CLEARY GOTTLIEB

NEW YORK WASHINGTON PARIS BRUSSELS LONDON MOSCOW FRANKFURT COLOGNE ROME MILAN HONG KONG BEIJING

SEC Proposes Amendments to its Financial Responsibility Rules for Broker-Dealers

Washington, DC
March 20, 2007

On March 9, 2007, the Securities and Exchange Commission (the "SEC") proposed amendments (the "Proposed Amendments") to its financial responsibility rules for broker-dealers under the Securities Exchange Act of 1934.[1] The Proposed Amendments would address a wide range of issues arising in connection with the SEC's net capital rule (Rule 15c3-1), customer protection rule (Rule 15c3-3), books and records rules (Rules 17a-3 and 17a-4), and notification rule (Rule 17a-11). Comments are due on or before May 18, 2007.

Among the more significant elements of the Proposed Amendments are the following (which are summarized in greater detail at the pages indicated below):

Proposed Amendments to the Customer Protection Rule (Rule 15c3-3)

- **Proprietary Accounts of Other Broker-Dealers.** Broker-dealers that carry proprietary accounts of other broker-dealers would be required to calculate a reserve requirement for such accounts and deposit this amount in a separate "reserve account" for the benefit of such broker-dealers. (p. 4)

- **Restrictions on Banks Used for Cash Deposits in Reserve Accounts.** Cash deposits in reserve accounts could no longer be held at an affiliated bank, and the amount of cash held at any single unaffiliated bank would be limited. (p. 6)

- **Money Market Funds as "Qualified Securities" for Reserve Accounts.** Certain money market funds would become eligible for deposit in a reserve account. (p. 6)

[1] SEC Release No. 34-55431 (Mar. 9, 2007), 72 Fed. Reg. 12862 (Mar. 19, 2007) ("Proposing Release").

- **Sweep Accounts.** New disclosure requirements and related procedures would apply to "sweep" arrangements in which customer cash deposits are swept into money market funds or bank deposits. (p. 7)

- **Futures in a Portfolio Margin Account.** Rule 15c3-3 would be modified in a manner intended to extend its protections and those under the Securities Investor Protection Act of 1970 ("SIPA") to futures positions carried in a portfolio margin account. (p. 10)

- **Aggregate Debits Deduction Under "Alternative Standard."** The deduction that broker-dealers using the "alternative standard" under the SEC's net capital rule must apply to their total debits when calculating reserve requirements would be reduced from 3% to 1%. (p. 11)

Proposed Amendments to the Net Capital Rule (Rule 15c3-1)

- **Capital Charges for Expenses Assumed by Third Parties.** A broker-dealer would be required to take a capital charge for any liability or expense relating to its business that has been assumed by a third party, unless it can demonstrate that the third party has adequate resources independent of the broker-dealer to pay the liability or expense. (p. 12)

- **Prohibition on Short-Term Capital Contributions.** A broker-dealer would be prohibited from treating as a capital contribution amounts that an investor has the option to withdraw or intends to withdraw within a one-year period. (p. 13)

- **Requirement that Firms Not Be "Insolvent."** Broker-dealers would be deemed in violation of Rule 15c3-1 and required to cease their securities business if they become "insolvent," as defined in the Proposed Amendments. (p. 14)

- **Expanded SEC Ability to Restrict Withdrawals of Capital.** The SEC would be permitted in appropriate circumstances to restrict any withdrawals of a broker-dealer's capital (not merely those that exceed 30% of net capital during a 30-day period). (p. 15)

- **Presumption of "Principal" Capacity in Certain Securities Lending Transactions.** Broker-dealers that participate in a loan of securities by one party to another would be presumed to be acting as principals for purposes of applicable capital charges, unless they meet certain requirements. (p. 16)

Other Proposed Amendments

- **Requirement to Document Risk Management Controls.** Certain larger broker-dealers would be required to document their internal risk management controls for managing a variety of business risks. (p. 16)

- **Reporting Requirements for Securities Borrowing/Repurchase Activities.** Broker-dealers would be required to notify the SEC if their securities borrowing or repurchase activities (excluding U.S. government securities) exceed certain thresholds. (p. 16)

Other Areas on Which Comment Is Solicited

- **Early Warning Triggers.** The SEC solicited comment on whether to reduce the percentage triggers (net capital as a percentage of aggregate debit items) at which notifications must be made to the SEC for firms with very large aggregate debit items. (p. 18)

- **Capital Charges for Securities Lending and Repurchase Transactions.** Comments were requested on whether capital charges for securities lending and repurchase transactions should be harmonized to prevent regulatory arbitrage. (p. 18)

- **Third-Party Liens on Customer Securities.** The SEC raised questions as to how third-party liens on customer securities held at a broker-dealer should be treated for purposes of Rule 15c3-3 and other requirements. (p. 19)

These and other provisions of the Proposed Amendments are discussed more fully below.

