

REPORT ON BROKER-DEALER FINANCIAL RESPONSIBILITY REQUIREMENTS

I. Background

In the past two years, the Association has witnessed the demise of 34 non-exchange and 16 exchange members as a result of financial insolvencies. In addition to these 50 firms countless others, experiencing somewhat less severe capital problems, found it necessary to merge their operations with more financially sound firms while others have had to reduce their scope of activities and reorient their nature of business. In addition, most firms have embarked upon cost reduction programs in an effort to ward off unnecessary drainages of much needed capital so as to remain in compliance with requirements.

This seemingly rapid deterioration in the financial health of the industry has not only been widely publicized by the press but has also aroused the attention of several key legislators. Presently pending before the Congress are several bills designed to afford public investors with insurance protection against future broker-dealer failures.

Although much has been accomplished by the Association in its attempts to locate and assist operationally and financially troubled firms, there is clearly a need for the Association to do much more.

In recent years, many governors, committeemen, committees and staff members have suggested that the current financial requirements for brokers and dealers, as set forth under SEC Rule 240.15c3-1, are not sufficiently restrictive in protecting the interest of the public especially during prolonged periods of

market decline and reduced volume.

However, before delving into the adequacy or inadequacy of current financial requirements, it may be helpful to trace the evolutionary development of the net capital rule.

II. The History of the Net Capital Rule

The forerunner of today's rule is found in Section 8(b) of the Securities Exchange Act of 1934, which states that:

It shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts business in securities through the medium of any such exchange member, directly or indirectly -- (b) to permit in the ordinary course of business as a broker his aggregate indebtedness to all other persons, including customers' credit balances (but excluding indebtedness secured by exempted securities), to exceed such percentage of the net capital (exclusive of fixed assets and value of exchange membership) employed in the business, but not exceeding in any case 2,000 per centum, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.

This section, however, which is still a part of the Act; does not apply to brokers and dealers who do not do a business through the medium of an exchange member and those firms which act exclusively as dealer. Furthermore, it excludes from aggregate indebtedness liabilities incurred outside of a firm's brokerage business (i. e., dealer transactions) even though the firm maybe engaged in a general securities business and be holding customers' funds and securities.

A. The NASD Proposed Capital Rule

It was not until 1942, that the next major development in this general area took place. After having received the overwhelming approval of the member-

ship, the NASD brought before the Commission a proposed amendment to the By-Laws which would have required that all members and prospective members have a fixed minimum net capital of \$5,000, if they dealt directly with customers, and a minimum of \$2,500, if they did not effect certain transactions with the public. In October 1942, after a public hearing on the proposal, the Commission issued an order of disapproval of the proposed NASD rule on the basis that such a requirement was unduly restrictive. The Commission stated that membership in the Association would be denied small firms if this rule as proposed was adopted and therefore would be contrary to Section 15A of the Act under which the Association had been founded. The Commission also cited the NASD's own estimate that the approval of this proposal would have resulted in the expulsion of over one-fourth of the membership. The SEC further stated that the elimination of smaller firms would "vitaly and adversely affect the organization and character of the NASD as representative of the over-the-counter market industry."

B. The SEC's Counter Proposal

Incorporated in the text of the release outlining the Commission's opinion (Securities Exchange Act Release No. 3322) was an announcement of a proposed SEC net capital rule which was ostensibly believed by the Commission to be a better alternative to the NASD proposal. The SEC proposed its rule under Section 15c3 which as amended June 25, 1938, reads as follows:

No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transactions in, or to induce the purchase or sale of, any security (other than an exempted security or

commercial paper, banker's acceptances, or commercial bills) otherwise than on a national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibilities of brokers and dealers.

Primarily on the basis of the precedent established by Section 8(b) of the Exchange Act, the Commission decided to draft its proposed rule in terms of a ratio between net capital and aggregate indebtedness. The proposed rule provided that:

No broker or dealer shall permit his aggregate indebtedness to all other persons (exclusive of indebtedness secured by exempted securities) to exceed 2000 per centum of his net capital (exclusive of fixed assets and value of exchange memberships).

After soliciting comments from interested parties regarding proposed definitions of net capital and aggregate indebtedness and after intensive experimentation with reports filed by broker-dealers pursuant to X-17A-5; the Commission finally declared the rule effective November 9, 1944. The Commission advised that it would be impractical to impose any more comprehensive requirements at this time, but that it would consider appropriate amendments as it acquired additional experience.

