dealers may have assets that are not always readily available to them. Under the Net Capital Rule, any assets "not readily convertible into cash" must be deducted from net worth and should be classified as non-allowable assets when calculating net capital.

This situation prompted concerns by NASD Regulation and the New York Stock Exchange (NYSE) that both an introducing broker/dealer and a clearing broker/dealer may be using the same proprietary assets in conducting their individual businesses. NASD Regulation and the NYSE requested the SEC to clarify its position regarding PAIBs.

Treatment Of Assets Held In A PAIB

In order for an introducing broker/dealer to treat its PAIB assets as allowable

assets in calculating its net capital, the introducing firm and its clearing broker/dealer must enter into a written agreement providing that the clearing broker/dealer will perform the PAIB calculation in accordance with the following provisions:

1. A clearing broker/dealer must perform a computation for PAIB assets (PAIB reserve computation) of all its introducing broker/dealers in accordance with the customer reserve computation set forth in the Customer Protection Rule (customer reserve formula) with the following modifications:

A. Any credit (including a credit applied to reduce a debit) that is included in the customer reserve formula cannot be included as a credit in the PAIB reserve computation;

B. Note E(3) to Rule 15c3-3a which reduces debit balances by one percent under the basic method and subparagraph (a)(1)(ii)(A) of the Net Capital Rule which reduces debit balances by three percent under the alternative method will not apply; and

C. Neither Note E(1) to Rule 15c3-3a nor NYSE Interpretation /04 to Item 10 of Rule 15c3-3a regarding securities concentration charges is applicable to the PAIB reserve computation.

2. The PAIB reserve computation must include all the proprietary accounts of all introducing broker/dealers covered by the PAIB Agreement. All PAIB assets must be kept separate and distinct from customer assets under the customer reserve formula in the Customer Protection Rule.

3. The PAIB reserve computation must be prepared within the same time frames as those prescribed by

the Customer Protection Rule for the customer reserve formula.

4. The clearing broker/dealer must establish and maintain a separate "Special Reserve Account for the Exclusive Benefit of Customers" with a bank in conformity with the standards of paragraph (f) of the Customer Protection Rule (PAIB Reserve Account). Cash and/or qualified securities as defined in the customer reserve formula must be maintained in the PAIB Reserve Account in an amount equal to the PAIB reserve requirement.

5. If the PAIB reserve computation results in a deposit requirement, the requirement can be satisfied to the extent of any excess debit in the customer reserve formula of the same date. However, a deposit requirement resulting from the customer reserve formula cannot be satisfied with excess debits from the PAIB reserve computation.

6. Within two business days of entering into any PAIB Agreement, an introducing broker/dealer must notify its designated examining authority (DEA) in writing that it has entered into such an agreement with a clearing broker/dealer.

7. Commissions receivable and other receivables of an introducing broker/dealer from its correspondent clearing broker/dealer (excluding clearing deposits) that are otherwise allowable assets under the Net Capital Rule are not to be included in the PAIB reserve computation, provided the amounts have been clearly identified as receivables on the books and records of the introducing broker/dealer and as payables on the books of the clearing broker/dealer.

8. The proprietary account of an introducing broker/dealer that is a guaranteed subsidiary of a clearing broker/dealer or that guarantees a

clearing broker/dealer (*i.e.*, guarantees all liabilities and obligations) is to be excluded from the PAIB reserve computation.

9. Upon discovery that any deposit made to the PAIB Reserve Account did not satisfy its deposit requirement, a clearing broker/dealer shall by facsimile or telegram immediately notify its DEA and the SEC. Unless a corrective plan is found to be acceptable by the SEC and the DEA, the clearing broker/dealer must provide written notification within five business days of the date of discovery to its introducing broker/dealers that PAIB assets held by the clearing broker/dealer will not be deemed allowable assets for net capital purposes. The letter should also state that if the introducing broker/dealer wishes to continue to count its PAIB assets as allowable, it has until the last business day of the month following the month in which the notification was made to transfer all PAIB assets to another clearing broker/dealer. However, if the deposit deficiency is remedied before the time at which the introducing broker/dealer must transfer its PAIB assets to another clearing broker/dealer, the introducing broker/dealer may choose to keep its assets at the original clearing broker/dealer.

Interpretations

In addition, the No-Action Letter stipulates that certain interpretations are applicable to PAIBs. These interpretations were developed in conjunction with representatives from the Capital and Clearing Firm Committees of the Securities Industry Association. See the attached No-Action Letter for details.