* * *

I. Proposed Amendments to the Customer Protection Rule

By way of background, the SEC's customer protection rule, Rule 15c3-3, generally requires a broker-dealer to take steps to segregate funds and certain securities held for the account of customers. The purpose of the rule is to limit the broker-dealer's use of customer funds and securities to support its own business activities and to facilitate the prompt return of customer assets in the event of the broker-dealer's insolvency.

The amount of cash required to be segregated for the benefit of customers is computed pursuant to a "Reserve Formula," under which the broker-dealer adds up certain

"credit" items (*e.g.*, cash balances in customer accounts, funds obtained through the use of customer securities, etc.) and certain "debit" items (*e.g.*, money owed by customers to the broker-dealer, securities borrowed by the broker-dealer to settle customer short sales, etc.). If the credit items exceed the debit items, the broker-dealer must maintain the excess in cash or qualified securities in a "Reserve Account," a special segregated account maintained at a bank for the exclusive benefit of the broker-dealer's customers.

Rule 15c3-3 also requires a broker-dealer to maintain physical possession or control of all "fully paid" and "excess margin" securities carried for customers.[2] Such securities cannot be re-hypothecated by the broker-dealer and must be maintained in the firm's physical possession or at a satisfactory "control" location (*e.g.*, a clearing agency or a bank). On a daily basis, the broker-dealer must determine the amount of fully paid and excess margin securities it carries for customer accounts and compare that amount to the amount of such securities it holds in its possession or control on a segregated basis free of any lien. If there is a deficit (sometimes referred to as a "segregation deficit"), the firm must take specified actions to obtain possession or control of the relevant securities.

A. New Reserve Account Computations for PAB Accounts

The Proposed Amendments would modify Rule 15c3-3 to require broker-dealers to treat proprietary accounts they carry for U.S. or foreign broker-dealers ("PAB accounts") much like customer accounts for purposes of the Reserve Formula requirements under Rule 15c3-3.[3]

Currently, neither U.S. nor foreign broker-dealers are "customers" for purposes of Rule 15c3-3, and a firm carrying their accounts is not required to take them into account in performing its Reserve Formula calculation. This approach is somewhat inconsistent with SIPA, however, which treats broker-dealers as "customers" entitled to share *pro rata* in the customer property of the failed broker-dealer. Thus, according to the Proposing Release, although a broker-dealer is not required to "reserve" for accounts it carries for other broker-dealers, if the carrying firm is subject to liquidation under SIPA those other broker-dealers may be able to share in the customer property of the insolvent

---

[2] "Fully paid securities" are securities carried in any type of account for which the customer has made full payment. *See* Rule 15c3-3(a)(3). "Excess margin securities" consist of securities having a market value in excess of 140% of the amount the customer owes the broker-dealer. *See* Rule 15c3-3(a)(5).

[3] A "PAB account" would not include "an account where the account owner is a guaranteed subsidiary of the carrying broker or dealer, the account owner guarantees all liabilities and obligations of the carrying broker or dealer, or the account is a delivery-versus-payment account or a receipt-versus-payment account." Proposed amendment to paragraph (a)(16) of Rule 15c3-3.

firm, thus increasing the risk that customer claims will exceed the amount of customer property available.

The Proposed Amendments would address this inconsistency by requiring a carrying broker-dealer to perform a separate Reserve Formula calculation for PAB accounts and to establish and fund a separate Reserve Account for its PAB accounts.[4] A broker-dealer thus would maintain two Reserve Accounts – one for customers, and one for PAB accounts.[5] If the PAB Reserve Formula computation results in a deposit requirement, the Proposed Amendments would permit the requirement to be offset by excess debits (if any) in the customer Reserve Formula computation of the same date. However, the reverse offset would not be permitted – *i.e.*, a computed deposit requirement for customers could not be reduced by excess debits in the contemporaneous PAB Reserve Formula calculation.[6]

The Proposed Amendments would impose a capital charge on broker-dealers whose cash is carried by another broker-dealer that does not comply with the new PAB Reserve Account requirements.[7] The Proposing Release states, however, that the SEC "would not expect broker-dealers to audit or examine their carrying broker-dealers to determine whether the carrying broker-dealer is in compliance with the proposed rules."[8]

Under the Proposed Amendments, a broker-dealer would not be required to maintain physical possession or control of fully paid and excess margin securities carried for PAB accounts (as it must for customer accounts), provided the carrying broker-dealer obtains the written permission of the PAB accountholder to use such securities in the ordinary course of the carrying broker-dealer's securities business.[9]

---

4 The Proposed Amendments codify many requirements applicable to proprietary accounts of introducing brokers set forth in a 1998 no-action letter, although that letter did not extend to foreign broker-dealers or banks. *See* Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Raymond J. Hennessy, Vice President, New York Stock Exchange LLC ("NYSE"), and Thomas Cassella, Vice President, NASD Regulation, Inc. (Nov. 10, 1998).

