

Key. SEC Financial Responsibility Rules

The Securities and Exchange Commission's (SEC)¹ uniform net capital rule (15c3-1) and customer protection rule (15c3-3) form the foundation of the securities industry's financial responsibility framework.² The net capital rule focuses on liquidity and is designed to protect securities customers, counterparties, and creditors by requiring that broker-dealers have sufficient liquid resources on hand at all times to satisfy claims promptly. Rule 15c3-3, or the customer protection rule, which complements rule 15c3-1, is designed to ensure that customer property (securities and funds) in the custody of broker-dealers is adequately safeguarded. By law, both of these rules apply to the activities of registered broker-dealers, but not to unregistered affiliates.

The SEC Net Capital Rule (Rule 15c3-1)

Background

SEC amended the net capital rule (Rule 15c3-1) in 1975 to establish uniform net capital standards for brokers and dealers' registered with SEC under Section 15(b) of the Securities Exchange Act of 1934 (Exchange Act). With few exceptions, all broker-dealers registered with SEC must comply with this liquidity standard.³ The primary purpose of this rule is to ensure that

¹SEC is the federal agency responsible for administering the Federal Securities Laws. One objective of the Federal Securities Laws is to protect investors.

²Other financial responsibility rules include the records maintenance and preservation rules (17a-3 and 17a-4); the financial reporting rule (17a-5); the early warning or "telegraphic" notice rule (17a-11); the quarterly security counts rule (17a-13); the hypothecation rules (8c-1 and 15c2-1); the initial margin requirements of the Board of Governors of the Federal Reserve System (12 C.F.R. Section 220.3(b)); and the maintenance margin rules of the self-regulatory organizations (e.g., New York Stock Exchange rule 431).

Note: SEC and Commodity Futures Trading Commission (CFTC) officials stated that the futures industry capital adequacy and customer assets protection requirements (CFTC Rules 1.17, and 1.20-1.30, respectively) generally mirror the requirements in SEC rules 15c3-1 and 15c3-3.

³A broker is any person that engages in the business of effecting transactions in securities for the account of others, but does not include a bank. A dealer is any person that engages in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business. Broker-dealers combine the functions of brokers and dealers.

⁴The sole market maker (a dealer that makes bids and offers at which he/she will trade) and sole specialist (a member designated by an exchange to be the sole market maker for a particular stock) on the options floor are exempted from the SEC net capital rule; and floor brokers on an exchange, under certain circumstances are exempted from the rule. Also, SEC may exempt certain broker-dealers from the rule upon a determination that it is "not necessary in the public interest or for the protection of investors" to subject the particular broker-dealer to the rule. See Rule 15c3-1(b).

registered broker-dealers maintain at all times sufficient liquid assets⁵ to (1) promptly satisfy their liabilities—the claims of customers, creditors, and other broker-dealers; and (2) to provide a cushion of liquid assets in excess of liabilities to cover potential market, credit, and other risks if they should be required to liquidate. The rule achieves its purpose by prescribing a liquidity test that requires a broker-dealer to maintain the greater of a specified minimum dollar amount or specified percentage of net capital in relation to either aggregate indebtedness (generally all liabilities of the broker-dealer) or customer-related receivables (money owed to the broker-dealer by customers) as computed by the reserve requirements of Rule 15c3-3. The net capital rule thus enhances investor/customer confidence in the financial integrity of broker-dealers and the securities market. The net capital rule applies only to the registered broker-dealer and does not apply to the broker-dealer's holding company or unregulated subsidiaries or affiliates.'

To comply with SEC's net capital rule, broker-dealers must perform two computations: one computation determines the broker-dealer's net capital (liquid capital), and another computation determines the broker-dealer's appropriate minimum net capital requirement (base capital requirement).

Net capital is defined as U.S. Generally Accepted Accounting Principles (GAAP) equity plus qualified subordinated liabilities⁸ and credits less nonallowable assets,⁹ certain operational charges (e.g., fail-to-deliver),¹⁰

⁵Liquid assets are assets that can be converted easily into cash with relatively little loss of value. Broker-dealers must have at all times at least \$1 of liquid assets for each \$1 of liabilities (except for subordinated liabilities that are treated as part of the broker-dealer's capital) in addition to the minimum requirements of the net capital rule in case they fail the net capital test or voluntarily cease operations. Once liquidation is decided upon, a broker-dealer's operations are generally liquidated in an orderly manner within a short time frame without the use of a formal bankruptcy proceeding.

'Generally, a customer is defined as any person from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of such person.

'An exception to this principle is where the registered broker-dealer guarantees or assumes responsibility for the liabilities of the related unregistered entity. In such a situation, the broker-dealer is required to consolidate into a single computation the assets and liabilities of both itself and the guaranteed entity. See Rule 15c3-1(a) and Appendix C to the rule.

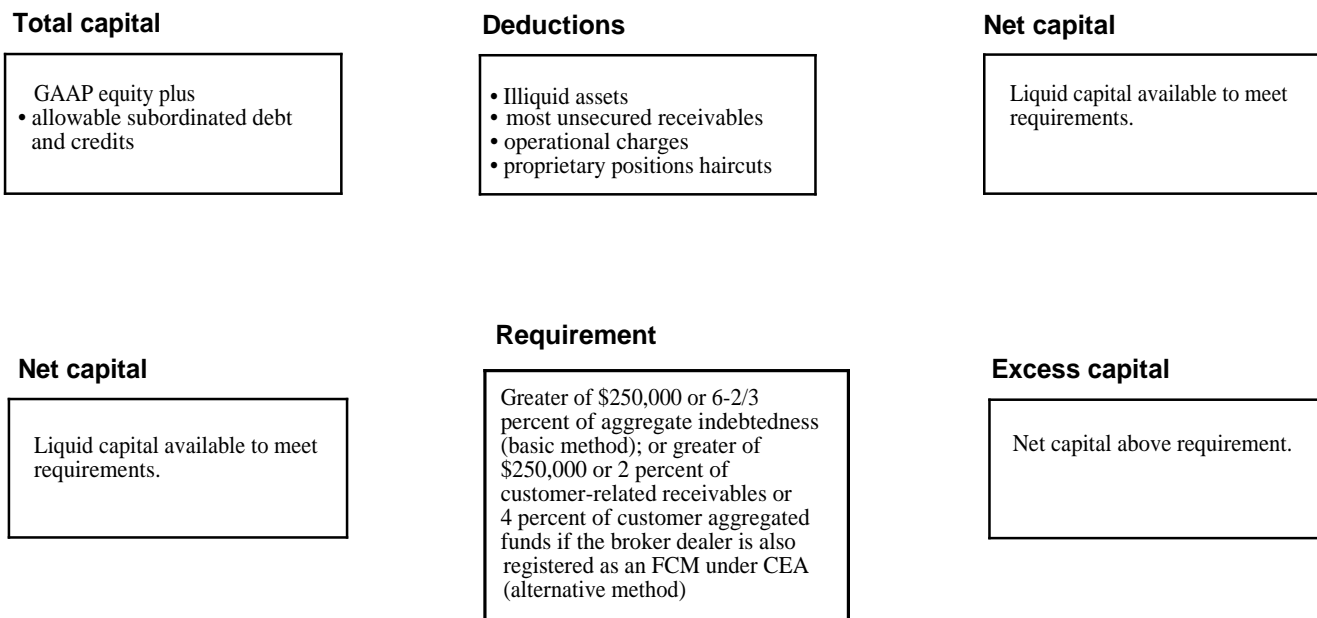
'To be counted as capital in the net capital computation, the subordinated liabilities, among other things: (1) must have an initial term of 1 year or more; (2) must be subordinated to the claims of all present and future creditors, including customers; (3) may not be repaid if the repayment would reduce regulatory net capital below certain required amounts; and (4) must be approved for inclusion as net capital by the broker-dealer's self-regulatory organization (SRO).

⁹Nonallowable assets are considered illiquid assets (assets that cannot be immediately or quickly converted into cash) by the net capital rule. Such assets decrease a broker-dealer's net capital, because they are deducted from GAAP equity in the net capital computation.