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DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

November 3, 1998

Mr. Raymond J. Hennessy
Vice President
New York Stock Exchange, Inc.
Member Firm Regulation
20 Broad Street
New York, New York 10005

Mr. Thomas Cassella
Vice President
NASD Regulation, Inc.
1735 K Street, NW
Washington, D.C. 20006-1500

Re: Proprietary Accounts of Introducing Brokers and Dealers

Dear Messrs. Hennessy and Cassella:

The New York Stock Exchange, Inc. ("NYSE") and NASD Regulation, Inc. ("NASDR") have raised concerns regarding the capital treatment of assets of broker-dealers that introduce their proprietary accounts on a fully disclosed basis ("introducing brokers") to other broker-dealers ("clearing brokers") for clearance and settlement. You have advised us that under certain circumstances an introducing broker and its correspondent clearing broker may each utilize the same proprietary assets of the introducing broker in their individual operations. You have requested that the Division of Market Regulation ("Division") clarify its position as to the capital treatment of assets in the proprietary account of an introducing broker ("PAIB") held by a clearing broker, and you propose a methodology under which introducing brokers may properly account for PAIB assets for purposes of the net capital computation required by Rule 15c3-1 ("net capital rule").¹

I. BACKGROUND

A. Rules 15c3-1 and 15c3-3

Rule 15c3-1 requires every broker-dealer to maintain at all times specified minimum levels of liquid assets, or net capital, sufficient to enable a firm that falls below its minimum requirement to liquidate in an orderly fashion. The rule is designed

¹ 17 CFR 240.15c3-1.

to protect the customers of a broker-dealer that fails. To compute its current amount of liquid assets, a broker-dealer begins with its net worth and then makes various positive and negative adjustments to arrive at its net capital. This amount is then compared against the firm's minimum net capital requirement. If a firm's net capital computation yields an amount less than its minimum net capital requirement, the firm must immediately cease doing business.

Rule 15c3-3 ("customer protection rule") generally requires every broker-dealer that carries customer accounts to maintain physical possession or control of all fully-paid and excess margin securities. The customer protection rule also requires firms to make a periodic computation ("customer reserve formula") to ascertain the amount of money it holds that is either customer money or money obtained from the use of customer securities (i.e., customer credits). If customer credits exceed the amount customers owe the firm (i.e., customer financing or debits), the broker-dealer must deposit the excess in a special reserve bank account for the exclusive benefit of its customers. In this way, Rule 15c3-3 protects customer funds and securities held at a broker-dealer by requiring firms to maintain possession or control of customer securities, and by permitting firms to use customer money only to the extent necessary to finance customer related business.

B. Treatment of Assets Held in a PAIB

In addition to the regular customer accounts held by a clearing broker on behalf of the introducing broker, an introducing broker itself may maintain a proprietary trading account, or PAIB, with a clearing broker. When computing its net capital, an introducing broker typically includes its proprietary cash and securities held by the clearing broker as allowable assets. However, because the customer protection rule specifically excludes brokers and dealers from the definition of "customer,"² the clearing broker is not subject to the restrictions of Rule 15c3-3 with regard to PAIB assets. Therefore, a clearing broker is not required to maintain the physical possession or control of PAIB assets, nor is the clearing broker restricted as to its use of PAIB assets which, if attributable to "customers," would constitute customer credits in the customer reserve formula.

Consequently, this interaction between the net capital rule and the customer protection rule serves to permit an introducing broker to treat PAIB assets as allowable assets for purposes of Rule 15c3-1 while a clearing broker can exclude these assets as credits from the customer reserve formula. In effect, this permits clearing brokers to use the same PAIB assets free of the restrictions imposed by Rule 15c3-3 that are otherwise applicable to a broker-dealer's use of customer funds and securities. In

² 17 CFR 240.15c3-3(a)(1). Rule 15c3-3 reads, in pertinent part, that "[t]he term [customer] shall not include a broker or dealer or a registered municipal securities dealer."

effect, the clearing broker can treat the assets as their own, free of any restrictions. Consequently, the assets may not be readily available to the introducing broker if its correspondent clearing broker fails or otherwise experiences financial difficulties. This result is inconsistent with subparagraph (c)(2)(iv) of net capital rule which requires that assets "not readily convertible into cash" be deducted from a broker-dealer's net worth, and accordingly, PAIB assets should be considered as non-allowable assets, and an introducing broker should deduct such assets from its net worth when calculating its net capital.

