

Notice to Members

OCTOBER 2003

SUGGESTED ROUTING

Accounting
Executive Representatives
Internal Audit
Legal & Compliance
Operations
Senior Management

KEY TOPICS

Expense-Sharing Agreements
Net Capital
Recordkeeping
SEC Rule 15c3-1
SEC Rules 17a-3, 17a-4, and 17a-5

ACTION REQUIRED

Expense-Sharing Agreements

SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers

Executive Summary

On July 11, 2003, the Securities and Exchange Commission (SEC) Division of Market Regulation (DMR) issued a letter (the "Letter") to clarify its position under SEC Rules 15c3-1, 17a-3, 17a-4, and 17a-5 (collectively, the "financial responsibility rules") regarding the treatment of broker/dealer expenses and liabilities. The Letter addresses situations in which another party has agreed to pay expenses related to the business of the broker/dealer. The Letter's requirements became effective when it was issued; however, the DMR and NASD recognize that some firms may need time to revise existing agreements and to obtain required documentation. NASD members must be able to demonstrate compliance with the requirements stated in the Letter (a copy of which is attached) by no later than December 1, 2003.

Questions/Further Information

Questions concerning this *Notice to Members* may be directed to NASD's Financial Operations Department at (202) 728-8221.

Background

Both NASD and the New York Stock Exchange (NYSE) (collectively, the self-regulatory organizations or the SROs) have become increasingly concerned that some broker/dealers are using expense-sharing agreements as a basis for not recording expenses and liabilities on the broker/dealer's books and records.¹ In such circumstances, the books and records of the broker/dealer may not accurately reflect its operating performance and financial condition and may appear to artificially inflate its profitability and, ultimately, cause it to appear to be in capital compliance when it is not. Further, such firms may continue to conduct a securities business when not in capital compliance, which is a violation of the SEC's Net Capital Rule, as well as a violation of NASD Rule 2110. In addition, as the party paying the expenses of the broker/dealer is usually not a member of an SRO, obtaining books and records related to the broker/dealer's operations can be problematic. As a result, the SROs requested guidance from the DMR concerning the application of the financial responsibility rules 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.

Recording Certain Broker/Dealer Expenses and Liabilities

The Letter addresses nine items/requirements based on how a broker/dealer incorporates an expense-sharing agreement into its operations. For clarification, the nine requirements are repeated below with additional information provided by NASD to explain the requirements of the letter.²

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.

For purposes of this Letter, expenses include all costs for which a broker/dealer would derive direct or indirect benefit and/or for which a broker/dealer would be responsible if another entity had not agreed to pay for it. This would certainly include, but not be limited to, rent, telephone, copy services, etc. A broker/dealer's business is to be understood broadly. It includes the existence of the legal entity that is registered as a broker/dealer (even when not conducting a securities business) and all of that entity's activities (whether or not the activities are securities-related).

The last sentence of this item indicates that a broker/dealer meets the requirements of the Letter if it records its expenses as incurred in amounts determined according to a reasonable allocation, applied on a consistent basis, of the costs assumed by the third party. A reasonable allocation is one that attempts to equate the proportional cost of a service or product to the proportional use of or benefit derived from the service or product. The broker/dealer must be prepared to provide the SROs with evidence of the reasonableness of the expenses.

Members are advised that to the extent a third party pays certain expenses of a broker/dealer, particularly those costs related to compensation of its registered personnel, the third 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.

Further, members are cautioned that an arbitration award rendered against the broker/dealer is a liability of the broker/dealer until it is satisfied in an appropriate manner. See Notice to Members 00-63. NASD will consider any attempt to move the obligations associated with an unsatisfied arbitration award to a third party as a violation of NASD Rule 2110, and the firm may be subject to severe disciplinary action.

Examples:

Fact Patterns 1 and 2:

- 1. An expense agreement provides that the broker/dealer will pay a certain monthly fee to an affiliated company "in consideration of the mutual covenants and agreements to be kept and performed on the part of the parties."*
- 2. An expense agreement states that the broker/dealer will pay its parent \$25,000 per month for "management services and other administrative services" that the parent provides. The written agreement does not further define the services. The broker/dealer does not record any expenses such as rent, utilities, telephone, etc., and management says that all such expenses are included in the \$25,000 per month fee.*

Analysis: In the computations of net capital, each broker/dealer in Fact Patterns 1 and 2 must reduce net worth by its actual expenses as if there were no expense agreement. An expense agreement must enumerate the services or products being provided to the broker/dealer, with a reasonable cost assigned to each.

Fact Pattern 3:

An expense agreement specifies that the broker/dealer will pay its holding company \$1,000 per month for rent and \$500 per month for utilities and telephone services. The broker/dealer occupies two floors of a three-story building, while the holding company and another affiliate occupy the third floor; the holding company pays \$25,000 per month to rent the building, and pays \$15,000 per month for telephones and utilities. Management states that the rent and utilities fees specified in the expense agreement are consistent with the business goals and objectives of both firms, and therefore have been allocated on a reasonable basis.

Analysis: The expenses do not appear to be allocated on a reasonable basis. In its computation of net capital, the broker/dealer must reduce net worth by expenses allocated 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.

To the extent a broker/dealer reflects its expenses and liabilities as part of its general ledger, and maintains proper backup documentation relative to the expense, no other documentation would be necessary relative to items 1 and 2 above. Otherwise, the broker/dealer must maintain the "record" as noted. This record must be updated as expenses are incurred similar to those records that support the broker/dealer's financial statements.

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;
- 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;
- 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.