¹⁰A fail-to-deliver is a situation in which the selling broker-dealer does not receive securities from the client in time to make delivery with the buying broker-dealer.

and prescribed percentages of the market value (otherwise known as haircuts)" of securities and commodities that constitute the broker-dealer's trading and investment positions. See figure 11.1 below.

Figure 11.1: SEC Net Capital Formulation



Source: GAO analysis of SEC's net capital rule.

The process of computing a broker-dealer's regulatory net capital is really a process of separating its liquid and illiquid assets. In computing net capital, under either the basic or alternative method (discussed below),

"The haircut is based on the risk characteristics (i.e., market risk, price volatility, and liquidity) of a particular security. For example, securities perceived as risky typically receive a large haircut (e.g., 100 percent for nonmarketable securities); those perceived as less risky generally receive a small haircut (e.g., 0 percent for short-term government securities). This means that for a 100-percent haircut the broker-dealer must finance 100 percent of the security's value with firm capital. Reduced haircuts are allowed when risk is reduced through utilization of hedging strategies. Hedging is a strategy designed to protect a position in securities or commodities against price movements by taking an offsetting investment position. A haircut serves as a safety margin for market fluctuations and delays encountered in liquidating securities and commodities positions. See pages 140-145 for greater detail on haircuts.

the broker-dealer must first determine its equity in accordance with GAAP. GAAP liabilities deducted from GAAP assets result in GAAP equity. GAAP requires that the broker-dealer mark to market all securities and commodities positions daily, thereby reflecting unrealized gains (which add to equity) and losses (which subtract from equity) the current market value-and making it difficult to forbear market losses beyond a day.

Once GAAP equity is computed, a number of adjustments are made to reflect the estimated value of the broker-dealer if it was liquidated in a hurry. Liabilities that are properly subordinated to the claims of creditors, including customers, are then added back to GAAP equity as well as certain deferred income tax liabilities and accrued liabilities. Assets considered not readily convertible into cash are deducted from GAAP equity. This includes intangible assets (goodwill); fixed assets (furniture, fixtures, and buildings); prepaid items (rent and insurance); and the value of exchange memberships. The broker-dealer also deducts most unsecured receivables, including unsecured customer debits and bridge loans; and charges for delays in processing securities transactions beyond the normal settlement date. These collective additions and subtractions to GAAP equity result in an amount called tentative net capital. Tentative net capital is then reduced by certain percentage deductions, called haircuts, of the current market value of a broker-dealer's securities and commodities positions and an undue concentration charge, which reflects the risk of a large, concentrated holding in one security, to arrive at the broker-dealer's net capital. Then, the net capital base requirement (required net capital amount) is subtracted from the net capital amount to determine the amount of excess net capital held by the broker-dealer.

Methods Available for Broker-Dealers to Compute Required Net Capital

A broker-dealer may compute its net capital requirement by one of two methods. The first method, called the basic or aggregate indebtedness method, requires that the net capital of a broker-dealer conducting a general securities business (i.e., a firm that clears securities transactions and carries customer accounts) be equal to the greater of \$250,000 or 6-2/3 percent of its aggregate indebtedness. The 6-2/3 percent requirement says a broker-dealer must have at least \$1 of net capital for every \$15 of its indebtedness (i.e., a leverage constraint). In the broker-dealer's first year of operation, its net capital must exceed 12.5 percent of its aggregate indebtedness. Most of the smaller broker-dealers typically use the basic method to compute their net capital requirements because of the nature of their business. Typically, smaller broker-dealers either do not hold

customer or broker-dealer accounts and therefore need less than the \$250,000 required for broker-dealers that carry customer accounts; or they want to be subject to the less stringent requirements of Rule 15c3-3.

Under the second method, the so-called alternative method, the broker-dealer is required to have net capital equal to the greater of \$250,000 or 2 percent of its customer-related receivables from the reserve calculation of Rule 15c3-3 or, if registered as a futures commission merchant (FCM),¹¹ 4 percent of the customer funds required to be segregated pursuant to the Commodity Exchange Act (CEA) and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the customer's account). When a firm is registered both as a securities broker-dealer with SEC and an FCM with CFTC,¹³ known as being "dually-registered," it must comply with both agencies' regulations. However, a dually-registered firm is required to meet only the capital standard that would cause it to hold the most capital. SEC offers this method to broker-dealers as a voluntary alternative (with self-regulatory organization approval) to the basic net capital requirement. This method is based on the broker-dealers' responsibilities to customers rather than aggregate indebtedness. Reversion to the basic method by the broker-dealer requires SEC's approval. This option (most commonly used by large broker-dealers because it can result in a lower net capital requirement than under the basic method), in conjunction with Rule 15c3-3 (discussed below), is designed to ensure that sufficient liquid capital exists to return all property (assets-funds and securities) to customers, repay all creditors, and have a sufficient amount of capital remaining to pay the administrative costs of a liquidation if the broker-dealer fails. The broker-dealer's ability to return customer property is addressed by Rule 15c3-3. The repayment of creditors and the payment of the broker-dealer's liquidation expenses is addressed by the 2 percent of customer-related receivables net capital requirement and the deductions from net worth for illiquid assets and risk in securities and commodities positions. See pages 148-151 for an example of a hypothetical simplified net capital computation under the alternative method.

¹¹An FCM is an individual, association, partnership, corporation, or trust that solicits or accepts orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that accepts payment from or extends credit to those whose orders are accepted.

¹³CFTC is the federal agency responsible for administering the CEA and overseeing the futures and commodity options industry to protect the public from fraud and manipulation in the marketplace.

There are some differences between the two methods of computation. For example:

The alternative method ties required net capital to customer-related assets (receivables) rather than all liabilities like the basic method.

The alternative method requires a broker-dealer to provide a bad debt reserve of 3 percent of its customer-related receivables versus 1 percent under the basic method.

Under the alternative method, stock record differences and suspense account items (prospective losses due to recordkeeping problems) must be included in the calculation of net capital after 7 business days versus the 30 calendar days required under the basic method.

However, both methods limit a broker-dealer's ability to increase its customer commitments only to the extent that net capital supports such an increase.

Also, the type of securities business a broker-dealer conducts determines its minimum net capital requirements. For example, for broker-dealers engaging in all facets of a securities business (involves clearing securities transactions and holding customer and broker-dealer accounts), the minimum dollar net capital requirement is \$250,000; for broker-dealers that generally do not carry customer or broker-dealer accounts (introducing brokers), the minimum dollar amount is \$5,000. See pages 152-153 for more detail on the SEC minimum net capital requirements for specialized types of business.

Early Warning Capital Levels

In addition to the minimum base net capital requirements, SEC and SROs (such as the National Association of Securities Dealers and the national exchanges) have established "early warning" levels of capital that exceed the broker-dealer's minimum capital requirement. This advance warning alerts SEC and the SROs to the fact that a broker-dealer is experiencing financial difficulty (i.e., broker-dealer's net capital is

"A more detailed description is a broker-dealer who buys and sells stocks, bonds, options, or municipal securities, and/or engages in firm commitment underwritings as underwriter or selling group member.

"Securities SROs set rules (with oversight by SEC) for fair conduct, license or approve firms engaged in market making activities, and supervise the activities of market participants.

"This early warning system also includes other criteria for notification to SEC and the designated SRO by broker-dealers: when the broker-dealer fails to keep books or records current, when the broker-dealer's independent accountant notifies it of a material inadequacy in financial statements, or upon occurrence of other specified events. See Rule 17a-11.

dropping toward its minimum requirement) and allows time for initiation of corrective action. Broker-dealers that violate the early warning levels must immediately notify SEC and their designated SRO" and are thereby subject to closer regulatory scrutiny by SEC and the sRo.l8 sRos may also impose additional operating restrictions or warning requirements on their members, which can be more stringent than SEC's. For example, the New York Stock Exchange's rule 326 restricts the business activities of member broker-dealers that are approaching financial or operational difficulties. When a broker-dealer's net capital drops below its minimum net capital requirements, SEC requires the broker-dealer to cease operations immediately and get additional capital to come into capital compliance or liquidate its operations.

The early warning notice levels are as follows:

Under the basic method, the broker-dealer's ratio of aggregate indebtedness to net capital is greater than 1,200 percent.

