

## Financial and Operational Surveillance

### New Alert-Reporting Criterion for Leverage in FOCUS Reports

#### Executive Summary

In its continued effort to effectively monitor the financial and operational condition of firms, FINRA is publishing the alert-reporting criteria for FOCUS Reports and adding a new criterion for leverage. The new leverage criterion will be implemented with the next scheduled quarterly FOCUS filing.

Questions concerning this *Notice* should be directed to:

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#### Background & Discussion

SEA Rule 17a-5(a) requires that every broker-dealer registered with the SEC file a periodic FOCUS Report (Part II or Part IIA of Form X-17A-5 Financial and Operational Combined Uniform Single Report) depending upon a firm's activities. These reports, which detail a firm's financial and operational conditions, are submitted electronically to FINRA and serve as the foundation for our financial and operational surveillance program. Our internal technology system compares FOCUS data to pre-established criteria to identify variances and discrepancies, and alerts staff to items that may require further review.

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#### Notice Type

- ▶ Guidance

#### Suggested Routing

- ▶ Finance
- ▶ Operations
- ▶ Regulatory Reporting

#### Key Topic(s)

- ▶ Financial and Operational Surveillance

#### Referenced Rules & Notices

- ▶ FINRA Rule 4120
- ▶ FINRA Rule 4521
- ▶ SEA Rule 15c3-1
- ▶ SEA Rule 17a-5

FINRA closely monitors the net capital position as well as the profitability of firms for early signs of potential problems. A pattern of sizeable losses provides a warning signal that if such losses were to continue unchecked, the firm could be approaching financial difficulty in the near future.

More detailed reporting may be required to provide a more complete picture of the condition of the firm. When deemed necessary, pursuant to FINRA Rule 4521, FINRA may require a single carrying or clearing firm or group of carrying or clearing firms to report certain financial and operational information weekly, or even daily, where FINRA deems such reports essential for the protection of investors and the public interest.

FINRA's alert-monitoring criteria is designed to more closely surveil those firms that carry customer accounts or self-clear transactions that may be experiencing financial or operational problems that warrant special monitoring. The criteria that historically have been used include:

1. Cumulative losses in two consecutive months equal to or in excess of 25 percent of current excess net capital.
2. Cumulative losses in three consecutive months equal to or in excess of 30 percent of current excess net capital.
3. Net capital ratio at or in excess of 1,000 percent or less than 5 percent of SEA Rule 15c3-3 aggregate debits.
4. Net capital of less than 150 percent of a firm's minimum net capital requirement.
5. Debt/equity ratio of 70 percent or greater for a period of 30 days or more.
6. Net capital of less than 25 percent of haircuts, excluding contractual commitment haircuts.
7. Restriction or reduction in business pursuant to FINRA Rule 4120.
8. Other internal or external factors as determined by the staff, including but not limited to, severe operational or books and records problems, cash flow problems and proprietary and/or customer concentrations.

FINRA is adding an additional criterion to the above list that is intended to measure leverage. The new leverage ratio will be computed by dividing total balance sheet assets, less U.S. Treasury and U.S. government agency inventory by total regulatory capital (the sum of stockholder's equity and subordinated debt). Any carrying or clearing firm whose ratio of such assets to regulatory capital exceeds 20 to one will be identified for further follow-up. If a firm meets this criterion, it should expect to be contacted by its Regulatory Coordinator with a request for more information, including a breakdown of the collateral between government-guaranteed and other securities collateralizing reverse repurchase and securities borrowed agreements.

Firms that continue to exceed the 20 to one ratio, after excluding government-guaranteed assets, will be subject to heightened monitoring. This monitoring may include, but not be limited to, a request for high, low and average monthly balances for certain balance sheet line items, weekly net capital and reserve formula computation estimates, as well as more detail on specific balance sheet line items.

FINRA intends to use the information obtained through this additional monitoring during the next year to determine whether it should implement rulemaking regarding leverage limits.