CLIENT UPDATE

SEC AMENDS FINANCIAL RESPONSIBILITY RULES AND ADOPTS CUSTODY RULES

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On July 30, the Securities and Exchange Commission (the "SEC") adopted new rules with respect to broker-dealer financial responsibility and custody. The rules came in two separate rulemakings. The first concerns amendments to SEC Rules 15c3-1 and 15c3-3 (and related "books and records" and notification rules).[1] The second concerns new broker-dealer notification and audit requirements with respect to custody activities.[2] In summary, the new rules and amendments:

- Amend Rule 15c3-1 to, *inter alia*, clarify the regulatory capital treatment of (i) liabilities assumed by third parties, (ii) capital infusions that are, or are permitted to be, withdrawn within one year of their making, and (iii) securities loans/borrows and repos/reverse repos not done on an agency basis and without recourse to the broker-dealer.
- Amend Rule 15c3-3 to, *inter alia*, (i) provide additional protections for the assets of broker-dealer customers of a broker-dealer, (ii) prevent broker-dealers from depositing reserve account cash with affiliated banks, (iii) prevent broker-dealers from treating as an acceptable reserve account deposit any amounts greater than 15% of an unaffiliated bank's equity capital and (iv) require disclosures and consent in connection with automatic sweeps of customer cash

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1 Available here: http://www.sec.gov/rules/final/2013/34-70072.pdf

2 Available here: http://www.sec.gov/rules/final/2013/34-70073.pdf

into money market mutual funds or bank deposit accounts.

- Establish new regulatory notification and audit requirements with respect to the custody activities of broker-dealers (whether or not they actually hold assets in custody) that require, *inter alia*, (i) filing reports with the SEC concerning those activities, (ii) retaining a Public Company Accounting Oversight Board ("PCAOB") qualified accountant to audit those reports, (iii) producing audit documentation and work papers to regulators upon request and (iv) filing the newly created "Form Custody", requiring information about its clearing and custody arrangements.

CHANGES TO RULE 15C3-1

Rule 15c3-1, commonly referred to as the "net capital rule," imposes capital requirements on all registered broker-dealers. The net capital rule essentially looks to a broker-dealer's net liquid assets and requires a broker-dealer to maintain more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (such as money owed to customers, counterparties and creditors). When calculating net capital, a broker-dealer is required to sum all "allowable" assets, including securities positions and certain qualifying subordinated debt. Examples of "non-allowable" assets include unsecured receivables, fixed assets, real estate and other illiquid assets. Many allowable assets are subject to haircuts that reduce (sometimes substantially) their value for regulatory capital purposes.

Once the broker-dealer has performed these calculations, Rule 15c3-1 requires the broker-dealer to compare its net liquid assets to one of two financial ratios: (a) a 15:1 aggregate indebtedness to net capital ratio or (b) the 2% of aggregate debit items ratio. The aggregate indebtedness standard is the default under the rule, but a broker-dealer may elect to use the 2% of aggregate debit items ratio by notifying its designated examining authority ("DEA"). Both ratios are designed to compare net liquid assets to liabilities in order to ensure that net liquid assets exceed the relevant percentage of liabilities. Rule 15c3-1 also sets a floor amount of net liquid assets that applies even if the broker-dealer's net liquid assets exceed the ratio. The applicable floor is based on the nature of the broker-dealer's business and ranges from $5,000 to $250,000.

The amendments to Rule 15c3-1 essentially make the following changes:

- A broker-dealer must adjust its net worth by including in that calculation liabilities assumed by a third party (typically, although not always, an affiliate) if that third party lacks the resources to pay those liabilities. Rule 15c3-1(c)(2)(i)(F). The broker-dealer can exclude those liabilities if it can demonstrate that the third party has the resources

(independent of the broker-dealer) to pay the liabilities. This provision is substantially consistent with prior guidance by SEC staff members.[3]

- A broker-dealer now must treat as a liability any capital contribution made by an investor who has a right to withdraw that contribution, or the intention to withdraw it, within one year. Rule 15c3-1(c)(2)(i)(G). Any capital contribution withdrawn within one year of its making (unless withdrawn pursuant to written permission from the broker-dealer's DEA) will be treated as having been made with the intention to withdraw it within one year.
- A broker-dealer also must now deduct from net capital the amount of any deductible under its fidelity bond that is in excess of the deductible permitted by SRO rules. Rule 15c3-1(c)(2)(xiv).
- Another new requirement forces broker-dealers to cease their business upon the occurrence of certain insolvency events, including bankruptcy, appointment of a receiver, a general assignment for the benefit of creditors, admission of insolvency, or the inability to establish compliance with Rules 15c3-1 and 15c3-3. Rule 15c3-1(a) (requiring that broker-dealer must not be "insolvent", among other things) & 15c3-1(c)(16) (defining "insolvent").
- The SEC also amended its power under Rule 15c3-1(e)(3) to prevent temporarily a broker-dealer from withdrawing capital, or making loans or advances to owners, officers, directors and affiliates. The new rule eliminates the quantitative standards and instead permits the SEC to exercise this authority when it deems necessary or appropriate to protect the financial integrity of the broker-dealer.

