Notice to Members

MAY 2005

SUGGESTED ROUTING

Senior Management
Executive Representatives
Legal & Compliance
Operations

KEY TOPICS

Clearing Firms
Deficits in Introduced Accounts
Introducing Firms

ACTION REQUIRED

Deficits in Introduced Accounts

NASD Reminds Broker-Dealers of Their Responsibilities Regarding Deficits in Introduced Accounts; Immediate Action May Be Required to Ensure Compliance

Executive Summary

NASD is concerned that clearing firms and introducing firms are frequently failing to properly consider deficits in introduced accounts in accordance with an August 1988 interpretation published in *NASD Guide to Rule Interpretations* (May 1996). This *Notice* is intended to remind members of their responsibilities in this regard. In addition, please note that reviews for the proper handling of deficits in introduced accounts will be an integral part of NASD's examination program for both clearing and introducing firms.

Questions/Further Information

Questions concerning this *Notice* may be directed to Susan M. DeMando, Associate Vice President, Financial Operations, at (202) 728-8411; or Anne Harpster, Financial Analyst, Financial Operations, at (202) 728-8092.

Discussion

The SEC's Net Capital Rule specifies the circumstances in which a clearing firm must take a charge to its net capital for unsecured or partly secured debits.[1] Since most clearing agreements, however, usually state that clearing firms have the right to charge their introducing firms for certain losses, NASD published the following interpretation (Interpretation):

> **Deficits In Introduced Accounts**
>
> Deficits in unsecured and partly secured introduced accounts shall be deducted by the carrying broker-dealer and the introducing broker-dealer *when the clearing agreement*

> *states that such deficits are the liability of the introducing broker-dealer.*[2] ….
> The amount is deductible by the carrying broker-dealer upon occurrence after application of timely calls for margin, marks to market, or other required deposits which are not outstanding for more than five business days unless there is reason to believe payment will not be made. The introducing broker-dealer *must* deduct the charge on the day after it becomes a charge to the carrying broker and the carrying broker-dealer *must* advise the introducing broker-dealer *in writing on a daily basis of all such deficits to be charged. (Emphasis added.)*
>
> – SEC Staff to NYSE, August 1988

NASD believes that some clearing firms may fail to notify their introducing firms of the deficits to be charged, as required by the Interpretation. Even when notified, introducing firms may fail to take the capital charge. Some clearing firms appear to believe that the use of the term "when" in the Interpretation (which specifically refers to the existence of language in the clearing agreement indicating that deficits are the responsibility of the introducing firm) can be read to permit the clearing firm to determine "when" a deficit has occurred. Some clearing and introducing firms appear to have concluded that as long as they are "in discussions" as to how to collect or otherwise resolve a deficit, the clearing firm can delay providing the required notification, and the introducing firm can postpone taking the capital charge.

The Interpretation does not permit a clearing firm to delay "passing on the deficit," nor does it permit an introducing firm to postpone taking a capital charge for deficits in introduced accounts. If the clearing agreement states that the introducing broker-dealer is responsible for customer deficits, the clearing firm and the introducing broker-dealer must comply with the conditions of the Interpretation. These conditions require that the amount (of the deficit) is deducted by: (1) the carrying broker-dealer "upon occurrence…"; and (2) the introducing broker-dealer "on the day after it becomes a charge to the carrying broker." This language, therefore, does not permit any delay in "passing on the deficit," as the Interpretation requires the clearing firm must advise the introducing broker-dealer in writing on a daily basis of all such deficits.

NASD believes that the delays in "passing on the deficit" may be more prevalent when the size of the deficit would cause the introducing firm to be under capital. In such cases, failure to properly inform the introducing firm of a deficit allows the clearing firm to continue to receive revenue (for example, ticket charges and/or execution fees) and permits the introducing firm to continue to conduct a securities business even though it is not in compliance with the Net Capital Rule. This conduct gives the introducing firm a competitive advantage compared to other introducing firms that voluntarily cease conducting a securities business when under capital. The economics of such situations have caused some clearing firms to regard delays in "passing on the deficit" as simple "business decisions," rather than conduct entirely inconsistent with the Interpretation.