II. PROPOSAL

A. PAIB Agreement: You believe that under certain circumstances, it may be appropriate for an introducing broker to be permitted to treat such assets as allowable for purposes of the net capital rule. Accordingly, you have proposed the methodology set forth below as an elective procedure to be followed by an introducing broker and its correspondent clearing broker that would permit the introducing broker to treat its PAIB assets as allowable assets for purposes of its net capital calculation. Specifically, you propose that for an introducing broker to treat its PAIB assets held at a clearing firm as allowable for purposes of the net capital rule, an introducing broker and its correspondent clearing broker must agree (in writing) to perform the PAIB calculation in accordance with the following provisions ("PAIB Agreement"):

1. A clearing broker must perform a computation for PAIB assets ("PAIB reserve computation") of all its introducing brokers in accordance with the customer reserve computation set forth in Rule 15c3-3 ("customer reserve formula") with the following modifications:
 - A. Any credit (including a credit applied to reduce a debit) that is included in the customer reserve formula cannot be included as a credit in the PAIB reserve computation;
 - B. Note E(3) to Rule 15c3-3a which reduces debit balances by 1% under the basic method and subparagraph (a)(1)(ii)(A) of the net capital rule which reduces debit balances by 3% under the alternative method will not apply; and
 - C. Neither Note E(1) to Rule 15c3-3a nor NYSE Interpretation /04 to Item 10 of Rule 15c3-3a regarding securities concentration charges is applicable to the PAIB reserve computation.
2. The PAIB reserve computation must include all the proprietary accounts of all introducing brokers covered by the PAIB Agreement. All PAIB assets must be kept separate and distinct from customer assets under the customer reserve formula in Rule 15c3-3.

3. The PAIB reserve computation must be prepared within the same time frames as those prescribed by Rule 15c3-3 for the customer reserve formula.
4. The clearing broker must establish and maintain a separate "Special Reserve Account for the Exclusive Benefit of Customers" with a bank in conformity with the standards of paragraph (f) of Rule 15c3-3 ("PAIB Reserve Account"). Cash and/or qualified securities as defined in the customer reserve formula must be maintained in the PAIB Reserve Account in an amount equal to the PAIB reserve requirement.
5. If the PAIB reserve computation results in a deposit requirement, the requirement can be satisfied to the extent of any excess debit in the customer reserve formula of the same date. However, a deposit requirement resulting from the customer reserve formula cannot be satisfied with excess debits from the PAIB reserve computation.
6. Within two business days of entering into any PAIB Agreement, an introducing broker must notify its designated examining authority in writing that it has entered into such agreement with a clearing broker.
7. Commissions receivable and other receivables of an introducing broker from its correspondent clearing broker (excluding clearing deposits) that are otherwise allowable assets under the net capital rule are not to be included in the PAIB reserve computation, provided the amounts have been clearly identified as receivables on the books and records of the introducing broker and as payables on the books of the clearing broker.
8. The proprietary account of an introducing broker that is a guaranteed subsidiary of a clearing broker or who guarantees a clearing broker (i.e., guarantees all liabilities and obligations) is to be excluded from the PAIB reserve computation.
9. Upon discovery that any deposit made to the PAIB Reserve Account did not satisfy its deposit requirement, a clearing broker shall by facsimile or telegram immediately notify its designated examining authority and the Securities and Exchange Commission ("Commission"). Unless a corrective plan is found acceptable by the Commission and the designated examining authority, the clearing broker must provide written notification within 5 business days of the date of discovery to its introducing brokers that PAIB assets held by the clearing broker will not be deemed allowable assets for net capital purposes. The letter should also state that if the introducing broker wishes to continue to count its

PAIB assets as allowable, it has until the last business day of the month following the month in which the notification was made to transfer all PAIB assets to another clearing broker. However, if the deposit deficiency is remedied before the time at which introducing broker must transfer its PAIB assets to another clearing broker, the introducing broker may choose to keep its assets at the clearing broker.

