

July 11, 2003

Ms. Elaine Michitsch
Member Firm Regulation
New York Stock Exchange, Inc.
20 Broad Street
New York, New York 10005

Ms. Susan Demando
Director, Financial Operations
NASD Regulation, Inc.
1735 K Street, NW
Washington, D.C. 20006-1500

Re: Recording Certain Broker-Dealer Expenses and Liabilities

Dear Ms. Michitsch and Ms. Demando:

You have requested guidance from the Division of Market Regulation (“Division”) of the U.S. Securities and Exchange Commission (“Commission”) concerning the application of the financial responsibility rules¹ when a third party, which may include a parent, holding company, or affiliate of a broker-dealer, agrees to assume responsibility for payment of the broker-dealer’s expenses.² You are concerned that some broker-dealers are using these expense-sharing agreements as a basis for not recording expenses and liabilities on the broker-dealer’s books and records. In that instance, the books and records of the broker-dealer may not accurately reflect its performance and financial condition, artificially inflating its profitability, causing it to appear to be in capital compliance when it is not, and possibly disguising fraudulent activity. Further, you need access to sufficient records to verify that the broker-dealer is in compliance with the financial responsibility rules.

Under the financial responsibility rules, broker-dealers are required to prepare certain financial statements in accordance with generally accepted accounting principles (“GAAP”). A broker-dealer is also required to make and keep current certain books and

¹ For purposes of this letter, the financial responsibility rules include the net capital rule, Rule 15c3-1 under the Securities Exchange Act of 1934 (“Exchange Act”), and reporting and record keeping requirements under Exchange Act Rules 17a-3, 17a-4, and 17a-5.

² If a third party pays certain expenses of a broker-dealer, that party may be required to register with the Securities and Exchange Commission as a broker-dealer in accordance with Section 15 of the Exchange Act.

records relating to its business, including records “reflecting all assets and liabilities, income and expense and capital accounts.”³ A broker-dealer must also retain copies of all written agreements entered into by the broker-dealer relating to its business.⁴

It is the view of the Division that:

1. Pursuant to Exchange Act Rule 17a-3(a)(1) and (a)(2), a broker-dealer must make a record reflecting each expense incurred relating to its business and any corresponding liability, regardless of whether the liability is joint or several with any person and regardless of whether a third party has agreed to assume the expense or liability. A broker-dealer must make a record of each expense incurred relating to its business, including the value of any goods or services used in its business, when a third party has furnished the goods or services or has paid or has agreed to pay the expense or liability, whether or not the recording of the expense is required by GAAP and whether or not any liability relating to the expense is considered a liability of the broker-dealer for net capital purposes. One proper method is to record the expense in an amount that is determined according to an allocation made by the third party on a reasonable basis.
2. If the broker-dealer does not record certain expenses on the reports it is required to file with the Commission or with its designated examining authority (“DEA”) under the financial responsibility rules, the broker-dealer may satisfy the Exchange Act Rule 17a-3(a)(1) and (a)(2) requirement to make a record of those expenses by making a separate schedule of the expenses.
3. If a third party agrees or has agreed to assume responsibility for an expense relating to the business of the broker-dealer, and the expense is not recorded on the reports the broker-dealer is required to file with the Commission or with its DEA under the financial responsibility rules, any corresponding liability will be considered a liability of the broker-dealer for net capital purposes unless:
 - a. If the expense results in payment owed to a vendor or other party, the vendor or other party has agreed in writing that the broker-dealer is not directly or indirectly liable to the vendor or other party for the expense;⁵
 - b. The third party has agreed in writing that the broker-dealer is not directly or indirectly liable to the third party for the expense;
 - c. There is no other indication that the broker-dealer is directly or indirectly liable to any person for the expense;

³ Exchange Act Rule 17a-3.

⁴ Exchange Act Rule 17a-4.

⁵ This requirement does not apply to a fixed term arrangement with a lessor that was in place before the issuance of this letter.