Action Required

Clearing firms must review their operations to ensure that they have policies and procedures in place to comply with the Interpretation. Firms must immediately correct any deficiencies noted as a result of this review. If a clearing firm designated to NASD for financial and operational purposes determines that it does not have systems in place to ensure its compliance with this *Notice* and/or cannot remedy the deficiency by **June 30, 2005,** the clearing firm must contact its district office immediately to discuss an anticipated timeframe to ensure compliance. Where necessary, NASD may impose limitations on a clearing firm's operations relative to introduced accounts until the clearing firm can demonstrate compliance with this *Notice.*

Record Retention

Clearing firms issuing deficit reports, and introducing firms receiving such reports, must maintain these records for a period of not less than three years, the first two years in an easily accessible place.[3] Such reports are considered "working papers" connected with net capital computations.

Satisfaction of Deficits

NASD anticipates that deficits will be satisfied in several ways. We believe the most common will be: (1) full cash payment by the owner of the introduced account to satisfy the deficit; (2) full cash payment by the correspondent to satisfy the deficit in an introduced account; (3) a write-off of the loss by the clearing firm (*i.e.,* the write-off must be without any right/intent to re-establish the receivable or enter into any legal proceeding to collect it; and/or (4) the establishment of a payment plan (by the customer or correspondent) to satisfy the obligation.

If the correspondent satisfies the deficit by agreeing to a payment schedule, or agrees to make the clearing firm whole if the customer fails to honor a payment schedule that he/she has agreed to, then the correspondent broker-dealer must deduct the entire unpaid amount from its net worth in its net capital calculation.

If the parent or affiliate of the broker-dealer (or other third party) agrees to pay the deficit in full or through payments, the introducing firm must comply with the SEC July 11, 2003, letter titled *Recording Certain Broker-Dealer Expenses and Liabilities (see NASD Notice to Members 03-63),* whether or not the introducing firm and the paying party have an expense sharing agreement for other purposes.

Reporting the "Deficit" to Introducing Firms

For each correspondent, the clearing firm must report the *total deficit,* in writing, on a daily basis.[4]

Endnotes

1 *See* SEC Rule 15c3-1(c)(2)(iv)(B), Certain Unsecured and Partly Secured Receivables.

2 The Interpretation also states: "If the carrying broker-dealer subordinates its receivable for the deficit amount to the claims of creditors of the introducing broker-dealer, the subordinated receivable shall be deducted as a nonallowable asset by the carrying broker-dealer. The introducing broker-dealer may exclude the subordinated liability from Aggregate Indebtedness; however, it shall be considered as a liability in the determination of net worth if it is not subject to a satisfactory subordination agreement as defined in Appendix D of SEC Rule 15c3-1." The interpretation, as quoted in the body of this *Notice,* does not contain the "subordination language" as NASD has encountered few instances of subordination. This language is relevant to the discussion, however, in that it states that where no subordination agreement exists relative to a deficit in an unsecured or partly secured introduced account, it must be considered as a liability in the determination of the net worth of the introducing firm.

3 SEC Rule 17a-4(b)(5) requires every broker or dealer to preserve for a period of not less than three years, the first two years in an easily accessible place…"[a]ll trial balances, computations of aggregate indebtedness and net capital (and working papers in connection therewith), financial statements, branch office reconciliations, and internal audit working papers, relating to the business of such member, broker or dealer, as such."

4 Deficits in customers' unsecured and partly secured accounts of an introducing broker-dealer do not have to be deducted from net capital by the carrying broker-dealer, provided sufficient deposits were received from the introducing broker-dealer that can be legally applied to cover (fully secure) the applicable deficits. The introducing broker-dealer must still take the customers' deficits as a deduction in computing net capital when the clearing agreement states that such deficits are the introducing firm's responsibility. The amount of the introducing broker-dealer's deposits must also be included in the carrying broker-dealer's PAIB computation. *SEC Staff of DMR to NYSE, July 2001.*

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