Under the alternative method, the broker-dealer's net capital is less than 5 percent of customer-related receivables or, if an FCM, net capital is less than 6 percent of CEA customer segregated funds.

The broker-dealer's net capital is less than 120 percent of its required minimum dollar net capital.

Market participants indicated that prudent broker-dealers maintain capital levels far in excess of their required minimum net capital amount. They told us that the largest broker-dealers typically hold \$1 billion or more in excess of their required capital levels because, among other reasons, their counterparties require it for conducting business with them.

Financial Reporting Requirements

SEC has delegated to the SROS primary responsibility for enforcing broker-dealer compliance with the net capital and customer protection

"If a broker-dealer is a member of more than one SRO, one of them will be designated as the SRO responsible for overseeing the broker-dealer's activities and its compliance with the financial responsibility rules.

⁸A broker-dealer is prohibited from withdrawing equity capital if such withdrawal would cause the broker-dealer's aggregate indebtedness to net capital to exceed 10 times its net capital; its net capital to fall below 120 percent of its minimum dollar requirement; its net capital to fall to less than 5 percent of customer-related receivables under the alternative method; or, if an FCM, less than 7 percent of cFA-segregated funds; or subordinated debt to exceed 70 percent of total capital, or net capital to be less than 25 percent of haircuts used in calculating net capital. This limitation includes withdrawals in the form of redemption or repurchase of stock, dividends, or other distributions as well as unsecured loans or advances to stockholders, partners, sole proprietors, employees, or affiliates (i.e., related persons). Under certain conditions, a broker-dealer is required to notify (written form) SEC and the designated SRO when capital is transferred out of the broker-dealer to related persons. For example, the broker-dealer is required to notify SEC and the designated SRO 2 business days before any withdrawals of equity capital greater than 30 percent of the broker-dealer's excess net capital.

rules. SEC and the SROs have established a uniform system of reporting by broker-dealers and inspection schedules and procedures to routinely monitor broker-dealers' compliance with such rules. Registered broker-dealers, depending on their type of business, are required to file either monthly or quarterly reports with their designated SROs. Focus (an acronym for Financial and Operational Combined Uniform Single Report (SEC Form X-17A-5)), the report broker-dealers are required to file, contains confidential key financial and operational information of a broker-dealer's operations. If a broker-dealer has financial or operational difficulties, SEC or the SRO may require it to accelerate its reports filing at any time as specified in Rule 17a-5(a)(2)(iv). Focus is an integral part of the SRO's early warning system and provides the SRO with a substantial amount of information to detect existing or potential financial and operational problems. Additionally, Rule 17a-5 requires broker-dealers to file annual audited financial statements supplemented by an accountant's report setting forth any material inadequacies.

The SEC Customer Protection Rule Restricts Broker-Dealer Use of Customer Securities and Funds

SEC Rule 15c3-3, adopted in 1972, provides regulatory safeguards regarding the custody and use of customer securities and free credit balances (funds)¹⁹ held by broker-dealers. The rule, with limited exceptions,²⁰ requires compliance by all registered broker-dealers. The purpose of Rule 15c3-3 is to protect customer funds and securities held by the broker-dealer.

Rule 15c3-3 has two parts. The first part requires broker-dealers to promptly obtain and maintain the physical possession or control of all fully paid and excess margin customer securities. The second part

¹⁹Free credit balances are a broker-dealer's liabilities to customers and are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits, or otherwise. However, they exclude funds in commodity accounts that are segregated in accordance with the CEA or in a similar manner.

²⁰Certain types of broker-dealers are exempted from the requirements of the customer protection rule. See Rule 15c3-3(k)(2) for more detail.

²¹Fully paid securities are securities that are purchased in transactions for which the customer has made full payment. Margin securities in a customer account are those securities with a market value equal to or less than 140 percent of the customer's debit balance (the amount the customer owes the broker-dealer for the purchase of the securities). Excess margin securities in a customer account are those securities with a market value greater than 140 percent of the customer's debit balance. An example of excess margin securities: A customer buys \$80,000 worth of securities on 50 percent margin. The broker-dealer loans the customer \$40,000 (debit balance). The amount of the customer margin securities that can be pledged as collateral for a bank loan is \$56,000 (140 percent x \$40,000 debit = \$56,000 available as collateral). Because only \$56,000 of the \$80,000 of customer securities can be pledged to the bank, the remaining \$24,000 of securities are excess margin securities that must be segregated and held in safekeeping by the broker-dealer.

requires broker-dealers to segregate all customer cash or money obtained from the use of customer property that has not been used to finance transactions of other customers.

Part 1: Physical Possession or Control of Customer Securities

SEC's requirement that broker-dealers maintain possession or control of all customer fully paid and excess margin securities substantially limits broker-dealers' abilities to use customer securities. Rule 15c3-3 requires broker-dealers to determine, each business day, the number of customer fully paid and excess margin securities in their possession or control and the number of fully paid and excess margin securities that are not in the broker-dealer's possession or control. Should a broker-dealer determine that fewer securities are in its possession or control than is required (a deficit position in security), Rule 15c3-3 requires the broker-dealer to initiate action and specifies time frames by which these securities must be placed in the broker-dealer's possession or control. For example, for securities that are subject to a bank loan,¹ the broker-dealer must issue a recall instruction within 1 business day of a deficit position determination, and the securities must be returned to the broker-dealer's possession or control within 2 business days of the recall instruction. Once a broker-dealer obtains possession or control of customer fully paid or excess margin securities, the broker-dealer must thereafter maintain possession or control of those securities.

Rule 15c3-3 also specifies where a security must be located to be considered "in possession or control," of the broker-dealer. "Possession" of securities means the securities are physically located at the broker-dealer. "Control" of securities means the securities are located at one of the approved "control" locations discussed below. "Control" locations include a clearing corporation or depository, free of any lien; a Special Omnibus Account in compliance with Federal Reserve System Regulation T²³ with instructions for segregation; a bona fide item of transfer of up to 40 calendar days (longer with written permission from the transfer agent); foreign banks or depositories approved by SEC; a bank (as defined by the Exchange Act) supervised by a federal banking authority, provided the

¹Securities that have been pledged to a bank as collateral are an example of securities that are subject to a bank loan.

²³Federal Reserve System Regulation T (12 C.F.R. 220) regulates the extension of credit by and to broker-dealers. For the purposes of SEC Rule 15c3-3, it deals primarily with broker-dealer margin accounts. In securities industry parlance, margin is credit extended by a broker-dealer to a purchaser of a security to fund part of the purchase price. Interest is charged on the balance amount, and ownership of the stock certificate passes immediately to the purchaser. Regulation T currently allows a purchaser of securities to borrow up to 50 percent of a security's purchase price.

securities are being held free of any lien; in transit between offices of the broker-dealer (for no more than 5 business days) or held by a majority-owned corporate subsidiary of the broker-dealer if the broker-dealer assumes or guarantees all of the subsidiary's obligations or liabilities; or in any other location designated by SEC (e.g., a mutual fund or its agent in the case of a registered open-ended investment company).

The second requirement of Rule 15c3-3 dictates how broker-dealers may use customer cash credit balances and cash obtained from the permitted uses of customer securities,²⁴ including from the pledging of customer margin securities. Essentially, the customer protection rule restricts the use of customer cash or margin securities to activities directly related to financing customer securities purchases. That is, the broker-dealer may not use customer property as a source of working capital for its operations.

The rule requires a broker-dealer to periodically (weekly for most broker-dealers)²⁵ compute the amount of funds obtained from customers or through the use of customer securities (credits) and compare it to the total amount it has extended to finance customer transactions (debits). If credits exceed debits, the broker-dealer is required to have on deposit in an account for the exclusive benefit of customers²⁵ at least an equal amount of cash or cash-equivalent securities (e.g., U.S. treasuries). Consequently, the rule serves to protect any required deposit in a secured location from creditors of the broker-dealer in an insolvency. For most broker-dealers, the calculation must be made as of the close of business every Friday, and any required deposit must be made by the following

²⁴Permissible uses of customer funds by broker-dealers include, among others: financing customers' margin accounts (i.e., an account in which a customer uses credit from a broker-dealer to take security positions); borrowing of securities to effect customers' short sales (i.e., securities sold but not owned at time of sale by broker-dealer); and delivery on customers' fail-to-deliver (i.e., selling broker-dealer does not receive securities from client in time to make delivery to buying broker-dealer).