5 Proposed amendments to paragraphs (e) – (g) of Rule 15c3-3.

6 "This means the carrying broker-dealer could use PAB credits to finance 'customer' debits, but not the other way around. Thus, 'customers' (which include retail investors but exclude broker-dealers) would receive greater protection." Proposing Release at 12864.

7 Proposed amendment to paragraph (c)(2)(iv)(E) of Rule 15c3-1.

8 Proposing Release at 12864.

9 Proposed amendment adding new paragraph (b)(5) to Rule 15c3-3.

B. Limits on Banks Eligible to Hold Cash Deposits in Reserve Accounts

The Proposed Amendments would prohibit a broker-dealer from counting toward its Reserve Account requirements (both customer and PAB): (i) any cash deposit at an affiliated bank; and (ii) any cash deposit at an unaffiliated bank to the extent such deposit exceeds 50% of the broker-dealer's excess net capital (based on its most recent FOCUS report) or 10% of the bank's equity capital (based on its most recent Call Report or Thrift Financial Report). [10]

According to the Proposing Release, these restrictions reflect the SEC's concern that because cash deposits in a Reserve Account are "fungible with other deposits carried by the bank and may be freely used in the course of the bank's commercial lending activities," there is a risk that such cash "could be lost or inaccessible for a period if the bank experiences financial difficulties."[11] The SEC appears especially concerned about these risks when the deposits are held at an affiliated bank, since a broker-dealer may not be as diligent in reviewing the financial soundness of an affiliate, and in any event if the broker-dealer's parent becomes insolvent any deposits held by an affiliate may provide little protection to customers.[12]

The Proposed Amendments would not restrict the banks in which a broker-dealer may deposit "qualified securities" for Reserve Account purposes, since under current rules a bank must agree not to re-hypothecate such securities and they therefore should be readily available to satisfy claims of the broker-dealer's customers.

C. Money Market Funds Eligible for Reserve Account Deposits

The Proposed Amendments would expand the definition of "qualified securities" eligible to meet Reserve Account requirements to include money market funds (as described in Rule 2a-7 of the Investment Company Act of 1940) that: (i) invest only in securities issued or guaranteed by the United States as to principal and interest; (ii) are not affiliated with the broker-dealer; (iii) agree to redeem fund shares in cash no later than the business day following a redemption request by a shareholder; and (iv) have an amount of net assets equal to at least 10 times the value of the shares held by the broker-dealer for purposes of its Reserve Account requirements.[13]

---

[10] Proposed amendment adding new paragraph (e)(5) to Rule 15c3-3.

[11] Proposing Release at 12864.

[12] Proposing Release at 12864.

[13] Proposed amendment to paragraph (a)(6) of Rule 15c3-3.

D. Possession or Control of Securities Allocated to Firm Short Positions

As noted above, under Rule 15c3-3 a broker-dealer must take certain steps to obtain possession or control of securities when there is a segregation deficit. According to the Proposing Release, however, Rule 15c3-3 does not presently require such action when a short position on the broker-dealer's stock record allocates to a customer's long position – *e.g.*, if the broker-dealer sells a security short to a customer, the broker-dealer is not required to have possession or control of the security, even if the customer pays for it in full. Instead, the broker-dealer enters the mark-to-market value of the security as a credit item in the Reserve Formula. The cash paid by the customer to purchase the security can be used to meet any increased Reserve Account requirement caused by the credit item. The Proposing Release states that this approach in effect permits the broker-dealer to "monetize" a customer's fully paid security, which the SEC considers inconsistent with the objectives of Rule 15c3-3.[14]

To address this concern, the Proposed Amendments would modify Rule 15c3-3 to require a broker-dealer that has a segregation deficit in securities to take prompt steps to obtain possession or control over any such securities included on the broker-dealer's books as a proprietary short position or as a short position for another person.[15] Such action would not be required until the short position had aged more than 10 business days (or more than 30 calendar days if the broker-dealer is a market maker in the securities).[16]

E. Treatment of Free Credit Balances

1. *New Requirements for Sweeps or Other Transfers*

The Proposed Amendments would add a new paragraph to Rule 15c3-3 governing the use of sweep arrangements for customer "free credit balances" (*i.e.*, in general, funds payable to a customer on demand, such as cash deposits).[17] Currently, broker-dealers may offer to transfer (sweep) customers' free credit balances to money

---

[14] In particular, the Proposing Release states that if the increased Reserve Account deposit "is less than the cash paid, the broker-dealer could use the excess funds in its own business operations. Moreover, if the value of the security decreases, the broker-dealer could withdraw funds out of the Reserve Account and use them as well." Proposing Release at 12865.

[15] Proposed amendment adding paragraph (d)(4) to Rule 15c3-3.

[16] The proposed amendment would not apply to securities that are sold for a customer but not obtained from the customer within 10 days after the settlement date, since according to the SEC this situation is already addressed by Rule 15c3-3(m). Proposing Release at n.31.