B. Interpretations: In addition, you have proposed the following interpretations regarding the PAIB reserve computation that were developed in conjunction with representatives from the Capital and Clearing Firm Committees of the Securities Industry Association. The interpretations are as follows:

1. Credits included in the PAIB reserve computation that result from the use of PAIB securities pledged to meet intra-day margin calls in a cross margin account established between The Options Clearing Corporation and any regulated commodity exchange can be reduced to the extent that the excess margin held by the other clearing corporation in the cross margin relationship is used the following business day to replace the PAIB securities that were previously pledged. In addition, balances resulting from a cross margin account which are segregated pursuant to Commodities Future Trading Commission regulations need not be included in the PAIB reserve computation.
2. Deposits received prior to a transaction pending settlement³ which are \$5 million or greater for any single transaction or \$10 million in aggregate can be excluded as credits from the PAIB reserve computation if such balances are placed and maintained in a separate PAIB Reserve Account by 12 noon eastern time ("ET") on the following business day.⁴ Thereafter, the money representing any such deposits may be withdrawn to complete the related transactions without performing a new PAIB reserve computation.
3. Clearing deposits required to be maintained at registered clearing agencies may be included as debits in the PAIB reserve computation to the extent the percentage of the deposit, which is based upon the clearing agency's aggregate deposit requirements (e.g., dollar trading volume),

³ For example, large deposits could include moneys accumulated prior to underwritings, required at foreign clearing facilities, or for settlement of domestic transactions requiring federal funds in which next day funds were originally deposited.

⁴ This account would be in addition to any other reserve account maintained by the clearing broker under this no-action letter or otherwise.

that relates to the proprietary business of introducing brokers can be identified.

4. Any clearing broker that does not carry "customers" as defined by Rule 15c3-3 or conduct a proprietary trading business must still obtain the PAIB Agreement from its introducing brokers. But as long as such clearing broker does not have a PAIB deposit requirement, it may make its PAIB reserve computation monthly rather than weekly. If a clearing broker computing on a monthly basis has, at the time of any required computation, a PAIB deposit requirement, the clearing broker shall thereafter compute weekly until four successive weekly computations are made, none of which is made at a time when the clearing broker had a PAIB deposit requirement.
5. A credit balance resulting from a PAIB reserve computation can be reduced by the amount that items representing such credits are swept into money market funds or mutual funds of an investment company registered under the Investment Company Act of 1940 on or prior to 10 a.m. ET on the deposit date provided that the credits swept into any such fund are not subject to any right, charge, security interest, lien, or claim of any kind in favor of the investment company or the clearing broker. Any credits which have been swept into money market funds or mutual funds must be maintained in the name of a particular introducing broker or for the benefit of an introducing broker. This treatment of credit balances applies only to the PAIB reserve computation and does not apply to the customer reserve formula.
6. Carrying brokers that clear the PAIB accounts of their correspondents through an affiliate or third party clearing broker must include these PAIB accounts balances and the omnibus PAIB account balance in their computation provided the clearing broker agrees in writing to (1) perform a computation for PAIB assets as described in IIA, and (2) include the omnibus PAIB account balance in its computation.

You also propose that, on a case by case basis, the designated examining authority ("DEA") of a clearing broker may grant extensions of time regarding compliance with the terms of the PAIB Agreement as set forth in this letter if the DEA is satisfied the broker-dealer is acting in good faith and that exceptional circumstances warrant the extension. The DEA may confer with the staff of the Commission before granting an extension. The designated examining authority must maintain a summary of the justification for the extensions in a manner similar to the treatment of extensions granted under Rule 15c3-3(n).

Messrs. Hennessy and Cassella
November 3, 1998
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III. CONCLUSION

Based on the foregoing, the Division will not recommend to the Commission that enforcement action be taken if an introducing broker includes PAIB assets as allowable assets in its net capital computation so long as the introducing broker and clearing broker adhere to the elective procedures regarding the PAIB Agreement and its attendant interpretations that are set forth in this letter. We understand that introducing and clearing brokers must make operational changes to comply with the terms of this letter; therefore, introducing firms may continue their current practice of treating PAIB assets as allowable until June 1, 1999.

You should be aware that this is a staff position with respect to enforcement only and does not purport to express any legal conclusions. This position is based solely on the foregoing description. Factual variations could warrant a different response, and any material change in the facts must be brought to the Division's attention. This position may be withdrawn or modified if the staff determines that such action is necessary for the protection of investors, in the public interest, or otherwise in furtherance of the purposes of the securities laws.

Sincerely,

A handwritten signature in cursive script, reading "Michael A. Macchiaroli".

Michael A. Macchiaroli
Associate Director