

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST

WASHINGTON D.C. 20006

January 05, 1978

Mr. Nelson S. Kibler

Assistant Director

Division of Market Regulation

Securities and Exchange Commission

500 North Capitol Street

Washington, D.C. 20549

Dear Mr. Kibler:

Recently, we received an inquiry from one of our District Offices concerning the net capital treatment of a judgement resulting from an adverse court decision against a broker-dealer.

The pertinent facts are as follows. The broker-dealer currently conducts its business on a fully-disclosed basis and as a result claims the (k)(2)(B) exemption from Rule 15c3-3. As of November 30, 1977, the firm had a minimum net capital requirement and net capital of \$5000 and approximately \$8500, respectively. Its aggregate indebtedness and ratio of aggregate indebtedness to net capital are approximately \$13,000 and approximately 1.5:1, respectively.

Recently the staff discovered that on July 20, 1977, a U.S. District Court ruled against this broker-dealer, its parent company (a non-broker-dealer entity formed primarily to subordinate funds to the broker-dealer), the principal stockholder of the parent (who is also the President and a registered principal of the broker-dealer) and a registered representative of the broker-dealer, (collectively known as the "defendants"). The court awarded the plaintiff, a former customer, a judgement in the amount of \$72,259 plus accrued interest at 7%. This judgement against the

aforementioned defendants was joint and several. Subsequent to this judgement, the defendants filed an appeal.

No writ of execution has been requested yet by the plaintiff. However, should one be requested, it is our understanding that the defendants would have to post a bond in the amount of the judgement. It is also our understanding that none of the defendants, jointly or severally, could post such a bond. Furthermore, we understand that should such a writ of execution be granted and the required bond not posted, the broker- dealer would have to plead poverty before the court, an action which would result in the liquidation of the assets of the broker-dealer.

Under the circumstances, it appears to us that the firm would, at a minimum, have to include such a judgement in its aggregate indebtedness as a contingent liability when computing its ratio of aggregate indebtedness to net capital. This has the affect of increasing its aggregate indebtedness to approximately \$85,259 and would yield a ratio of aggregate indebtedness to net capital of approximately 10:1.

We wish to know whether the Commission's staff agrees that such a judgement would have to be included in aggregate indebtedness. Also, at what point would such a contingent liability have to be recorded as an actual liability on the books and records of the broker-dealer, thus resulting in a deduction to net worth?

We would appreciate your prompt response to our inquiry. Should you have any questions on this matter do not hesitate to contact me.

Sincerely,

John J. Cox

Assistant Director Department of Regulatory Policy and Procedures

FEB 8 1978

Mr. John J. Cox

Assistant Director

Department of Regulatory

Policy and Procedures

National Association of Securities Dealers, Inc.

1735 K Street, N.W.

Washington, D.C. 20006

Dear Mr. Cox,

This is in response to your letter of January 5, 1978 in which you inquire as to the net capital treatment of a court judgment against a broker-dealer. You indicate that a court has entered a judgment against a broker-dealer arising out of a customer's suit, and the broker-dealer has appealed. You also state that the customer has not yet sought a writ of execution, which would entail the broker's posting a bond in the amount of the judgment. Inasmuch as the broker could not post such a bond, the granting of a writ of execution would eventuate in the liquidation of the broker-dealer.

You indicate your belief that the judgment is a contingent liability and thus includable in the broker-dealer's aggregate indebtedness. You request our concurrence. You also ask at what point such a contingent liability would be considered an actual liability, thus resulting in a deduction from net worth.

A court judgment adverse to a broker-dealer is, at minimum, a contingent liability of the broker-dealer. (Of course, if the broker has exhausted his remedies, the liability is actual). Other factors that must be considered, however, may dictate that an accounting reserve be established or that the liability be booked as an actual liability. Such factors include the magnitude of the judgment (in relation to the broker's net worth), the broker's defenses to the action, and counsel's opinion as to the likelihood of reversal on appeal. Each situation must be analyzed on its particular facts.

I trust the foregoing information is helpful. Please let me know if you have any questions.

Sincerely,

Nelson S. Kibler

Assistant Director

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