²⁵A broker-dealer with customer credits (funds) of less than \$1 million and aggregate indebtedness of less than 800 percent of net capital can compute the reserve requirement on a monthly basis as of the month's close of business. The broker-dealer is required to make a deposit of 105 percent of the excess credits on the second business day following the computation date. See Rule 15c3-3(e)(3).

²⁶Rule 15c3-3(e)(1) requires that a broker-dealer maintain a bank account that is separate from any other account of the broker-dealer and specified as a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (reserve account). The broker-dealer must also obtain written notification from the bank that all cash or qualified securities within the reserve account are being held for the exclusive benefit of customers; are being kept separate from any other accounts maintained by the broker-dealer with the bank; cannot be used directly or indirectly as security for any loan to the broker-dealer by the bank; and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

Tuesday morning. If the required deposit is not made by the broker-dealer, the broker-dealer must immediately notify its sRo and SEc by telegram and promptly confirm such notice in writing. Such notice must be given even if a broker-dealer is presently in compliance with the reserve portion of the rule but discovers that it was previously out of compliance due to a computational error or otherwise. If a broker-dealer fails to make a deposit to the special reserve account when required to do so, it is a criminal violation, and the broker-dealer must cease doing business. If the debits exceed the credits, no deposit is required.

U.S. Securities Haircuts

The haircuts described below are from SEC Rule 15c3-1(c)(2)(vi)(A)-(M).

Securities Haircuts

The percentage amount of the haircut varies depending on the type of security, the maturity date, the quality, and the marketability. Generally, the haircut is deducted from the market value of the greater of the long or short position in each security; however, in some cases haircuts apply to the lesser position as well. The haircuts are designed to discount the firm's own positions to account for adverse market movements and other risks faced by the firms, including liquidity and operational risks.

U.S. and Canadian Government and Agency Debt Securities

This refers to securities issued (or guaranteed as to principal and interest) by the U.S. or Canadian government or agency. A haircut is applied to aggregate net long or short positions in 4 main categories (and 12 subcategories) of maturity dates ranging from less than 3 months to 25 years or more. The haircuts range from 0 percent for the short-term securities (0-3 months) to 6 percent for securities with later maturities.

For the most part, government securities haircuts are also applied to quasi-agency debt securities, such as those issued by the Export-Import Bank, Tennessee Valley Authority, and the Government National Mortgage Association (Ginnie Mae).

Municipal Debt Securities

These are securities that are direct obligations of, or guaranteed as to principal and interest by, a state or any political subdivision thereof as well as agencies and other state and local instrumentalities. Haircut percentages are applied to the market value of the greater of the long or short position according to maturity date. For municipal securities issued

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with stated maturities of 2 years or less, haircuts range from 0 percent for securities maturing under 30 days to 1 percent for those maturing in 456 days but less than 732 days.

For longer term securities with stated maturities of 2 years or longer, haircuts range from 3 percent to 7 percent.

Certain Municipal Bond
Trusts and Liquid Asset
Funds

These funds are redeemable securities issued by investment companies whose assets consist of cash, securities, or money market instruments. The haircut ranges from 2 percent to 9 percent based upon the types of assets held by the fund.

Commercial Paper,
Bankers Acceptances, and
Certificates of Deposit

The percentage deductions for highly rated corporate short-term debt instruments (money market instruments) that (1) have a fixed rate of interest or (2) are sold at a discount and that have maturity dates not exceeding 9 months range from 0 percent to 0.5 percent in five maturity categories ranging from less than 30 days to less than 1 year.

Bankers acceptances and certificates of deposit guaranteed by a bank and with maturity dates over 1 year have the same haircuts as U.S. government securities.

Nonconvertible Debt
Securities

These securities are corporate bonds that cannot be exchanged for a specified amount of another security, (e.g., equity securities), at a stated price. Highly rated bonds are assigned haircuts ranging from 2 percent to 9 percent for maturity dates ranging from less than 1 year to over 25 years. Certain positions in nonconvertible securities can be excluded from the foregoing haircuts if hedged with U.S. government securities.

Also included in this category are foreign debt securities for which a ready market exists. For purposes of foreign securities, a ready market is deemed to exist if such securities (1) are issued as a general obligation of a sovereign government; (2) have a fixed maturity date; (3) are not traded flat or in default as to principal or interest; and (4) are highly rated (implicitly or explicitly) by at least two nationally recognized statistical rating organizations, such as Standard & Poor's and Moody's Investors Service.

For positions hedged with U.S. government securities, haircuts on the hedged positions range from 1.5 percent for maturities of less than 5 years to 3 percent for maturities of 15 years or more. For positions hedged with nonconvertible debt, haircuts on the hedged positions range from 1.75 percent for a maturity of less than 5 years to 3.5 percent for a maturity of 15 years or more. In either case, no haircut is taken on the hedging position (i.e., the U.S. government securities or the nonconvertible debt).

Convertible Debt Securities

The treatment of debt securities that can be converted into equities and have fixed rates of interest and maturity dates is based on the securities' market value. If the market value is 100 percent or more of the principal amount, the haircut is the same as that applied to "all other securities," or 15 percent of the market value of the greater of the long or short positions, plus 15 percent of the market value of the lesser position, but only to the extent that this lesser position exceeds 25 percent of the greater position. If the market value is less than the principal amount, the haircut is the same as for nonconvertible debt securities.

Preferred Stock

This stock is cumulative, nonconvertible, highly rated, and ranked prior to all other classes of stock. The stock is not in arrears as to dividends and carries a haircut of 10 percent of the market value of the greater of the long or short position.

Open Contractual Commitments

These commitments are haircut at 30 percent of the market value of the greater of the net long or net short position (minus unrealized profits), unless the class and issue of securities are listed on a national securities exchange or are designated as NASDAQ National Market System Securities. If the securities are listed or designated, the haircut is then 15 percent (unless the security is an initial public offering whereupon the percentage deduction reverts to 30 percent).

All Other Securities

These securities include corporate equities and certain foreign securities (other than preferred stock discussed above). They are assigned haircuts of 15 percent of the market value of the greater of the long or short positions, plus 15 percent of the market value of the lesser position, but only to the extent that this lesser position exceeds 25 percent of the greater position (i.e., the first 25 percent of the lesser position incurs no haircut).

Securities With a Limited Market

In cases where there are only one or two independent market makers submitting regular quotations in an interdealer quotation system for the securities, the haircut is 40 percent on both the long and short positions. In cases where there are three or more independent market makers submitting regular quotations, the haircut is the same as for the "all other securities" category above.

Undue Concentration

This refers to a situation where a broker-dealer has a securities position for which the market value is more than 10 percent of the broker-dealer's net capital before haircuts (i.e., "tentative net capital"). For the charge to apply to equities, the market value of the position must exceed the greater of \$10,040 or the market value of 500 shares. For debt securities, the provision applies to positions valued over \$25,000. The haircut is an extra percentage of the usual haircut applied, and it is applied only to the excess portion of the total position (over 10 percent). The additional haircut for concentrated positions in equity securities is 15 percent. For other securities, it is 50 percent of the normal haircut on the concentrated securities.

Nonmarketable Securities

These are securities for which there is no ready market, and they carry a 100-percent haircut. Such securities have no independent market makers, have no quotations, and are not accepted as collateral for bank loans.

U.S. Options and Commodities Haircuts

The net capital rule also includes deductions for hedged positions, including futures and options contracts. Options to buy and sell securities and commodities are subject to haircuts because their market values change. See Appendix A to Rule 15c3-1 for options contracts and Appendix B to Rule 15c3-1 for relevant haircuts for futures contracts. CFFC generally has jurisdiction over the regulation of futures and options markets, including their relevant haircuts. Since securities broker-dealers hold futures and options positions in their portfolios, SEC incorporates CFFC's haircuts for commodities futures and options into its net capital rule. CFFC also incorporates SEC's securities haircuts into its net capital rule (Rule 1.17).