CHANGES TO RULE 15C3-3

Known as the customer protection rule, Rule 15c3-3 sets forth the methods by which a broker-dealer must obtain and retain possession and control of customer funds and securities. A broker-dealer may be exempt from these requirements by, among other ways, contracting with a carrying broker on a fully-disclosed or omnibus basis.

The rule also requires broker-dealers to "lock up" customer cash (known as free credit balances) and other credit items so that the broker-dealer cannot use such monies in its business. The broker-dealer must deposit in a "Customer Reserve Bank Account" the amount resulting from application of the formula set forth in Exhibit A to Rule 15c3-3. The

[3] Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Elaine Michitsch, Member Firm Operations, NYSE and Susan DeMando, Director, Financial Operations, NASD Regulation, Inc. (July 11, 2003).

credits used in calculating the amount to be placed in the reserve account have not traditionally included monies belonging to the broker-dealer's customers who are other U.S. broker-dealers,[4] although the credits did include monies belonging to non-U.S. broker-dealers. The reserve account monies must be deposited with a qualifying bank.

The rule amendments to Rule 15c3-3 essentially make the following changes:

- The new rule attempts to harmonize the definition of "customer" between this rule and the Securities Investor Protection Act by requiring carry brokers to create and maintain a new type of reserve account for U.S. broker-dealer customers. Rule 15c3-3(a)(15) (defining "PAB Account"). The so-called PAB Reserve Bank Account will function much like the current Customer Reserve Bank Account. Rule 15c3-3(e), (f) & (g). It uses a similar, though not identical, calculation methodology, found in the revised Exhibit A to Rule 15c3-3. All other provisions applicable to Customer Reserve Bank Accounts apply equally to the new PAB Reserve Bank Account.
- The reserve account deposit requirements (both customer and PAB) now require that the reserve account cash deposited with any one bank not exceed 15% of that bank's equity capital. Rule 15c3-3(e)(5). Thus, the combined balances of both the Customer and PAB Reserve Bank Accounts cannot exceed the 15% threshold, which is determined by reference to the bank's most recent Call Report filed with federal banking regulators. Moreover, the rule amendments now prohibit the inclusion of deposits at affiliated banks as qualifying reserve account monies. Id. Banks with affiliated broker-dealers stand to lose potentially significant amounts of cash deposits as a result. All banks that accept broker-dealer Reserve Bank Account deposits can expect regular requests for their Call Reports.
- The new rules also establish disclosure and consent requirements with respect to sweep accounts for customer free credit balances, whether the monies are swept into a bank deposit account or a money market mutual fund. Rule 15c3-3(j). Broker-dealers also are prohibited from "convert[ing], invest[ing] or transfer[ring] to another account or institution, credit balances held in a customer's account" without the customer's authorization. Rule 15c3-3(j)(2). Any changes to an existing sweep program cannot be implemented until after a thirty-day written notice period lapses. Rule 15c3-3(j)(3).

[4] Under the SEC no-action letter relating to proprietary accounts of introducing brokers, a carrying broker may have locked up certain monies of its introducing brokers.

CHANGES CONCERNING SECURITIES LOAN AND REPO ACTIVITIES AND DOCUMENTING RISK MANAGEMENT CONTROLS

The adopting release containing the rule amendments discussed above also focuses on two other areas: securities borrowing/lending and repurchase/reverse repurchase activities (collectively, "securities loan and repo activities") and risk management controls. With respect to the first, the SEC adopted amendments to Rule 15c3-1 requiring that the provision of settlement services in connection with customer securities loan and repo activities constitutes acting as a principal for which the broker-dealer must take applicable capital deductions. Rule 15c3-1(c)(2)(iv)(B) & (F).[5] The broker-dealer can avoid being treated as a principal if it takes certain steps, as outlined in the rule.[6]

The SEC also amended the notification requirements of Rule 17a-11 to require broker-dealers to notify the SEC whenever the total amount of money payable against all securities loaned or subject to repurchase agreements, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement, exceeds 2500 percent of tentative net capital. Rule 17a-11(c)(5). Excluded from these computations are amounts from securities loan and repo activities in government securities. Broker-dealers that make monthly reports to their DEA concerning securities loan and repo activities are exempt for these notification requirements.

