

Interpretation Memo

Member Firm Regulation



New York
Stock Exchange, Inc.

20 Broad Street
New York, NY 10005

Number 92-8
June 30, 1992

**PLEASE ROUTE TO CHIEF EXECUTIVE, FINANCIAL AND OPERATIONS
OFFICER/PARTNER AND COMPLIANCE DEPARTMENT**

TO: MEMBERS AND MEMBER ORGANIZATIONS AND HANDBOOK SUBSCRIBERS

SUBJECT: VIOLATIONS OF SEA RULE 15c3-1 AND 17a-5

The SEC recently barred a former Chief Financial Officer of a broker-dealer for violations of Sections 15 (c)(3) and 17 (a) of the Securities Exchange Act of 1934 and Rules 15c3-1 and 17a-5 thereunder (SEC Release No. 34-30444, March 4, 1992). The violations involved a "seg-offset" banking arrangement which was improperly used to increase the firm's net capital by "converting an unsecured intercompany receivable, which is a non-allowable asset for net capital purposes, into an allowable asset". The unsecured intercompany receivable on the broker-dealer's books was reduced, on a daily basis, by a clearing house check drawn by the parent who "had neither sufficient cash nor liquid assets of its own to cover this check when it was presented for payment the next business day". This banking transaction resulted in the improper pre-clearance recognition of checks received from an affiliated entity for regulatory net capital purposes. Through the employment of this device, the firm incorrectly computed its net capital and continued to conduct a securities business at a time when its net capital did not (otherwise) equal the amount required under the Rule. The disallowance of this arrangement resulted in significant net capital deficiencies over a period of several months. In addition, the accounting treatment of this transaction resulted in violations of SEA Rule 17a-5 (inaccurate monthly and quarterly FOCUS reports).

The SEC previously censured another broker-dealer for using a similar series of transactions to "create the illusion of assets allowable for net capital purposes and included them in its computation of net capital" (SEC Release No. SEC 34-20492, December 15, 1983). This situation also involved the improper use of a "seg-offset" account, the misclassification of intercompany accounts and the improper pre-clearance recognition of checks received from an affiliate. The activity resulted in a censure for willful violations of Section 15(c)(3) and 17(a) of the Securities Exchange Act of 1934.

This issue is also addressed in CFTC Interpretation No. 13 (NYSE Information Memo 91-28, dated July 23, 1991) which clearly states that the pre-clearance recognition of funds represented by checks from a parent or affiliated entity or drawn on an intra-company account is improper for its regulatory accounting purposes, including for purposes of recognizing such funds as capital. Interpretation No. 13 extends to segregated funds maintained in accordance with Section 4d(2) of the Commodity Exchange Act.

Member organizations are reminded that practices that involve the pre-clearance recognition of checks from affiliates or the misclassification and netting of intercompany accounts for the purpose of improperly increasing net capital may be considered willful violations of Net Capital Rules. Particular attention should be made to not recording items in intercompany accounts that do not represent intercompany transactions and which are actually receivables and payables to outside third parties. Interpretation 15c3-1(c)(2)(iv)(C) /073 (NYSE Interpretation Memo 91-9, dated July 12, 1991) discusses the proper treatment of intercompany receivables and payables with affiliates. Securities and non-securities accounts should not be netted and netting between accounts of different affiliates is not permitted.

Any questions regarding this interpretation should be directed to your Finance Coordinator.

Attached are updated handbook pages which are being distributed as replacements for existing pages. Also included in the updated pages are two interpretations which were previously published in Interpretation Memos 91-9 and 92-1, which had not been inserted in the Interpretation Handbook when they were originally issued.

The following should be reviewed carefully before insertion into the handbook.

<u>Page & Reference</u>	<u>Subject</u>
NEW INTERPRETATION:	
167, 15c3-1(c)(2) (iv)(C)/074	Reduction of Intercompany Accounts Receivable
INTERPRETATIONS PREVIOUSLY ISSUED IN INTERPRETATION MEMOS:	
163, 15c3-1(c)(2) (iv)(B)/13	Customers' Debits Secured by Control or Restricted Stock
166, 15c3-1(c)(2) (iv)(C)/073	Netting of Intercompany Receivables and Payables with Affiliates

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RETAIN ALL INTERPRETATION/INFORMATION MEMOS FOR FUTURE REFERENCE