Appendix A to SEC Rule 15c3-1 (Options Haircuts)

Appendix A to SEC Rule 15c3-1 prescribes haircut methodologies for listed and unlisted options.

Risk-Based Haircut Methodology for Listed Options

Recently, to better reflect the market risk in broker-dealers' options positions and to simplify the net capital rule's treatment of options for capital purposes, SEC adopted a risk-based methodology using theoretical option pricing models to calculate required capital charges (haircuts) for listed options and related hedged positions. A simple, strategy-based methodology, similar to the old haircut methodology, remains for those firms that do not transact enough options business to warrant the expense of using option pricing models. This is the first time SEC has approved the use of modeling techniques for computing regulatory capital charges. The effective date of the new rule was September 1, 1997.

Third-party source models (and vendors) approved by a designated examining authority (i.e., self-regulatory organization) are used to perform the actual theoretical gain and loss calculations on the individual portfolios of the broker-dealers. Such approved vendors provide, for a fee, a service by which the broker-dealers may download the results generated by the option pricing models to allow broker-dealers to then compute the required haircut for their individual portfolios. The greatest loss at any one valuation point would be the haircut. At this time, the only approved vendor/model is the Options Clearing Corporation's Theoretical Intermarket Margining System (TIMs).

Underlying Price Movement Assumptions

Specified underlying price movement assumptions designed to provide for the maintenance of capital sufficient to withstand potential adverse market moves are included. The underlying price movement assumptions were established to be consistent with the volatility assumptions currently incorporated into the net capital rule." Specifically, the models calculate the theoretical gains and losses for a portfolio containing proprietary or market maker options positions at 10 equidistant valuation points using specified increases and decreases in the price of the underlying instrument. The greatest loss at any valuation point becomes the haircut for the entire portfolio.

"The option pricing model, for each option series, would calculate theoretical prices at 10 equidistant valuation points within a range consisting of an increase or decrease of the following percentages of the daily market price of the underlying instrument: (i) +/-15 percent for equity securities with a ready market, narrow-based indexes (as defined), and non-high-capitalization diversified indexes (as defined); (ii) +/-6 percent for major market currencies (e.g., European Currency Unit, Japanese Yen, and Deutsche Mark); (iii) +/-10 percent for high-capitalization diversified indexes (as defined); and (iv) +/-20 percent for currencies other than major market currencies. For nonclearing specialists and market makers, there is a reduction in the underlying price movements: +/-4 1/2 percent for major market currencies positions, +/- 10 percent for non-high-capitalization diversified indexes, and +/-6(-8) percent for high-capitalization diversified indexes. The maximum loss at any one valuation point would be the haircut for the portfolio. An option series includes option contracts of the same type (a call or a put) and exercise style covering the same underlying instrument with the same exercise price, expiration date, and number of underlying units.

Permissible Offsets

A percentage of a position's gain at any one valuation point is allowed to offset another position's loss at the same valuation point.' For example, options covering the same underlying instrument are afforded a 100-percent offset. Other offsets are permitted between qualified stock baskets and index options, futures, or futures options on the same underlying index. Broker-dealers are permitted to offset 95 percent of gains with losses (i.e., a 5 percent capital charge).

Minimum Charge

In addition, broker-dealers must take certain minimum deductions to address decay and liquidity risk if the option pricing model calculated an insignificant or no capital charge for a portfolio. This minimum charge is generally one-quarter of a point, or \$25 per option contract, unless the basic equity option contract covers more than 100 shares. In this case, the charge is proportionately increased.

SEC rules also require a deduction of 7.5 percent of the market value for each qualified stock basket of non-high-capitalization diversified indexes. The rules also require 5 percent of the market value for each qualified stock basket of high-capitalization diversified and narrow indexes used to hedge options or futures positions that are subject to the minimum charge.

Alternative Strategy-Based Haircut Methodology for Listed and Unlisted Options

SEC also permits firms with limited options business to use an alternative strategy-based haircut methodology that generally follows the haircut approach in the previous version of Appendix A to the net capital rule. See Table 11.1. This rule was designed for firms whose options business would not make it cost effective to use an option pricing model. A similar strategy-based methodology is also employed for broker-dealers that engage in buying and writing unlisted over-the-counter options. See Table 11.2.

¹A valuation point refers to the repricing of an option in relation to assumed changes in the value of the underlying instrument.

Table 11.1: Alternative Strategy-Based Haircut Methodology for Listed Options

Type of option/definition ^b	Adjustments to net worth: listed options only	Haircuts on listed options
Uncovered short: Short put or call with no related stock or option position.	Add market value of option. Add time value ^o of short option position.	Appropriate percentage of the current market value of the securities underlying the option security less the out-of-the-money amount, but reduction cannot serve to increase net capital. Minimum haircut is the greater of \$250 per 100 share option contract or 50 percent of aforementioned percentage.
Long options (calls or puts): No offsetting securities or options position.	None	50 percent of the current market value of the option.
Hedged call: Long call option vs. short underlying stock.	Deduct time value on long call.	Take applicable haircut on the short stock position not to exceed the out-of-the-money amount on the call option. Minimum haircut of \$25 for each 100 share option contract, but minimum charge need not exceed intrinsic value of the option.
Hedged put: Long put option vs. long underlying stock.	Deduct time value on long put.	Take applicable haircut on the long stock position not to exceed the out-of-the-money amount on the call option. Minimum haircut of \$25 for each 100 share option contract, but minimum charge need not exceed intrinsic value of the option.
Hedged call: Short call option vs. long underlying stock.	Add time value of short option.	Take applicable haircut on the long stock position reduced by the call's intrinsic value. The minimum charge here is \$25 per each 100 share option contract.
Spread: Long put options vs. short put options and long call options vs. short call options.	Add net short market value or deduct net long market value of options.	Call spread: excess of exercise value of long call over short call. If exercise value of long call is less than or equal to the exercise value of the short call, no haircut is required. Put spread: excess of exercise value of short put over long put. If exercise value of long put is greater than or equal to exercise value of short put, no haircut is required.

(Table notes on next page)

Appendix II
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'A listed' option is any option traded on a registered national securities exchange or automated facility of a registered national securities association.

bUncovered means an option that is written without any corresponding security or option position as protection in seller's account. A call is an option giving its holder (buyer) the right to demand the purchase of a certain number of shares of stock at a fixed price any time within a specified period. A put is an option giving its holder (seller) the right to demand acceptance of delivery of a certain number of shares of stock at a fixed price any time within a specified period. Short means the investor sells the option. Long means the investor buys the option. Hedge means any combination of long and/or short positions taken in securities, options, or commodities in which one position tends to reduce the risk of the other. A spread is the simultaneous purchase and sale of the same class of options at different prices.

'Time value is the amount by which the current market value of an option exceeds its intrinsic value.

dIntrinsic value (or "in-the-money amount") is the amount by which the exercise value, if a call option, is less than the current market value of the instrument underlying the call; and if a put option, the amount by which the exercise value of the option is greater than the current market value of the instrument underlying the put. "Out-of-the-money" is the amount by which the exercise value, if a call, is greater than the current market value of the underlying instrument; and, if a put, the amount by which the exercise value is less than the current market value of the underlying instrument.

'Exercise value is the price at which an option can be exercised.

Source: The SEC Division of Market Regulation, Appendix A to SEC Rule 15c3-1, and SEC Release No. 34-38248.

Table 11.2: Alternative Strategy-Based Haircut Methodology for Unlisted Options

<u>Type of option'</u>	Haircuts on unlisted options
Uncovered calls and puts	15 percent, if equities, (or appropriate other percentage) of the current market value of the underlying security less any out-of-the-money amount. Minimum haircut of \$250 per 100 share option contract.
Covered calls and puts	15 percent, if equities, (or appropriate other percentage) of the current market value of the underlying security less any in-the-money amount. Net capital cannot be increased because of haircut.
Conversion accounts ^b	5 percent, if equities, (or 1/2 the appropriate other percentage for other securities as set forth in the rule) of the current market value of the underlying security.
Long options	15 percent, if equities, (or appropriate other percentage for other securities as set forth in the rule) of the current market value of the underlying security. Limited to allowable asset value of the option.