[17] Proposed amendment adding new paragraph (j) to Rule 15c3-3.

market funds or interest bearing bank accounts to earn higher interest rates. Broker-dealers may also subsequently seek to change the product into which a customer's funds are swept. The Proposing Release notes concern that customers be fully informed of the differences among sweep products, particularly with respect to the insolvency and credit risks (*e.g.*, SIPA protections vs. FDIC insurance, the extent to which principal is at risk, etc.). Accordingly, the Proposed Amendments would prohibit a broker-dealer from transferring customers' free credit balances except under three circumstances.

First, a broker-dealer may dispose of a free credit balance upon specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified by the customer. According to the Proposing Release, this provision "is not addressing free credit balance sweeps to money market funds and bank deposit accounts, but rather the use of customer free credit balances for other purposes," such as purchasing securities other than money market funds.[18]

Second, for customer accounts opened on or after the effective date of the Proposed Amendments, a broker-dealer may sweep free credit balances into a money market fund or bank deposit account (and subsequently change between such sweep options) if:

(i) The customer previously affirmatively consented to such treatment of its free credit balances after being notified of the terms and conditions of such products and of any changes between such products;

(ii) The broker-dealer provides the customer all notices and disclosures regarding free credit balances required by its SRO;[19]

(iii) The broker-dealer notifies the customer in the quarterly statement of account that the money market fund or bank deposit account can be liquidated on the customer's demand and converted back into free credit balances held in the customer's securities account; and

(iv) The broker-dealer provides the customer with at least 30 calendar days' notice before the free credit balances will begin being transferred to a different product, or into the same product but under

---

[18] Proposing Release at 12866.

[19] The NYSE has also addressed disclosure responsibilities with respect to sweep programs. *See* NYSE Information Memo 05-11 (Feb. 15, 2005) (discussing the responsibilities of a broker-dealer offering a bank sweep program to, *inter alia*, disclose material differences in interest rates among sweep products as well as the terms, conditions, risks, features, conflicts of interest, current and future interests rates, and insolvency protection regarding the sweep program).

materially different terms and conditions. The notice would need to explain how the customer could opt out of the change.

Third, for customer accounts opened before the effective date of the Proposed Amendments, a broker-dealer may change the sweep option of an account if the broker-dealer complies with items (ii), (iii), and (iv) above. The broker-dealer would not be required to obtain the prior consent in item (i) from existing customers.

2. *Rule 15c3-2 Rescinded, Incorporated into Rule 15c3-3*

The Proposed Amendments would rescind Rule 15c3-2, which requires a broker-dealer to provide customers on whose behalf it holds free credit balances with certain information on a periodic basis. The SEC notes that Rule 15c3-3, which was adopted after Rule 15c3-2, has "eliminated the need to have a separate Rule 15c3-2."[20] However, certain provisions of Rule 15c3-2 would be transferred to Rule 15c3-3, such as the requirement that a broker-dealer inform its customers of the amounts due to them and that such amounts are payable on demand.[21]

3. *"Proprietary Accounts" Under the Commodity Exchange Act Excluded from Definition of "Free Credit Balances"*

For broker-dealers that are also futures commission merchants under the Commodity Exchange Act ("CEA"), the definition of "free credit balances" under Rule 15c3-3(a)(8) excludes funds carried in commodities accounts that are segregated in accordance with the requirements of the CEA. Under applicable CEA regulations, however, certain types of accounts ("proprietary accounts") are not subject to a segregation requirement. Questions have arisen as to whether a firm carrying these types of proprietary accounts must treat their funds as "free credit balances" when performing their Reserve Account calculations. Since these proprietary accounts would likely not be protected as "customer" accounts under SIPA (because they relate to futures positions rather than securities positions), the Proposed Amendments would clarify that funds in such accounts should not be treated as "free credit balances" for purposes of a firm's Reserve Account calculations.[22]

---

[20] Proposing Release at 12867.

[21] Proposed amendment adding new paragraph (j)(1) to Rule 15c3-3.

[22] Proposed amendment to paragraph (a)(8) to Rule 15c3-3.

F. Treatment of Futures in a Portfolio Margin Account

The Proposed Amendments seek to provide the protections of Rule 15c3-3 and of SIPA to futures positions carried in a securities account under a portfolio margining regime.