The Net Capital Rule requires broker/dealers to have sufficient liquid capital to protect the assets of customers and to meet their obligations to other broker/dealers. In calculating net capital, broker/dealers begin with their net worth and then make various positive and negative adjustments. Item 3 refers to the requirement to charge a firm's net worth, in the computation of net capital, for any "liability" noted unless the broker/dealer can comply with all five conditions enumerated in 3(a) through 3(e).

Item 3 indicates that a broker/dealer cannot avoid recording the expenses it incurs as a result of its activities by arranging to have a third party assume responsibility for such expenses, if the third party lacks adequate resources independent of the broker/dealer to pay the costs incurred by the broker/dealer. Further, if the broker/dealer remits funds to such third party, the broker/dealer is viewed as being indirectly liable for the expenses assumed by the third party, and would need to reflect those expenses on the reports it is required to file with the SEC under the financial responsibility rules, as a deduction from net worth in determining net capital.

Upon entering into an expense-sharing agreement and annually thereafter, as of the broker/dealer's fiscal year-end, the broker/dealer has to obtain evidence that the third party has adequate resources independent of the broker/dealer to pay the costs incurred by the broker/dealer.

- i. If the third party is a reporting company under the Securities Act of 1933 and is current on all financial filings required under that Act, the firm may rely on those filings to determine whether the third party has adequate resources apart from the broker/dealer.*
- ii. If the third party is not a reporting company under the Securities Act of 1933, the broker/dealer must obtain evidence pursuant to either a. or b. below, at a minimum, as well as further information as requested by NASD:
 - a. A signed and dated copy of a complete set of the third party's most recent audited financial statements, but in no event with an as-of date older than 12 months; or a signed and dated copy of the third party's most current required Federal income tax return as it has been filed with the Internal Revenue Service within the last 12 months.*
 - b. If the shareholders, partners, or other owners of the third party want their abilities to infuse capital into the third party to be accepted as demonstrating adequate resources independent of the broker/dealer, they must, at a minimum, provide copies of their audited financial statements or Federal income tax returns, using the same twelve-month parameters as in a. Other additional evidence may also be required by NASD.**

With respect to the third party's financial statements, if, for example, the broker/dealer and the third party have a December 31st fiscal year-end, the broker/dealer could submit a copy of the third party's financial statements as of December 31st for the year prior. If the third party's fiscal year-end were June 30th, the broker/dealer would need to provide the third party's financial statements as of June 30th for the current year.

Example:

Fact Pattern 4:

A broker/dealer has an expense agreement under which its parent pays the broker/dealer's rent of \$10,000 per month, and GAAP (Generally Accepted Accounting Principles) does not require the broker/dealer to record a liability to either the vendor or the parent. The broker/dealer is unable to demonstrate to the SRO that the parent has adequate resources independent of the broker/dealer to pay the liability or expense.

Analysis: In its computation of net capital, the firm must reduce net worth by the actual \$10,000 rent expense. The firm must maintain a separate record of the rent 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.

Paragraph (e)(4)(iii) indicates that the notice and limitation provisions on capital withdrawals do not preclude broker/dealers from making required tax payments or paying partners reasonable compensation and that such amounts are not included in the calculation of withdrawals, advances, or loans for the purposes of these provisions.

Item 4 reaffirms the DMR's view that broker/dealers must maintain their financial records using an accrual basis of accounting. Capital withdrawals cannot be used as a means of timing the broker/dealer's recognition of the costs incurred in its operations.

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.

Item 5 is similar to item 4, and reaffirms the DMR's view that broker/dealers must maintain their financial records using an accrual basis of accounting. The difference in the two items relates to the type of accounting treatment that the broker/dealer uses. Item 5 applies, for example, where the broker/dealer's actual expense to a vendor or service provider was recorded on the broker/dealer's general ledger as an expense and a related liability owed to the third party; the third party then forgave the liability, and the broker/dealer removed (debited) the (forgiven) liability and credited a capital contribution from the third party.

The broker/dealer may not record the capital contribution until it demonstrates that the third party paid the expense, or has the financial wherewithal to pay the expense independent of the broker/dealer, and that the broker/dealer will not be obligated to repay the third party for any portion of the expense. To demonstrate the third party's ability to pay, the broker/dealer would need to provide the evidence discussed in the comments under item 3.

Under items 4 and 5, a firm from which capital is withdrawn as described in those items will be required to recalculate its net capital beginning at the date of the incurrence of the expense which was paid by the third party, and to provide telegraphic notice as required per SEC Rule 17a-11, if necessary, based upon the revised computation.

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 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 agreement 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.

If the broker/dealer does not provide appropriate access to all relevant books and records, including those of a third party with which it has an expense-sharing agreement, an SRO may operate under the rebuttable presumption that the broker/dealer was not in capital compliance for the period covered by the expense-sharing agreement.

If the broker/dealer applicant does not provide appropriate access to all relevant books and records, including those of a party that has agreed to assume responsibility for paying all or a portion of the applicant's costs pursuant to paragraph (a)(7) of Membership and Registration Rule 1014, NASD will not permit the applicant to use an expense-sharing arrangement to demonstrate that it is capable of maintaining sufficient excess net capital to support its intended business operations on a continuing basis.

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.

The notification required in item 9 must be made, in writing, to a firm's assigned District Office for both existing and new expense-sharing agreements.

Endnotes

1 Expense-sharing agreements include any arrangement in which another party bears or pays for all or a portion of the costs incurred by a broker/dealer.

2 The redacted portions of the Letter, which are included in this *Notice to Members*, do not include the footnotes; a copy of the original Letter is attached to this *Notice*. The additional information provided by NASD is in italics.



DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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.

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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.