The changes related to risk management controls came in the form of new books and records requirements. Rule 17a-3(a)(23) requires a broker-dealer to document its procedures concerning various types of risk management controls, including those related to market risk, credit risk and liquidity risk. Neither the rule nor the adopting release provides any detail about what is required, other than to say that if a broker-dealer has such controls, procedures or policies, they must be documented. Thus, the rule neither mandates particular types of policies and procedures nor requires them for any particular type of risk management. The rule exempts any broker-dealer with either $1 million or less in aggregate credit items under Rule 15c3-3a or $20 million or less in capital (including qualifying subordinated debt). The practical implications of this new requirement remain unclear. Certainly broker-dealers that are subject to the market access rule must now have written risk management procedures. See Rule 15c3-5(b).

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[5] These provisions require a broker-dealer to, respectively, (i) deduct from net worth the amount that the market value of a securities loan exceeds the value of the collateral, and (ii) deduct from net worth the amount that the market value of securities to be resold is less than the resale price.

[6] In particular, the broker-dealer must "fully disclose[] the identity of each party to the other and each party [must] expressly agree[] in writing that the obligations of the broker or dealer do not include a guarantee of performance by the other party and that such party's remedies in the event of a default by the other party do not include a right of setoff against obligations, if any, of the broker or dealer." 15c3-1(c)(2)(iv)(B).

RULEMAKING CONCERNING CUSTODY

The second rulemaking establishes new regulatory reporting and audit requirements relating to the custody activities of broker-dealers. Prior to this rulemaking, no such requirements were in place, and broker-dealers providing custody looked primarily, if not entirely, to Rule 15c3-3 for the custody requirements. In general, the new rules add the following requirements with respect to the custody activities (or lack thereof) of each broker-dealer:

- Broker-dealers now will be required to file either a "compliance report" or an "exemption report." Rule 17a-5(d)(3) & (4). Carrying brokers generally will file with the SEC the compliance report, while those brokers that do not hold custody will file the exemption report. The relevant report must be signed by an appropriate officer of the broker-dealer, just like the financial report.
- The compliance report will include statements concerning the broker-dealer's compliance with the financial responsibility rules and whether it maintained "Internal Control Over Compliance", defined as internal controls designed to reasonably assure compliance with the financial responsibility rules, especially custody arrangements and the protection of customer assets. Rule 17a-5(d)(3).
- The exemption report will include statements concerning which exemption from Rule 15c3-3 the broker-dealer relies on, and whether it experienced any deficiencies during the past year in meeting the exemption. Rule 17a-5(d)(4).
- Portions of the new compliance report or exemption report (as relevant) must be audited by a PCAOB-registered independent public accountant. Rule 17a-5(d)(1)(i)(C). These audit reports must be filed with the SEC and, if applicable, the SIPC. The accountant must immediately notify the broker-dealer if it determines that the broker-dealer is not in compliance with the financial responsibility rules or if material weaknesses are found in its internal controls relating to financial responsibility. Rule 17a-5(h). The broker-dealer must in turn notify the SEC and its DEA, with a copy of such notice sent to the independent accountant for review. Id.
- These new requirements will ensure that the broker-dealer will qualify as an acceptable custodian for registered investment advisers under Advisers Act Rule 206(4)-2, either for itself if it is a dual registrant, or for its registered investment adviser customers.[7]

[7] Sec. & Exch. Comm., "Broker-Dealer Reports," Exchange Act Release No. 70,073 [File No. S7-23-11] at 120-27 (July 30, 2013).

- The SEC and a broker-dealer's DEA are granted access to the audit documentation and work papers. This new rule proved controversial within the SEC, with two Commissioners dissenting from the adoption. Rule 17a-5(f).[8]
- These rules also create new Form Custody, adding another reporting obligation on all broker-dealers, regardless of whether they maintain custody of funds and securities. Rule 17a-5(a)(5). Form Custody is filed with the broker-dealer's DEA within 17 days of the end of each calendar quarter and fiscal year end. Form Custody asks for information on several topics, including (a) whether the broker-dealer is an introducing or carrying broker, (b) if the broker-dealer holds assets in custody and where, (c) the approximate value of assets held by the broker-dealer, (d) whether the broker-dealer or a third party sends statements and confirmations to customers, (e) whether the broker-dealer provides electronic access to account information and (f) whether the broker-dealer is, or is affiliated with, a registered investment adviser.

CONCLUSION

The changes to the net capital, customer protection, books and records, and notification rules will become effective 60 days after publication in the Federal Register. The custody audit and reporting changes will become effective with respect to reports to be filed at various points in time after December 31, 2013.

Each broker-dealer will have to review these rules carefully in light of its business lines and activities. Given the significant nuances in all of the new rules and amendments, broker-dealers may wish to start their analysis as soon as possible. The audit requirement associated with the "compliance report" and the "exception report" is likely to consume the most time and expense, so coordinating with an outside auditor promptly may improve the process and ensure readiness for this important new mandate.

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Please do not hesitate to contact us with any questions.

August 9, 2013

[8] The dissent by Commissioners Paredes and Gallagher can be found here: http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370539740528