The NYSE, the Chicago Board of Options Exchange, Incorporated ("CBOE"), and the National Association of Securities Dealers, Inc. ("NASD") recently amended their margin rules to expand the ability of member firms to compute margin requirements using a portfolio margining methodology. Among other provisions, these portfolio margin rules permit a customer to combine securities and futures positions into a single portfolio margin account, which is treated as a securities account.[23] SIPA, however, only protects customer claims for cash and securities, and it specifically excludes claims related to futures contracts that are not also securities. This raises questions as to how futures held in a portfolio margin account would be treated in a SIPA liquidation.[24]

The Proposed Amendments make two changes intended to address this uncertainty. First, the definition of "free credit balances" would be amended to include "liabilities carried in a securities account pursuant to [approved portfolio margining rules], including daily marks to market, and proceeds resulting from closing out futures contracts and options thereon, and, in the event the broker-dealer is the subject of a proceeding under SIPA, the market value as of the 'filing date' as that term in defined in SIPA … of any long options on futures contracts."[25] According to the Proposing Release, this modification will cause claims for these positions to constitute claims for "cash" under SIPA, and therefore to be part of the customer's net equity claim in a SIPA proceeding. As free credit balances, futures-related funds in a portfolio margin account also would need to be treated as credit items in the Reserve Formula.

Second, the Proposed Amendments would permit broker-dealers to include as a debit in the Reserve Formula customer margin required and on deposit with a futures clearing organization "related to the following types of positions written, purchased or sold

---

23 SEC Release No. 34-54918 (Dec. 12, 2006); 71 Fed. Reg. 75790 (Dec. 18, 2006) (NYSE amendments); SEC Release No. 34-54919 (Dec. 12, 2006), 71 Fed. Reg. 75781 (Dec. 18, 2006) (CBOE amendments); SEC Release No. 34-55471 (Mar. 14, 2007), 72 Fed. Reg. 13149 (Mar. 20, 2007) (NASD amendments).

24 Note that there are other issues raised by including futures in a securities account, such as compliance with the segregation regime for customer assets under the CEA. *See* Cleary Gottlieb, "SEC Approves Amendments to NYSE and CBOE Margin Rules that Substantially Expand Portfolio Margining," Jan. 3, 2007, *available at* http://www.cgsh.com/english/news/alertdetail.aspx?id=514, at pp. 23-24.

25 Proposed amendment to paragraph (a)(8) of Rule 15c3-3.

in customer accounts: (1) security futures products and (2) futures contracts (and options thereon) carried in a securities account pursuant to an SRO portfolio margining rule ...."[26] Since SIPA defines customer property to include "resources provided through the use or realization of customers' debit cash balances and other customer-related debit items as the [SEC] defines by the rule," according to the Proposing Release this amendment would permit such margin on deposit with a futures clearing organization to be considered "customer property" in a broker-dealer liquidation, available for distribution to the broker-dealer's customers.

G. Aggregate Debit Items Charge for "Alternative Standard" Firms

The Proposed Amendments would allow broker-dealers using the "alternative standard" for calculating net capital to reduce aggregate debit items by 1%, instead of 3% as currently specified in Note E(3) to Rule 15c3-3a.[27] This modification would treat firms using the "alternative" standard on a par with firms using the "basic method" for computing net capital. The SEC estimates that the reduction to 1% would decrease the industry-wide Reserve Account requirement by $7.6 billion.[28]

The current requirement to reduce aggregate debit items by 3% effectively increases Reserve Account deposits since it reduces the amount of debits available to offset aggregate credits. In the Proposing Release, the SEC notes that in recent years the amount of debit items carried by broker-dealers has increased substantially, causing firms to increase Reserve Account deposits by amounts "far in excess of the additional cushion envisioned" when the alternative standard was adopted.[29] According to the SEC, the level of risk assumed by broker-dealers does not increase proportionately as the amount of debits increases (partly because of an increase in diversity among the debits), and a uniform 1% reduction should provide an adequate cushion.[30]

---

[26] Proposed amendment to Rule 15c3-3a at Item 14.

[27] Proposed amendment to paragraph (a)(1)(ii)(A) of Rule 15c3-1.

[28] Proposing Release at 12882-83.

[29] Proposing Release at 12868.

[30] *Id.*

H. Technical Changes to Definitions

The Proposed Amendment would modify the definitions of "fully paid securities,"[31] "margin securities,"[32] and "bank"[33] in Rule 15c3-3. The Proposing Release specifically requests comment on the substantive impact of the amended definitions, stating that the Proposed Amendments are "not intended to substantively change the meanings of these defined terms but, rather, to remove text that is superfluous or redundant."[34]

II. Proposed Amendments to the Net Capital Rule

Under the SEC's net capital rule, Rule 15c3-1, broker-dealers must maintain a minimum amount of "net capital," which is defined as the firm's net worth (determined in accordance with generally accepted accounting principles) reduced by certain assets that are not readily convertible into cash (*e.g.*, fixed assets), and by certain percentages of securities positions or other liquid assets of the broker-dealer. The rule is generally intended to protect customers and markets by limiting the amount of leverage broker-dealers may assume and by providing an adequate cushion against broker-dealers' market and credit risk exposures to reduce the risk of insolvency.