- d. The liability is not a liability of the broker-dealer under GAAP; and
 - e. The broker-dealer can demonstrate that the third party has adequate resources independent of the broker-dealer to pay the liability or expense.
4. Any withdrawal of equity capital, as defined in paragraph (e)(4)(ii) of Exchange Act Rule 15c3-1, from a broker-dealer by a third party, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, within three months before or within one year after the broker-dealer incurs an expense which the third party has paid or agreed to pay, will be presumed for net capital purposes to have been made to repay the third party for the expense of the broker-dealer, unless the broker-dealer's books and records reflect a liability to the third party relating to the expense.
5. For purposes of determining net capital, if the broker-dealer records a capital contribution from a third party that has assumed responsibility for paying an expense of the broker-dealer, and the expense is not recorded on the reports the broker-dealer is required to file with the Commission or with its DEA under the financial responsibility rules, the broker-dealer must be able to demonstrate that the recording of a contribution to capital is appropriate. Among other things, the broker-dealer must be able to demonstrate that the third party has paid the expense or has adequate resources independent of the broker-dealer to pay the expense and that the broker-dealer has no obligation, direct or indirect, to a vendor or other party to pay the expense. For net capital purposes, any equity capital withdrawn by the third party, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, within three months before or one year after the broker-dealer incurs the expense, will be deemed to have been a repayment of the expense to the third party. For net capital purposes, if a contribution to capital is made to a broker-dealer with an understanding that the contribution can be withdrawn at the option of the contributor, the contribution may not be included in the firm's net capital computation and must be re-characterized as a liability. Any withdrawal of capital as to that contributor within a period of one year, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, shall be presumed to have been contemplated at the time of the contribution.⁶
6. If a third party agrees or has agreed to assume responsibility for an expense of the broker-dealer, the broker-dealer must make, keep current, and preserve the following records pursuant to Exchange Act Rules 17a-3 and 17a-4:
- a. If a vendor or other party has agreed that the broker-dealer is not liable directly or

⁶ Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, to Raymond J. Hennessey, Vice President, New York Stock Exchange, and Susan Demando, Vice President, NASD Regulation (February 23, 2000). This letter presumes that a broker-dealer's designated examining authority could recognize an exception to this presumption under appropriate circumstances.

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indirectly to the vendor or other party for an expense, a written agreement between the broker-dealer and the vendor or other party that clearly states that the broker-dealer has no liability, direct or indirect, to the vendor or other party; and

b. A record of each expense assumed by the third party.

7. A broker-dealer must make, keep current, and preserve a written expense sharing agreement⁷ between the broker-dealer and a third party that has paid or agreed to pay an expense of the broker-dealer. The agreement must set out clearly which party is obligated to pay each expense, whether the broker-dealer has any obligation, direct or indirect, to reimburse or otherwise compensate any party for paying the expense, and, when the broker-dealer records the expense in an amount that is determined according to an allocation made by the third party, the method of allocation.

8. Each broker-dealer and broker-dealer applicant must be able to demonstrate to the appropriate authorities that it is in compliance with the financial responsibility rules in connection with any expense-sharing agreement it has entered into, and therefore it may be required to provide these authorities with access to books and records, including those of unregistered entities, relating to the expenses covered by the agreement.

9. A broker-dealer must notify its DEA if it enters into, or has entered into, an expense sharing agreement and the broker-dealer does not record each of the expenses it incurs relating to its business on the reports it is required to file with the Commission or with its DEA under the financial responsibility rules. The notification must include the date of the agreement and the names of the parties to the agreement. The broker-dealer must provide a copy of the agreement to its DEA upon request.

Please contact me if you have any other questions or concerns relating to this matter.

Sincerely yours,

Michael A. Macchiaroli
Associate Director

⁷ Expense sharing agreements include franchising or other agreements relating to the costs of doing business of the broker-dealer.