^aAn unlisted option is any option that is not traded on a registered national securities exchange or automated facility of a registered national securities association,

^bA conversion is a call option created from a put option when a long position in the underlying equity is taken.

Source: The SEC Division of Market Regulation, Appendix A to SEC Rule 15c3-1 under the Exchange Act, and SEC Release No. 34-38248.

Appendix B to SEC Rule 15c3-1 (Commodities and Commodities Futures Haircuts)

As for securities, the net capital rule imposes a series of deductions from the market values of commodities. The amount of the deductions varies depending on whether the commodities are part of a hedged or spread position; whether the commodities stand alone as a long or short position; and what types of commodities accounts (inventory accounts, customer accounts) are at issue. These haircuts generally conform with similar provisions in CFTC's net capital rule and are dependent on the margin requirements set by the commodities boards of trade and clearing organizations. See Table 11.3.

Table 11.3: Commodities and Commodities Futures Haircuts

Commodities transaction:	Haircut:
1. Inventory registered as deliverable and covered by a futures or option	No charge
2. Covered inventory	5 percent charge of market value
3. Uncovered inventory	20 percent charge of market value
4. Covered commitments and forwards	10 percent charge of market value
5. Uncovered commitments and forwards	20 percent charge of market value
6. Futures and short and long options	Applicable margin requirements
	150 percent of applicable maintenance requirement ^b
	200 percent of applicable maintenance requirement ^c

^a If broker-dealer is a clearing member of a contract market with respect to applicable transactions.

^b If broker-dealer is a member of an SRO.

^c All other broker-dealers.

Source: The SEC Division of Market Regulation and Appendix B to Rule 15c3-1.

Hypothetical Example of a Broker-Dealer's Net Capital Calculation Under the Alternative Method

Tables 11.4 and 11.5 and 11.6 provide information for calculating net capital. Table IIA, a trial balance, provides a starting point for our simplified hypothetical example of a broker-dealer's net capital calculation under SEC's alternative method. A trial balance is a list of all open accounts in the general ledger and their balances. A general ledger is a collection of all assets, liabilities, capital, revenue, and expense accounts. Accounts are the means by which differing effects on business elements (e.g., revenues) are categorized and collected. In table 11.5, we converted the trial balance into a balance sheet of assets, liabilities, and capital. In table 11.6, we compute

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Key SEC Financial Responsibility Rules

the broker-dealer's net capital, including haircuts, using information contained in table IIA The result of the computation shows that the broker-dealer is in capital compliance and has \$352.6 million in excess net capital.

Table 11.4: Broker-Dealer's Trial Balance as of December 31, 1997

Account title	Debits	Credits
Cash in banks	\$400,000,000	
Customer debits"	40,000,000	
Customer credits		\$115,000,000
Dividends payable		8,000,000
Syndicate payable		30,000,000
Furniture and fixtures (net)	12,000,000	
Advances and loansb	20,000,000	
Good faith deposits°	13,000,000	
Subordinated loansd		40,000,000
Loans payable		30,000,000
Accrued expenses payable		7,000,000
Commission income		40,000,000
Trading accounte	130,000,000	
Investment accounte	100,000,000	
Real estate	50,000,000	
Mortgage payable'		35,000,000
Interest receivables9	5,000,000	
Capital account		465,000,000
Total	\$770,000,000	\$770,000,000

Notes to financial statements:

'Customer debits are in cash account and are outstanding for less than 7 days.

AAvances and loans to employees are unsecured.

°Good faith deposits with utility companies.

dSubordinated loan from firm's president, not approved by American Stock Exchange.

'All securities are listed on the American Stock Exchange and are of long equity positions. As of 12/31/97, the market value of the Investment account is \$99,000,000; and the market value of the Trading account is \$105,000,000.

(Mortgage payable is for business condo.

9Interest receivable less than 30 calendar days from payable date.

Source: GAO.

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Table 11.5 Broker-Dealer's Balance Sheet as of December 31, 1997

Assets	
Allowable assets	
Cash	\$400,000,000
Customer debits	40,000,000
Trading account	105,000,000
Investment account	99,000,000
Interest receivables	<u>5,000,000</u>
Total allowable assets	\$649,000,000
Non-allowable assets	
Real estate	\$ 50,000,000
Furniture & fixtures (net)	12,000,000
Advances & loans	20,000,000
Good faith deposits	<u>13,000,000</u>
Total non-allowable assets	\$ 95,000,000
Total assets	\$744,000,000
Liabilities	
Aggregate indebtedness	
Customer credits	\$115,000,000
Dividends payable	8,000,000
Accrued expenses payable	7,000,000
Loan payable	30,000,000
Mortgage payable	35,000,000
Syndicate payable	<u>30,000,000</u>
Total aggregate indebtedness	\$225,000,000
Other liabilities	
Subordinated loan	\$ 40,000,000
Total liabilities	\$265,000,000
Owners' equity	
Capital account	\$465,000,000
Commission income	40,000,000
Mark to market (investment)	(1,000,000)
Mark to market (trading)	<u>(25,000,000)</u>
Total capital	<u>\$479,000,000</u>
Total liabilities and capital	<u>\$744,000,000</u>

Source: GAO.

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Key SEC Financial Responsibility Rules

Table 11.6: Broker-Dealer's Net Capital Computation as of December 31, 1997

Accounting steps:	Description	Computation
	Total assets	\$744,000,000
minus	Total liabilities	265,000,000
equals	Net worth	\$ 479,000,000
minus	Deductions:	
	Non-allowable assets	95,000,000
equals	Net capital before haircuts	\$384,000,000
minus	Total haircut charges"	<u>30,600,000</u>
equals	Net capital	\$353,400,000
minus	Required minimum net capital	<u>776,000</u>
equals	Excess net capital	\$352,624,000

Haircut computation:

The haircut on equity securities is equal to 15 percent of the market value of the greater of the long or short positions, plus 15 percent of the lesser positions, but only to the extent that these positions exceed 25 percent of the market value of the greater position.

15% of trading account:	15% x \$105,000,000 = \$15,750,000
15% of investment account:	15% x \$99,000,000 = <u>\$14,850,000</u>
Total haircuts	\$30,600,000

Computation of Alternative Net Capital Compliance:

Base requirement: broker-dealer's net capital must be the greater of \$250,000 or 2 percent of aggregate customer debits (i.e., customer-related receivables) as computed per Rule 15c3-3's reserve formula.

Aggregate customer debits equal (customer debits - (customer debits x 3%)). In our example, aggregate customer debits equal \$38,800,000 (\$40,000,000 - (\$40,000,000 x 3%)). The 3 percent is analogous to the broker-dealer's loss reserve for the loans made to customers. Our base requirement is \$776,000 (2% x \$38,800,000).

Because the \$776,000 is more than the \$250,000 minimum dollar requirement, the broker-dealer must hold at least a minimum of \$776,000 in net capital. The broker-dealer is in compliance with this requirement because it has \$353,400,000 in net capital.

Another requirement is that the broker-dealer's subordinated debt to total debt-equity ratio may generally not exceed 70 percent for 90 days. The ratio is calculated by dividing a broker-dealer's total net worth into its subordinated debt (\$40,000,000/\$479,000,000). With a ratio of only 8.35 percent, the broker-dealer meets this requirement.

Source: GAO.