A. New Capital Charges

1. *Liabilities or Expenses Assumed by Third Parties*

The Proposed Amendments would require a broker-dealer to take a capital charge for (*i.e.*, subtract from net worth when determining its regulatory capital) any liability or expense relating to the business of the broker-dealer for which a third party has assumed responsibility for payment, unless the broker-dealer can demonstrate that the third party has adequate resources independent of the broker-dealer to pay the liability or expense.[35] The

---

[31] Proposed amendment to paragraph (a)(3) of Rule 15c3-3 ("The term *fully paid securities* shall include all securities carried for the account of a customer unless such securities are purchased in a transaction for which the customer has not made full payment.").

[32] Proposed amendment to paragraph (a)(4) of Rule 15c3-3 ("The term *margin securities* shall mean those securities carried for the account of a customer in a margin account as defined in section 4 of Regulation T …, as well as securities carried in any other account … other than the securities referred to as [fully paid securities].").

[33] Proposed amendment to paragraph (a)(7) of Rule 15c3-3 (referring only to "Canada," not the "Dominion of Canada").

[34] Proposing Release at 12874.

[35] Proposed amendment adding new paragraph (c)(2)(i)(F) to Rule 15c3-1.

Proposing Release expresses concern that failing to exclude from net worth expenses covered by a parent or affiliate may misrepresent the firm's actual financial condition in circumstances where the third party is dependent on the resources of the broker-dealer to pay the expenses.[36]

2. *Non-Permanent Capital Contributions*

The Proposed Amendments would also require a broker-dealer to take a capital charge for any contribution of capital to the broker-dealer: (i) under an agreement that grants the investor an option to withdraw the capital; or (ii) that is intended to be withdrawn within a period of one year (unless the withdrawal has been approved in writing by the broker-dealer's designated examining authority ("DEA")).[37] Any withdrawal of capital made within one year of its contribution to the broker-dealer is presumed to be subject to this charge. According to the Proposing Release, this amendment is intended to address the SEC's concern that although capital contributions to a broker-dealer should not be temporary, broker-dealers may be receiving capital contributions from individual investors that are subsequently withdrawn after a short period of time.[38]

3. *Excess Deductibles for Fidelity Bonds*

SRO rules typically require certain broker-dealers to comply with mandatory fidelity bonding requirements but permit the broker-dealer to maintain a deductible.[39] If a broker-dealer maintains a deductible in excess of certain maximums, SRO rules require the broker-dealer to deduct the excess amount when calculating its net capital under Rule 15c3-1. However, Rule 15c3-1 itself does not specifically reference this deduction, so broker-dealers are not required to indicate its impact in their FOCUS reports. The Proposed

---

[36] The SEC staff had previously addressed expenses paid by third parties in a 2003 letter. *See* Letter from Michael A. Macchiaroli, Associate Director, SEC, to Elaine Michitsch, NYSE, and Susan Demando, NASD (Jul. 11, 2003). The Proposing Release specifically requests suggestions for appropriate metrics and records by which "a broker-dealer could demonstrate a third party's current financial capacity," and proposes that such records might include "the third party's most recent and current (*i.e.*, as of a date within the previous twelve months) audited financial statements, tax return or regulatory filing containing financial reports." Proposing Release at 12871-72.

[37] Proposed amendment adding new paragraph (c)(2)(i)(G) to Rule 15c3-1

[38] Proposing Release at 12871.

[39] *See, e.g.*, NYSE Rule 319; NASD Rule 3020; CBOE Rule 9.22.

Amendments would add a provision to Rule 15c3-1 that explicitly requires a capital charge for the excess of any deductible amount over the maximum permitted under SRO rules.[40]

B. Prohibition on Being "Insolvent"

The Proposed Amendments would amend Rule 15c3-1 to provide that if a broker-dealer is "insolvent," it is not in compliance with its net capital requirements, and must cease its securities business. An "insolvent" broker-dealer would also be required to provide immediate notice to the SEC and other appropriate regulators.[41] According to the Proposing Release, insolvent broker-dealers pose a significant credit risk to counterparties, the clearance and settlement systems, and the ability of a SIPA trustee to make customers and other creditors whole.[42]

A broker-dealer would be considered "insolvent" for these purposes if it:[43]

(i) Is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate the broker-dealer or its property, whether commenced voluntarily or involuntarily;

(ii) Is applying for the appointment or election of a receiver, trustee, or liquidator or similar official for the broker-dealer or its property;

(iii) Has made a general assignment for the benefit of its creditors;

(iv) Is insolvent within the meaning of section 101 of title 11 of the United States Code or is unable to meet its obligations as they mature, and has made an admission to such effect in writing or in any court or before any agency of the United States or any State; or

(v) Is unable to make such computations as may be necessary to establish compliance with Rule 15c3-1.

