

U.S. Securities and Exchange Commission
Office of Public Affairs

Briefing Paper: Proposed changes in net capital requirements
for brokers and dealers.

This summary of recommendations which are being made by the staff of the Commission has been prepared in order to assist persons attending an open meeting scheduled for October 1, 1980, in following the discussion at the Commission table. It is neither exhaustive nor definitive, and users should be aware that changes in the proposals under consideration may be made in response to comments by Members of the Commission.

The revisions to the net capital rule for brokers and dealers (17 CFR 240.15c3-1) being proposed today are part of an ongoing effort by the Commission to provide a regulatory environment that permits an efficient deployment of scarce industry capital while at the same time assuring investors that their funds and securities are protected against financial instability and operational weaknesses of brokers and dealers. If approved, these revisions will lower capital required to support certain customer related activities of brokers and dealers and thus release previously committed capital which may be used in other "core" securities activities, such as underwriting and market making.

The net capital rule was substantially revised in 1975 and involved the adoption of a new concept for the computation of required net capital in addition to the traditional method based on a firm's aggregate indebtedness to all persons. This new method is commonly referred to as the "alternative" and

draws heavily on the Customer Protection Rule (17 CFR 240.15c3-3) which was adopted earlier in the 1970's. Both the Customer Protection Rule and the alternative have now been in operation for some years and the Commission is largely satisfied with their success. Based on this, and the fact that industry conditions and firms' securities activities have changed since 1975, Chairman Williams, in January of 1979, requested the participation of the Securities Industry Association in a renewed study of the effectiveness and adequacy of net capital requirements and sent specific staff questions to the SIA's Capital Committee.

In November of 1979, the SIA submitted a list of recommended changes to the net capital rule, many of which are being addressed today. These proposals go to the alternative method of computing net capital and lower capital requirements in areas which the SIA suggests are being currently supported by excess "regulatory" capital. The staff has studied the SIA's recommendations and has developed data assessing their impact. The result has been a determination by the staff that capital requirements may be lowered in certain areas without diminishing customer protection.

The alternative net capital rule determines a firm's net capital requirement based on the level of its customer related activity. Customer activity is measured by the "Reserve

Formula" of the Customer Protection Rule. 1/ The alternative requires a "cushion" of firm net capital above the amount required to satisfy all customer claims. It is the amount of this cushion which is being considered today.

The single largest determinant of a broker-dealer's customer related business is the amount of money owed by customers in cash and margin accounts. The alternative currently requires a cushion of firm capital of 4% of this amount (as well as 4% of certain other customer related items). The proposal being considered by the Commission today is whether this cushion should be reduced to 3% of customer margin account debits (still requiring 4% of all other customer related items). Since margin accounts comprise a large portion of a broker-dealers' customer activity, capital requirements are projected to be reduced by about 16.5%.

Other activities of the broker-dealer require entries in the Reserve Formula and therefore raise capital requirements. When the alternative was adopted, the Commission issued

1/ The Reserve Formula safeguards customer funds by the following method: All monies owed by the broker-dealer to customers or monies generated by permissible uses of customer securities are entered in the Reserve Formula as "credits." All monies owed to the broker-dealer by customers in the form of secured receivables (such as debit balances in margin accounts) are entered in the Reserve Formula as "debits." If the Reserve Formula nets to a credit, that amount must be locked-up in a Reserve Bank Account for the exclusive benefit of customers.

conservative interpretations relative to what items should be deemed customer related and therefore included in the Reserve Formula. Many of these items are arguably not related to customers (such as matched trades where a broker-dealer has simultaneously purchased and sold securities) and perhaps should be excluded from the Reserve Formula, thereby further lowering capital requirements. The Commission will consider this question, as well as examine the additional safeguards recommended by the staff to insure that customers will still be protected from firm exposure in these transactions.

A major portion of this release being considered today is a "concept release" which is designed to establish a dialogue between the Commission, the industry and the investing public on a broad range of questions regarding the Commission's financial responsibility rules. These questions explore the entire issue of the Commission's role in regulating the financial condition of brokers and dealers, how the Commission's requirements affect the business judgments of firms and the adequacy of protecting customers and inspiring confidence in the nation's investing public. The public is strongly encouraged to participate in this important effort.

Finally, in an accompanying release, the Commission will consider the adequacy of percentage deductions ("haircuts")

applied by broker-dealers to their holdings of debt security positions. 2/ Recent high interest rates have caused debt securities to move further and faster than the current haircut structure anticipates. The proposal would increase haircuts on debt securities, thereby creating an additional cushion to protect against adverse market movement.

2/ Haircuts are applied to the market value of securities held in the proprietary or other accounts of the broker-dealer and are designed to protect against adverse market movement pending liquidation of the position.