Although the haircut deductions for adjusting net capital under this new rule were much less than at present, the method for preparing the computation of net capital is basically the same as it is today. The definition of aggregate indebtedness however, was much more rigid, in that practically all

the liabilities of a firm were considered aggregate indebtedness (AI). The only exclusions from AI were:

- a. Indebtedness secured by exempted securities;
- b. Amounts segregated in accordance with the Commodity Exchange Act; and,
- c. Liabilities on open contractual commitments.

With the following exceptions, all broker-dealers were subject to this rule:

- a. Firms which did not extend credit to any person on securities sold to or purchased for; and
 - b. Firms which did not carry money or securities for the accounts of customers or owe money or securities to customers, except as incident to transactions with or for customers which would be promptly consummated by payment or delivery.
- C. Subsequent Amendments to the Capital Rule

On September 29, 1950, the members of the Boston, Los Angeles, Midwest, New York Curb, New York, Pittsburgh, Salt Lake and San Francisco Stock Exchanges were exempted by the SEC from the capital rule on the basis that the capital requirements of these exchanges were more comprehensive than those of the Commission.

The next major changes in net capital requirements took place in 1955, through the adoption of several amendments to 15c3-1. The essential features of these amendments were:

- a. Amended percentage deductions from net capital of the market value of securities owned by a firm (i. e. , from 5 to 30% on non-convertible debt securities, 20% on cumulative non-convertible preferred stock and 30% on all other securities);

- b. The exclusion of certain types of adequately collateralized liabilities from aggregate indebtedness.
 - c. The treatment of indebtedness obtained pursuant to a "satisfactory subordination agreement" as a part of capital; and,
 - d. The clarification of other minor provisions of the rule.
- D. The Report of the Special Study of the Securities Markets

The next link in the chain of events surrounding the capital rule developed from recommendations made by the Special Study Group in its report provided the Congress on April 3, 1963. Among the recommendations made by the panel was the suggestion that all broker-dealers should be subject to some sort of minimum net capital requirement. The Special Study Report stated however, that although it recommended some kind of minimum requirements, it recognized that such requirements may vary considerably for differing types of broker-dealers. They stated that the requirement need not and should not be a uniform one for all firms but should be appropriately scaled to reflect the type and size of business engaged in. Specifically, the Study Group suggested a minimum net capital of \$5,000 plus \$2,500 for each branch office and \$500 for each salesman employed at any time. In addition, they recommended that all underwriters, whether distributing shares on a "best efforts," "firm commitment," or any other basis, should be required to maintain a minimum net capital of \$50,000, plus 2 per cent of the aggregate of underwriting commitments or undertakings in the most recent 12 month period.

E. The 1965 Amendments

As a result of the Special Study the SEC adopted several amendments to the capital rule, which except for the recent addition of a fails-to-deliver haircut provision, is the exact rule which is in effect today (the amendment with respect to the minimum capital requirements became effective December 1, 1965). In regard to this revised rule, Louis Loss states in his text on Securities Regulation that, "Much later - in 1965 - the Commission amended its own rule to require substantially what the NASD has proposed twenty-three years earlier."

It should also be noted here that the Special Study Report was the principal element in prompting the Securities Act amendments of 1965. Of primary importance here is the Section 15A(b)(5) amendment which reads as follows:

(b) An applicant association shall not be registered as a national securities association unless it appears to the Commission that --

(5) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest ~~so to approve or direct~~, no person shall become a member and no natural person shall become a person associated with a member, unless such person is qualified to become a member or person associated with a member in conformity with specified and appropriate standards with respect to the training, experience, and such other qualifications of such person as the association finds necessary or desirable, and in the case of a member, the financial responsibility of such member (emphasis added). For purposes of defining such standards and the application thereof, such rules may -----

(E) provide that applications to become a member or a person associated with a member shall set forth such facts as the association may prescribe as to training, experience, and other qualifications (including, in the case of an applicant for membership, financial responsibility) (emphasis added) of the applicant and that the association may adopt procedures for verification of qualifications of the applicant.