---

40 Proposed amendment adding new paragraph (c)(2)(xiv) to Rule 15c3-1

41 Proposed amendment to paragraph (b)(1) of Rule 17a-11.

42 Proposed amendment to paragraph (a) of Rule 15c3-1.

43 Proposed amendment adding new paragraph (c)(16) to Rule 15c3-1

C. SEC Authority to Restrict All Withdrawals of Capital

Rule 15c3-1(e) currently allows the SEC, under specified circumstances, to restrict a broker-dealer from permitting or making any withdrawals, advances or loans that, when aggregated with all other withdrawals, advances or loans on a net basis during a 30 calendar day period, exceed 30% of a broker-dealer's net capital. The SEC has used this authority, which was adopted following the failure of Drexel Burnham Lambert, Inc., only once, in connection with the REFCO bankruptcy.[44]

The Proposing Release notes that "regulators often discover that the books and records of a troubled broker-dealer are incomplete or inaccurate," making "it difficult to determine the firm's actual net capital and excess net capital amounts."[45] Accordingly, the Proposed Amendments would delete the 30% limit, thereby allowing the SEC to restrict all withdrawals, advances or loans where the SEC concludes that the withdrawal, advance or loan may be detrimental to the financial integrity of the broker-dealer, or may unduly jeopardize the broker-dealer's ability to repay its customer claims or other liabilities.[46]

D. Requirements for Listed Options and Money Market Funds

The Proposed Amendments would make permanent certain relief previously granted on a temporary basis (and subsequently extended by no-action letter)[47] that effectively reduced the capital charges a firm carrying the account of an option specialist or market maker must apply to certain listed options on and related hedge positions in foreign currencies and diversified indexes in such account.[48]

The Proposed Amendments would also reduce the capital charge broker-dealers must apply to positions in money market funds (as defined in Rule 2a-7 of the Investment Company Act) from 2% to 1%.[49]

---

44 *See* SEC Release No. 34-52606 (Oct. 13, 2005).

45 Proposing Release at 12873.

46 Proposed amendment to paragraph (e)(3)(i) of Rule 15c3-1. *Cf.* Rule 15c3-1(e)(3)(i)(B).

47 *See* Rule 15c3-1a(b)(1)(iv)(B); Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Richard Lewandowski, Vice President, Regulatory Division, CBOE (Jan. 13, 2000).

48 Proposed amendment to paragraph (b)(1)(iv) of Rule 15c3-1a.

49 Proposed amendment to paragraph (c)(2)(vi)(D)(1) of Rule 15c3-1.

III. Other Proposed Amendments

A. Requirement to Document Risk Management Controls

The Proposed Amendments would amend Rule 17a-3 to require certain large broker-dealers to make and keep current records documenting any internal risk management controls established by such firms to assist in analyzing and managing the risks (*e.g.*, market, credit, liquidity, operational) associated with their business activities.[50] Such activities include, "for example, securities lending and repo transactions, OTC derivative transactions, proprietary trading and margin lending."[51]

According to the Proposing Release, the amendment to Rule 17a-3 is "designed to ensure that broker-dealers clearly identify the procedures, if any, they use to manage the risks in their business."[52] It does not specify any minimum elements that must be addressed by a firm's internal controls. "[B]roker-dealers that have already documented their internal controls would not be required to take any further steps"[53] beyond meeting new document retention requirements (*i.e.*, maintaining the required records for three years "after the termination of the use of the system of controls or procedures documented therein").[54]

The new recordkeeping requirements would only apply to a firm that has more than: (i) $1 million in aggregate credit items as computed under the Reserve Formula; or (ii) $20 million in capital (including debt subordinated in accordance with Rule 15c3-1d). The SEC estimates there are approximately 500 firms that meet these criteria.[55]

B. Securities Lending and Repurchase Transactions

The Proposed Amendments include two measures "designed to improve regulatory oversight of securities lending and repo transactions."[56]

---

50 Proposed amendment adding new paragraph (a)(23) to Rule 17a-3.

51 Proposing Release at 12871.

52 *Id.*

53 *Id.*

54 Proposed amendment adding new paragraph (e)(9) to Rule 17a-4.

55 Proposing Release at 12871.

56 Proposing Release at 12870.

First, for purposes of the net capital rule a broker-dealer that "participates in a loan of securities by one party to another party" would be deemed to be acting as principal and subject to applicable capital charges.[57] According to the Proposing Release, this amendment is intended to address issues that arose out of the MJK Clearing, Inc. bankruptcy,[58] including disputes as to whether certain broker-dealers were acting as principals or agents in securities lending transactions.[59] A broker-dealer may overcome this presumption and be considered an agent only if:

(i) The broker-dealer has fully disclosed the identity of each party to the other; and

(ii) Each party has expressly agreed in writing that the obligations of the broker-dealer shall 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 shall not include a right of setoff against obligations, if any, of the broker-dealer.

Second, the Proposed Amendments would require a broker-dealer to notify the SEC whenever either (i) the total amount of money payable against all securities loaned or subject to a repurchase agreement or (ii) the total contract value of all securities borrowed or subject to a reverse repurchase agreement exceeds 2,500% of tentative net capital.[60] Transactions in U.S. government securities would be excluded from these calculations.