**Appendix II
Key SEC Financial Responsibility Rules**

Table 11.7: SEC Minimum Net Capital Requirements for Brokers and Dealers

Type of broker or dealer	Minimum requirement
Brokers or dealers that carry accounts	
1. Firms that carry customer accounts or broker or dealer accounts and receive or hold funds or securities for those persons (known as general securities brokers or dealers).	
i. Basic or aggregate indebtedness (AI) method	Greater of \$250,000 or 6-2/3% of AI
ii. Alternative method	Greater of \$250,000 or 2% of Rule 15c3-3 Reserve Formula debits
2. Firms that carry customer accounts, receive but do not hold customer funds or securities, and operate under the paragraph (k)(2)(i) exemption of Rule 15c3-3.	
Introducing brokers*	
1. Firms that introduce accounts on a fully disclosed basis to another broker or dealer and do not receive funds or securities.	
	Greater of \$5,000 or 6-2/3% of At
2. Firms that introduce accounts on a fully disclosed basis to another broker or dealer and receive, but do not hold, customer or other broker-dealer securities and do not receive funds.	
	Greater of \$50,000 or 6-2/3% of At
Dealers*	
1. Brokers or dealers that trade solely for their own accounts, endorse or write options, or effect more than 10 transactions for their investment account in any 1 calendar year.	
	Greater of \$100,000 or 6-2/3% of At
Mutual fund brokers or dealers*	
1. Brokers or dealers transacting a business in redeemable shares of registered investment companies and certain other share accounts.	
i. Wire orders (or telephone calls)	Greater of \$25,000 or 6-2/3% of At
ii. Application (or subscription) method and do not otherwise receive or hold funds or securities	Greater of \$5,000 or 6-2/3% of At
Market makers*	
1. Brokers or dealers engaged in activities as a market maker	
	Greater of \$100,000 or 6-2/3% of AI or \$2,500 per security for securities with a market value greater than \$5 per share, and \$1,000 per security for securities with a market value of \$5 or less with a maximum requirement of \$1 million
Other brokers or dealers*	
1. Firms that deal only in Direct Participation Programs (i.e., real estate syndications).	
	Greater of \$5,000 or 6-2/3% of At
2. Firms that do not take customer orders, hold customer funds or securities or execute customer trades, because of the nature of their activities (e.g., mergers and acquisitions).	
	Greater of \$5,000 or 6-2/3% of At
Futures commission merchants	
1. Brokers or dealers registered with CFTC.	
	Greater of \$250,000 or 4% of customer funds required to be segregated pursuant to the CEA and regulations thereunder

(continued)

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Type of broker..or dealer	Minimum requirement
ALTERNATIVE METHOD"	
1. Any firm may elect this method; however, the firm will be subject to the \$250,000 minimum net capital requirement.	Greater of \$250,000 or 2% of Rule 15c3-3 Reserve Formula debits

°A broker or dealer electing this method to calculate its net capital levels must notify its examining authority in writing and may not thereafter revert to the Aggregate Indebtedness Method (unless approved by SEC.)

The minimum capital requirements opposite the type of broker-dealers are under the Basic (or Aggregate Indebtedness) Method.

Source: The SEC Division of Market Regulation and Rule 15c3-1 under the Securities Exchange Act of 1934.

OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS
OFFICE OF BROKER-DEALER EXAMINATIONS AND OVERSIGHT

Cathy J. Sabo

Branch Chief

Telephone: 202-942-7479

Fax: 202-942-9644

E-mail: Saboc@sec.gov

PURPOSE OF BROKER- DEALER EXAMINATION PROGRAM

"Cop on the Beat"

- "Eyes and Ears", of Commission
- Oversight of Examinations of Self-Regulatory Organizations

SEC Examination Program for Broker-Dealer Oversight

Inherently greater risk in business of broker-dealers:

- deal directly with investors
- receive funds and hold securities for customers
- diverse business

650 examinations annually

200 examiners and supervisors in 11 regional and district offices throughout the country

Regional office examinations are coordinated by Office of Compliance Inspections and Examinations

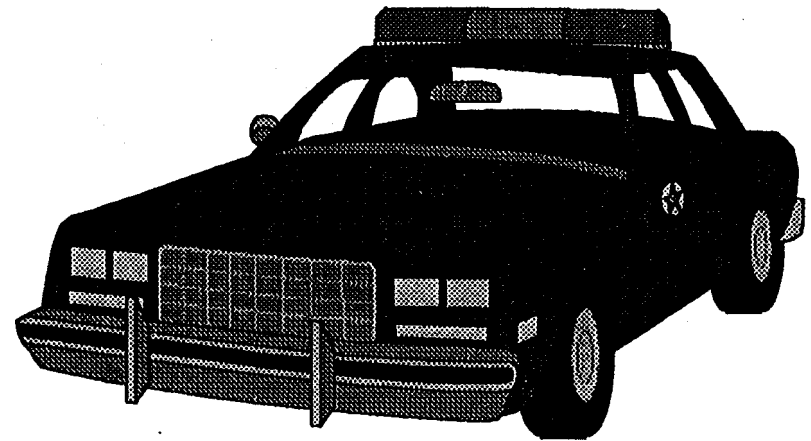
Regulating over 8,500 broker-dealers

- over 500,000 registered salespersons
 - over 60,000 branch offices throughout the U.S. and internationally
 - over 5,500 of the total broker-dealers do business with the investing public

"Cop on the Beat"

Promote broker-dealers' compliance with federal rules and regulations and SRO rules

Cooperate and coordinate with other regulators



Promote Broker-Dealer Compliance

Conduct unannounced examinations

Detect violations

Attain correction through deficiency letters or staff interviews which educate registrant about noncompliance with rule requirements

Require registrant to report on corrective action taken

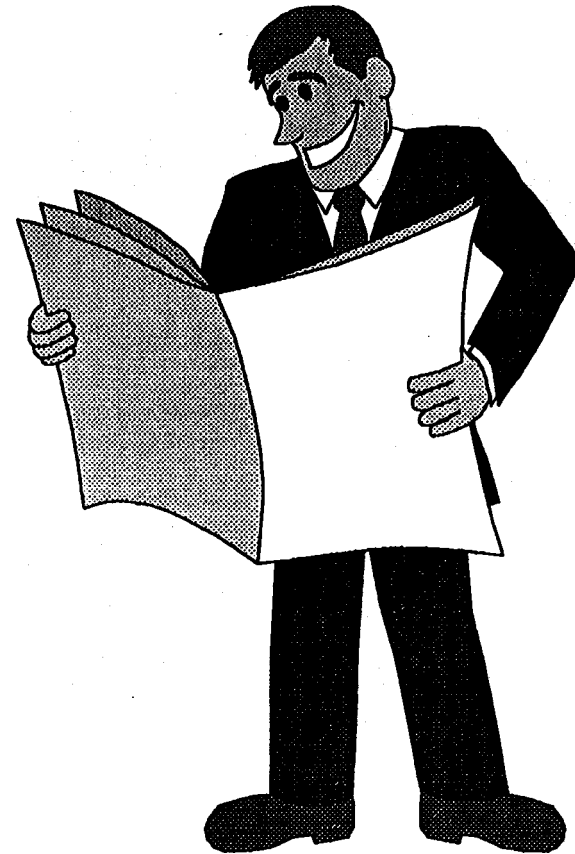
For serious violations, refer to Commission's Enforcement staff or to SROs for further investigation and possible disciplinary action

Cause Examinations

Review allegations of improper practices by broker-dealer or associated person

Sources include customer complaints, newspaper articles, informants, findings from other examinations, referrals from SROs, and leads from investigations

High percentage of cause examinations result in referrals for further investigation



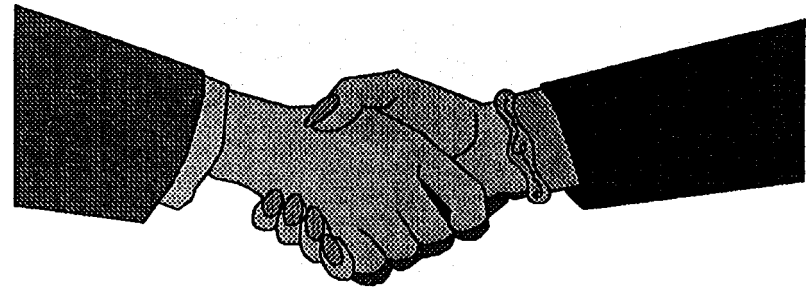
Coordination and Cooperation with Other Regulators

Work cooperatively with
SROs and state regulators

Maximize efficiency of
limited staff resources by
avoiding duplication of
efforts

Memorandum of
Understanding (November
1995)