According to Loss, the purpose of this amendment was to resolve the doubt cast by the SEC's 1942 opinion. In a footnote to Securities Exchange Act Release No. 7507, the SEC stated that, "Under the authority granted by Section 15A(b)(5) of the Securities Acts Amendments of 1964, the NASD can, of course, adopt capital requirements for special categories of members, such as underwriters or market makers, and impose other types of financial responsibility requirements on its members or types of members." Another footnote states that, "A provision of the Securities Acts Amendments of 1964 (Section 15A(b)(5)) was specifically designed to permit the NASD to impose financial responsibility requirements on its members." The release further stated that the Commission felt that a rule imposing minimum capital requirements should be a rule of the Commission rather than the NASD since not all broker-dealers are members of the NASD and also because the NASD does not have the power to move promptly to enjoin violators. In addition, the release indicated that the NASD agreed with this approach, since the Commission's rule did not and was not intended to preclude the NASD from adopting other appropriate financial responsibility standards.

The above discussion serves to clearly establish the Association's authority to adopt capital requirements more stringent and comprehensive than

those of the Commission.

F. Background to the 1965 Amendments

It should be noted here that consideration was given to a variety of differing proposals before the amendments to the SEC capital rule were finally adopted in 1965. At this point, therefore, it may be helpful to the committee to review certain of the major proposals, some of which were eventually adopted while others were eliminated, and the general reactions of some of the interested parties to these proposals.

The more significant proposed amendments to the capital rule were the following:

1. Establishment of minimum net capital requirements for brokers and dealers;
2. Requirements that broker-dealers maintain in liquid form (in cash or government obligations) a specified percentage of the total amount due to customers on free credit balances, with a provision that the deficiency would be a charge against capital;
3. Provisions for a charge against capital of an amount equal to the difference between the amount of margin required on a customer's futures commodity contract under applicable rules of the commodity exchange or clearing corporation, whichever is higher, and the actual amount of margin maintained by such customer on such contract if it is less than that amount;
4. Limitations on the amount of subordinated debt which may be treated as net capital by a broker-dealer; and,
5. Clarification, for net capital purposes, of the treatment of unregistered securities and other securities which cannot be publicly sold because of restrictions.

With respect to item 1 above both the Commission and industry representatives concluded that the recommendation of the special study which would

have required a broker-dealer to have and maintain additional net capital of \$2,500 for each branch office, and \$500 for each salesman, was not appropriate on the basis that the figure for a branch office was arbitrary and impossible to justify in terms of vast differences in the size and activities of the different branch offices of the different firms. Furthermore, the SEC stated that the salesman requirement would be a constantly changing variable which would be difficult to enforce and might even operate to discourage firms from utilizing funds for training and supervision if needed for capital. In connection with this same item, the proposed minimum of \$2,500 for firms whose business is limited to mutual funds or the solicitation of savings and loan shares, and \$5,000 for all other firms, received the support of the Association. The NASD did however, suggest the possibility of eliminating the haircut provision on marketable securities in calculating the minimum requirements.

The proposal for reserve requirements on customers' free credit balances encountered considerable opposition, especially from the NYSE. In responding to this proposal the NYSE based its objections primarily on the fundamental difference between customer free credit balances held by broker-dealers and deposits held by banks. The NYSE argued that demand deposits held by banks are recognized to be subject to immediate withdrawal, but in accordance with banking laws customers' free credit balances held by broker-dealers can only exist when such funds are awaiting reinvestment. The NYSE concluded therefore that customers' free credit balances held by broker-dealers are not subject to the same likelihood of withdrawal as demand deposits held by

banks. In discussing the rigid liquidity tests under both the SEC and NYSE capital rules the exchange pointed out that very few banks would be able to comply with the exchange's capital requirements even though their need for liquidity is more pressing. The NYSE further mentioned the fact that a requirement of this sort was inconsistent with current financial philosophy which emphasizes intelligent management of cash to reduce costs and increase income. They argued that the public customer would not be any more protected by a requirement for a reserve against free credit balances since most firms could comply with this requirement simply by increasing their bank loans without any additions to capital. They further advised that a total of 65 NYSE firms which had cash and government securities in amounts less than 25% of customer free credit balances might have to pay an additional \$2 million annually in interest to banks to borrow the necessary cash required -- a cost which they concluded would be passed on to customers. By acquiring the necessary cash for a reserve ratio via bank loans the NYSE concluded that the status of customer's free credit balances in the event of bankruptcy would not be improved.

Other opponents to this proposal included the IBA and several other exchanges. After considering the arguments offered by the opposition the SEC dropped this proposal.

In connection with item 3 above concerning deductions on customers' commodity futures, the Association did not make any specific recommendations. The proposal as finally adopted was very much similar to that of the exchange and provided for a deduction from capital of 1 1/2% of the market values of the

total long or short futures contracts in each commodity, whichever is greater, carried for all customers.

The next two SEC proposals, items 4 and 5 above, encountered a considerable amount of negative reaction from the financial community. Item 4, which would have restricted the amount of subordinated debt which could be treated as capital, specified that such indebtedness owed to other than "insiders" of the broker-dealer would be limited to 25% of the net worth of the broker-dealer. The reasons for this proposal were:

- a. To encourage the financing of firms by the owners and managers;
- b. To preclude unsophisticated customers from being induced to put up funds and securities without full knowledge of their acts; and,
- c. To preclude undesirables from gaining control of a securities firm.

The industry successfully argued that there is no other American business (such as banking, insurance, etc.) that equates managerial responsibility with capital contributions and therefore questioned the necessity for item (a) above. Industry representatives further argued that although there is a remote possibility that the proposal, if adopted, would bar the undesirable person from gaining control of an enterprise, the value of such a broad restriction was, at best, highly questionable. Finally, the worth of the proposal was challenged on the basis that the unsophisticated customer could be protected against the deceptive tactics of a firm by requiring the lender to complete a subordinated lender application which would be subject to review by a regulatory agency.

In view of the comments of the industry the Commission decided against this proposal. During the course of conversations regarding this proposal, it

was agreed that the Association, as part of its financial responsibility program, would screen subordination agreements to determine whether there has been an overreaching of customers.

As previously mentioned, the SEC proposed to amend Section (c)(2)(B) of the rule to include as assets not readily convertible into cash (1) all securities for which there is no ready independent market; (2) all securities which because of any restriction, arrangement or other limitation cannot be sold by such broker or dealer; and (3) all securities which can be publicly offered or sold by such broker or dealer only after registration under the Securities Act of 1933 or pursuant to some conditional exemption under Section 3(b) of such Act unless and until such securities have been effectively registered or the public offering and sale of such securities may be in compliance with an appropriate exemption under Section 3(b) of such Act. The proposal met with considerable objections.

The objections to item (1) above stemmed from the fact that under this proposal, securities which are readily convertible into cash but for which there is no publicly quoted market, such as municipals, etc., would be excluded from capital. Also, the exclusion from net capital of unregistered securities was challenged on the basis that in many instances these securities are highly liquid since they can be frequently placed with institutional or other type accounts. For the most part, those raising the objections to this proposal suggested that some measure of flexibility should be built into this section so as to permit administrative determinations on a case by case basis. Again, after discussing these matters with the industry the Commission decided against its proposed

revisions to Section (c)(2)(B).

III. NASDAQ and NCC

On the basis of the authority granted the Association under Section 15A(b)(5) of the Act, the NASD adopted financial responsibility standards for market maker participants in the NASDAQ system. Section C 3(a) of part I of Schedule D of the By-Laws requires that:

A registered market maker must continually maintain a net capital of \$50,000 or a net capital of \$5,000 for each security in which it is registered as a market maker, whichever is less. Net capital shall be determined as provided in paragraph (c)(2) of Commission Rule 15c3-1. Further, the registered market maker must furnish such additional financial information as maybe requested by the Corporation.

In adopting this requirement, the Association recognized the need for higher capital requirements for market makers not only as a protection to all other participants in the system, but ultimately to the public customer as well. The NASD took the position that all market makers participating in the system should have the necessary financial resources available to them to adequately cope with the day to day changes in the pressures on supply and demand in the securities in which they make a market.

It has tentatively been determined that all participants in the National Clearing Corporation will have to provide NCC with a financial guarantee bond or some other type of security against non-performance for the benefit of the clearing corporation. The amount of the guarantee bond or other security will probably vary from firm to firm in that it will be based upon volume and the type of transactions cleared. In addition each member will probably be assessed an

amount up to \$2,000 for deposit by NCC into a separate account designated as the "Special Fund". The Special Fund will be utilized by NCC in those situations where a "non-performing clearing member" has a liability to NCC in an amount exceeding his financial guarantee bond or other security. A provision has been made in NCC's proposed rules which will enable NCC to require an additional deposit from each clearing member should the Special Fund become depleted or reduced to a level whereby NCC's ability to satisfy its obligations or carry on with its intended operations is impaired.

IV. Financial Reporting of Members

In connection with any consideration of revisions to the net capital rule it appears relevant to discuss two of the recently adopted financial reporting requirements.

To begin with, on June 28, 1968, the Commission announced the adoption of SEC Rule 17A-10 which requires all brokers and dealers to submit on an annual basis, comprehensive reports concerning income and expenses. The data required to be furnished in these reports is similar to that provided by NYSE members to the exchange in I & E Reports. This reporting requirement was instituted in order to provide the SEC, the NASD and the national securities exchanges with continuous data regarding the ever changing securities industry. When properly analyzed, the various regulatory agencies will be able to assess in an informal way the potential impact of proposed rules and practices. This year, 1970, marks the first year that such reports were required to be filed. Under a plan which was approved by the Commission, the NASD is acting as the

collecting agent of this data from all its members except those who are members of an exchange which exchange has filed a similar plan with the Commission and has also received its approval. As was expected in this first filing year, numerous reporting problems were encountered. However, at the present time most of the errors and inaccuracies have been corrected and the data is being analyzed.

In addition to the annual reporting requirement outlined above, and commencing in January 1971, each member will be required to submit a financial report patterned after 17A-10 four times each calendar year. Unlike the 17A-10, all members, whether or not members of an exchange will be required to submit such reports to the Association. Although the reporting form is patterned after the 17A-10, it is considerably less comprehensive. The purpose of this report requirement is to provide an early warning system by alerting the NASD to impending critical situations in individual firms or in larger segments of the industry.

Both of these reporting requirements will provide the Association with financial data it has never before had. In some measure it will assist the Association in quickly pinpointing those members which are seemingly headed toward financial difficulties. With this information the NASD could initiate immediate action and hopefully ward off potential broker-dealer failures. Furthermore, the reporting requirement in and of itself may also operate to deter possible insolvencies by forcing firms to keep on top of back office operations.

V. Net Capital Requirements of the States

Included in the material previously provided the committee was a

"Summary of Net Capital, Net Worth and Bonding Requirements" of the various states. It is significant to note here that 31.6% of the membership or 1392 members are subject to mandatory net capital provisions of some of the states by statute and/or regulation in amounts in excess of that required under the SEC Net Capital Rule (see Schedule I). It is also worth noting that 39 states plus the District of Columbia have bonding requirements for broker-dealers. Some states will accept deposits of cash or securities in lieu of a bond. In addition other states do not require a broker-dealer to deposit a bond with the state if it has net worth in excess of a specified amount. A total of 1996 members or 45.2% of the membership is subject to bonding requirements in various amounts. For more specific information regarding these requirements please refer to the Summary Sheet.

VI. Net Capital Requirements of the Exchanges

Attached to this report are copies of the net capital rules of the New York, American, Midwest, Pacific Coast and Philadelphia-Baltimore-Washington Stock Exchanges. The major differences in these rules as compared with the SEC Net Capital Rule have been underscored for the committee's convenience.

VII. Current Financial Condition of Members

In order to evaluate properly the potential impact on the membership of possible changes in minimum net capital requirements or other items, it maybe helpful to the committee to review the following table which was prepared on the basis of a recent survey of financial condition of 848 members in District

No. 12. The data, which represents the sampled members' net capital both before and after haircuts, is as of April 30, 1970.

Survey of Financial Data
For District No. 12 Members
as of April 30, 1970

<u>Amount of Net Capital</u>	<u>Before Haircuts</u>		<u>Adjusted Net Capital</u>	
	<u>No. Firms</u>	<u>Cum. No.</u>	<u>No. Firms</u>	<u>Cum. No.</u>
Under \$2500	11	11	20	20
\$2501 - \$5000	23	34	31	51
\$5001 - \$10,000	206	240	258	309
\$10,001 - \$25,000	187	427	171	480
\$25,001 - \$50,000	121	548	116	596
\$50,001 - \$100,000	99	647	88	684
\$100,001 - \$250,000	86	733	76	760
\$250,001 - \$500,000	43	776	30	790
\$500,001 - \$1,000,000	34	810	31	821
\$1,000,001 - \$5,000,000	31	841	24	845
Over \$5,000,001	7	848	3	848
TOTALS	848	X	848	X

Although the survey did not include stock exchange firms, it does represent a reasonable cross section of the balance of the membership; i. e., it includes data from market makers, underwriters, OTC retailers, mutual fund retailers, mutual fund distributors, etc.

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