The SEC estimates that 21 broker-dealers would trigger this notification threshold "on a regular basis."[61] Since the new requirement would be aimed at identifying anomalous situations, the SEC would permit a broker-dealer that engages predominantly in

---

57 Proposed amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1.

58 *See* SEC Litigation Release No. 18641, 2004 LEXIS 706 (Mar. 26, 2004); SEC Complaint, *SEC v. Thomas G. Brooks*, Civil Action No. CV 03-3319 ADM/AJB, United States District Court (D. Minn. Jun. 2, 2003); *SEC v. Thomas G. Brooks*, SEC Litigation Release No. 18168, 2003 SEC LEXIS 1321 (Jun. 3, 2003); SEC Complaint, *SEC v. Kenneth P. D'Angelo et al.*, Case No. LACV 03-6499 CAS (VBKx), United States District Court (C.D.Cal. Sept. 11, 2003); SEC Litigation Release No. 18344, 2003 SEC LEXIS 2173 (Sept. 11, 2003). *See also In re MJK Clearing, Inc.*, 2003 U.S. Dist. LEXIS 5954 (D.Minn. 2003).

59 *See, e.g.*, *Nomura v. E*Trade*, 280 F.Supp.2d 184 (S.D.N.Y. 2003).

60 Proposed amendment adding new paragraph (c)(5) to Rule 17a-11

61 Proposing Release at 12870.

securities lending or repo transactions to submit, in lieu of the SEC notification, monthly reports to its DEA containing certain information regarding such transactions.[62]

IV. Additional Requests for Comment

The SEC also requests comments on three additional matters discussed below that are not specifically addressed in the Proposed Amendments.

A. Early Warning Levels

Rule 17a-11 currently requires broker-dealers using the "alternative standard" of calculating net capital requirements to notify regulators if their net capital falls below 5% of aggregate debit items. According to the Proposing Release, the Capital Committee of the Securities Industry and Financial Markets Association (the "Capital Committee") has argued that a broker-dealer with aggregate debit items exceeding $10 billion would not be approaching financial difficulty simply because its net capital falls below 5% of aggregate debit items. The Capital Committee has instead proposed a tiered approach under which early warning levels are determined as follows: (5% of the first $10 billion in debits) + (4% of the next $5 billion) + (3% of the next $5 billion) + (2.5% of all remaining debits). The SEC requests comments on the Capital Committee proposal. Since SROs have separate early warning rules, any modifications to Rule 17a-11 would need to be accompanied by similar changes to the relevant SRO rules.

B. Harmonizing Capital Treatment of Securities Lending and Repurchase Transactions

The SEC notes concern that the different treatment of repurchase transactions (Rule 15c3-1(c)(2)(iv)(F)) and securities lending transactions (Rule 15c3-1(c)(2)(iv)(B)) for net capital purposes has "created an opportunity for regulatory arbitrage."[63] For example, although a securities loan may be economically similar to a repurchase transaction, for a securities loan net capital charges apply to any deficit, while for a repurchase transaction capital charges apply only when deficits exceed certain percentages. For a securities borrowing transaction capital charges apply when deficits exceed certain amounts, while for a reverse repurchase transaction any deficit is subject to a capital charge. Accordingly, the SEC requests comment on the feasibility and mechanism for making the deductions for both types of transactions consistent.

---

62 *Id.*

63 Proposing Release at 12875.

C. Third-Party Liens on Customer Securities Held at a Broker-Dealer

The SEC requests comment on how third-party liens against customer fully paid securities carried by a broker-dealer should be treated under the SEC's financial responsibility rules. In particular, the Proposing Release notes that situations may arise in which a customer's securities are subject to a lien for a loan from a third party that is made to the customer rather than to the broker-dealer holding the securities. These securities may continue to be held in the customer's account, or may be transferred to a pledge account in the name of the third party lender.

The Proposing Release expresses concern regarding the implications of such arrangements if the broker-dealer is subject to a SIPA proceeding. For example, the Proposing Release raises a question as to whether the SIPA trustee could be placed in the situation of owing securities both to the customer and to the third party lender. In addition, if the securities are subject to liens of multiple creditors, whose exposures to the customer may vary daily based on market movements, the SEC expressed concern that each of these parties may have potentially competing claims for the securities, and that any resulting uncertainty regarding the status of the securities may increase the complexity and costs of a SIPA liquidation.

While requesting comment generally on how to address third party liens, the Proposing Release specifically inquires whether a broker-dealer carrying securities subject to such liens should be required to: (i) include the amount of the customer's obligation to the third party as a credit item in the Reserve Formula; (ii) move the securities subject to the lien into a separate pledge account in the name of the pledgee(s); or (iii) record on its books and records and disclose to the customer the existence of the lien, the identity of the pledgee(s), the obligation of the customer, and the amount of securities subject to the lien.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax