Notice To Members 80-49

SEC Rule 15c2-4 -- Transmission or Maintenance of Payments Received in Connection With Underwritings

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TO: All NASD Members

MEMORANDUM

In recent months, the Association has received a number of inquiries from members concerning SEC Rule 15c2-4, the rule of the Commission which governs the transmission or maintenance of payments received in connection with an underwriting. Most of these questions revolve around the rule's application to different types of distributions including private offerings. Several other questions have been raised regarding the operation of the rule. The purpose of this notice is to explain the workings of the rule and to respond to the questions which we have most frequently received about it.

By way of background, the rule imposes certain requirements on every broker, dealer or municipal securities dealer participating in a distribution of securities other than a firm commitment underwriting. This means that any member participating in a best efforts offering or an offering involving some future event or contingency, irrespective of whether it is a registered offering or a private offering, is subject to the rule's requirements. The rule is relatively brief and is as follows:

It shall constitute a "fraudulent, deceptive, or manipulative act or practice" as used in section 15(c)(2) of the Act, for any broker, dealer or municipal securities dealer participating in any distribution of securities, other than a firm-commitment underwriting, to accept any part of the sale price of any security being distributed unless:

(a) The money or other consideration received is promptly transmitted to the persons entitled thereto; or

(b) If the distribution is being made on an "all-or-none" basis, or on any other basis which contemplates that payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs, (1) the money or other consideration received is promptly deposited

in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons entitled thereto, or (2) all such funds are promptly transmitted to a bank which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred.

As to those offerings for which no future event or contingency must be satisfied, the rule requires that money or other consideration received from purchasers be promptly transmitted to the issuer or others on whose behalf the offering is made. As to offerings for which some future event or contingency must be satisfied, e.g., "all-or-none" or mini-maxi distributions, certain restrictions are imposed on the manner in which funds received from prospective purchasers are to be handled. More specifically, in all such offerings, funds received from prospective customers are to be safeguarded in one of the following ways:

- deposit the monies in a separate bank account, as agent or trustee for the potential purchasers; or,
- deliver the monies from prospective purchasers to a bank which has agreed in writing to serve as escrow agent for the offering.

In either instance, the monies must be held until the particular contingency or further event has taken place, e.g., the money equivalent of the minimum amount of securities offered has been deposited and cleared in the escrow or separate account. Should the contingency not occur, the monies on deposit must be returned to the potential purchasers. Once the contingency has been met, additional monies received in connection with the offering need not be deposited in the special account or delivered to the escrow agent, as the case may be, although for other reasons (discussed below), it may be desirable to do so.

The purpose of the rule is to protect against those situations in which underwriters have sold securities, collected funds due and failed to remit them to the issuer, with the insolvency of the broker in some cases making it impossible for the issuer to receive the proceeds. According to the SEC, the failure of a broker-dealer to

transmit or properly maintain offering proceeds "so that they will be insulated from and not jeopardized by his unlawful activities or financial reverses" could constitute fraud upon either the issuer or his customers.

While the rule permits members to employ either of the two methods for safeguarding monies received in connection with a contingent offering, a member's method of conducting its operations may affect that choice. This is a result of certain language embodied in SEC Rule 15c3-1 (the "net capital rule"). Among other things, Rule 15c3-1 prescribes various amounts of minimum net capital which are to be maintained by various categories of broker-dealers. These minimum net capital requirements are based generally on the nature of business activities and method of operation of a broker-dealer. Among these is one that establishes a minimum net capital requirement of $5,000 for brokers and dealers that observe certain limitations in the conduct of their business.

Among other things, a firm operating as a $ 5,000 category broker-dealer is permitted to participate in underwritings on a best efforts or on an "all-or-none" basis, i.e., contingent offerings. The pertinent provisions of the rule on this point are as follows:

Section 240.15c3-1 (a)(2)(ii) -- Net Capital Requirements for Brokers or Dealers

(a) ...every broker or dealer shall have the net capital necessary to comply with the following conditions, ...

(2) Brokers Who Do Not Generally Carry Customers' Accounts .... a broker or dealer shall have and maintain net capital of not less than $5,000 if he does not hold funds or securities for, or owe money or securities to, customers and does not carry accounts of, or for, customers, except as provided for in paragraph (a)(2)(v) of this section, and he conducts his business in accordance with one or more of the following conditions and does not engage in any other securities activities; ....

(ii) He participates, as broker or dealer, in underwritings on a "best efforts" or "all-or-none" basis in accordance with the provisions of 17 CFR 240.15c2-4(b)(2) and he promptly forwards to an independent escrow agent customers' checks, drafts, notes or other evidences of indebtedness received in connection therewith which shall be made payable to such escrow agent; ....

* * *

A broker-dealer which chooses not to use an escrow agent in an offering of securities subject to some contingency is, by the terms of the rule, unable to satisfy

the requirements of a $5,000 category broker- dealer. The decision not to use an escrow account to safeguard the funds received in such an offering would result in the firm's minimum net capital being raised to $25,000.

Another aspect of the net capital rule which bears on Rule 15c2-4 concerns the treatment of concessions receivable. Pursuant to a recent SEC staff interpretation, effective January 7, 1980, concessions receivable arising from contingent offerings of securities, among other things, are no longer considered a good asset in calculating a broker-dealer's net capital. However, if a bank escrow agent is employed and if that escrow agent is instructed to remit to the issuer or other person on whose behalf the offering is being made only that amount payable to the issuer or such other person, thereby retaining custody of the remaining monies owed directly to the broker-dealer, the concession receivable from such an offering may be given allowable asset treatment in the computation of net capital. The reason for this lies in the fact that the receivable is secured by the funds held in deposit by the escrow agent, an independent third party. As mentioned above, it would be appropriate in many cases to extend the escrow account arrangement beyond the point in time the particular contingency associated with an offering has been satisfied. The purpose of this extension would be to continue, up until closing, the allowable asset treatment for concession receivables derived from sales made in excess of the amount of the contingency. The use and continued use of an escrow agent beyond the point in time the contingency is satisfied is of particular significance to firms participating in an offering as members of a selling group primarily because, pursuant to existing SEC interpretations, concessions receivable from a managing or lead underwriter are not allowable assets while secured receivables from independent third parties are.

There are also a number of practices associated with contingent offerings of securities about which members should be aware since they may give rise to unforeseen regulatory problems. These practices include:

- "Breaking" escrow or releasing funds on the basis of indications of interest or confirmations sent rather than the actual amount of monies held on deposit in the escrow or separate account;
- Accepting checks from potential purchasers, depositing them in one or more of the firm's general accounts and writing a single check for deposit in the escrow or separate account;
- Holding checks received from purchasers and thereafter depositing them after the closing;
- Depositing funds received in connection with a contingent offering in a Special Account or Special Reserve Account established under the provisions of SEC Rule 15c3-3, the "customer protection rule";

- Using an escrow agent which is not a bank;
- Permitting the issuer to hold funds in a trust or agency account; or,
- Failing to wait for checks to clear before counting such monies towards the contingent amount.

This list is not all-inclusive. Members are advised to review with their counsel the mechanics of opening and handling accounts in conjunction with contingent offerings. The Association staff is also available for consultation on questions concerning the operation of the rule.
Questions concerning this notice should be directed to John J. Cox, Assistant Director, Department of Regulatory Policy and Procedures, telephone (202) 833-7320.

Sincerely,

Gordon S. Macklin
President