Coordinated examinations
by SROs of common
members



EYES AND. EARS OF COMMISSION

- Surveillance
Examinations
- 9 Examination Sweeps



Surveillance Examinations and Sweeps

- Understand industry practices
- Recommend rule changes

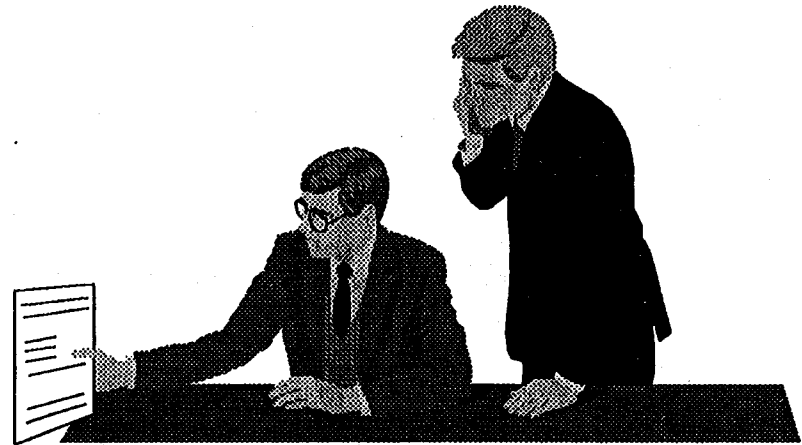
Joint Regulatory Sales Practice Sweep

Oversight of SROs

SROs are first line of defense

Re-examine registrants recently examined by SRO

Evaluate quality of SRO exam and overall exam program



Oversight Exams

Re-examine registrants within twelve months after SRO conducts examination

Did SRO examiner adequately prepare for examination and select an appropriate scope?

Did SRO examiner find all material violations were found by SRO?

Did the SRO examiner follow and apply his/her organization's examination procedures correctly?

Did SRO supervisor take appropriate action following the examination?

Communication of Oversight Examination Findings

Violations by the broker-dealer are communicated to registrant through deficiency letters

Criticisms of SRO exam procedures are communicated to SRO

Follow up to ensure SRO implements necessary corrections in its exam methodology and procedures

PLANNING AND CONDUCTING AN EXAMINATION

- Pre-examination preparation
- Entrance interview
- Fieldwork
- Analysis
- Disposition

Pre-examination Preparation

Review CRD System for current registration status, ownership and disciplinary history of registrant and principals

Review prior Commission and SRO examination reports

Review for pending Commission and SRO investigations and customer complaints

Consult with SRO

Review monthly/quarterly/annual financial (FOCUS) reports filed with SRO

Review news databases

Assess operations of greatest risk

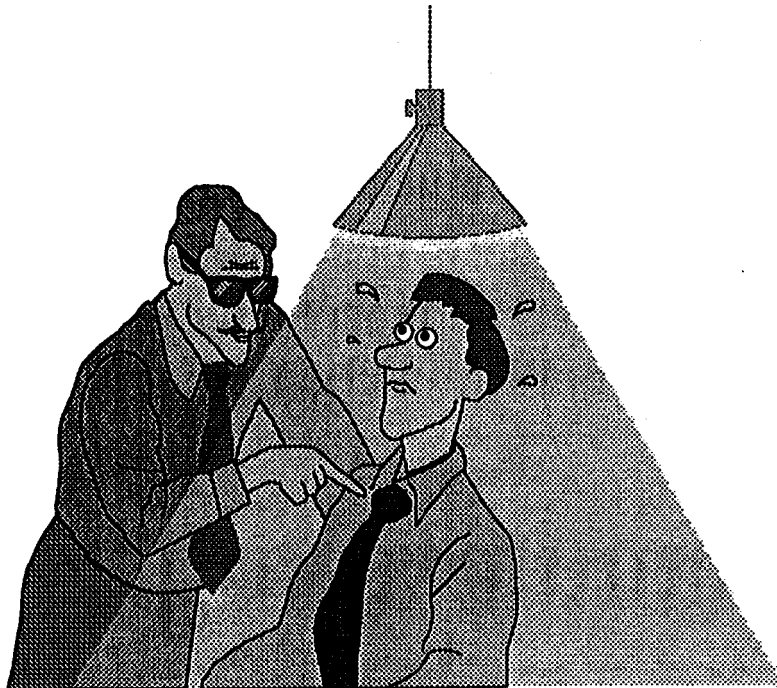
Determine tentative examination scope and focus

Entrance Interview

Overview of registrant's
current management
structure, lines of
business, and profitability

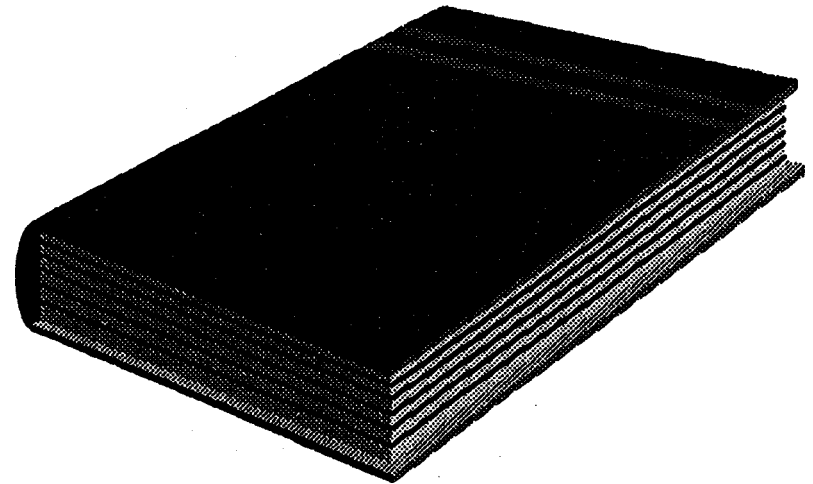
Refine/revise tentative
examination scope

Request books and records



Review of Books and Records

- Financial examination
(net capital and
customer protection)
Sales practice
examination



Financial Examination

Books and Records

Trial Balance and Income Statement

General ledger

Stock Record

Subsidiary ledgers

- Inventory
- Cash
- Repos/Reverse Repos
- Securities Borrowed/Loaned
- Customer Balances
- arils to Deliver/Receive

Financial Examination

- Net capital computation (SEC Rule 15c3-1)
- Reserve formula computation (SEC Rule 15c3-3)
- Possession and control of customers' securities (SEC Rule 15c3-3)
- Extension of Credit (Federal Reserve Regulation T and SRO rules)

Sales Practice Examination

Books and Records

Customer account statements

Commission reports

Trading blotters

Compliance exception reports

Customer complaints

Litigation and arbitration files

Advertising and sales literature

Scripts

Sales Practice Examination,

Unsuitable
recommendations
Excessive trading
(churning)
Excessive undisclosed
mark ups (+10%)
Unauthorized transactions

Misrepresentations
Improper cold calling
Mutual fund sales abuses
Low priced securities
Market manipulation
Unregistered offerings

Supervision and Internal Controls

- Supervision over conduct of sales persons
- Internal controls over trading desks

Analysis



- Analyze firm trading records
- Request trading records from other broker-dealers ("blue sheet")
- Analyze customer activity
- Send customer questionnaires
- Interview customers by telephone

Disposition

No further action

Deficiency letter

Enforcement Referral

Referral to SRO

Referral to Criminal Authorities (US Attorneys, Postal Inspectors, IRS)

Referral to State Regulators

Referral to Other Federal Regulators (Treasury, IRS, CFTC)

COMMON FINDINGS in EXAMINATIONS

- UNDERWRITING ABUSES: Manipulated aftermarket, tie-in sales, Reg M
- UNREGISTERED DISTRIBUTIONS: Abuses of Reg S exemption, S-8 offerings and Rule 144
- SALES PRACTICE ABUSES: Unauthorized trading, Misrepresentations, Suitability, Failures to sell
- EXCESSIVE MARK-UPS
- OFFERING FRAUD: Private Placements, Regulation D, Misappropriation of investor proceeds, ongoing ponzi scheme, misrepresentations in offering documents
- CONVERSION OF FUNDS: Unsupervised RRs operating in branch locations
- WEAK SUPERVISORY SYSTEMS, CONTROLS AND PROCEDURES: Firms employing large numbers of geographically dispersed independent contractors
- NET CAPITAL VIOLATIONS and RECORDKEEPING PROBLEMS