

Notice to Members

APRIL 2007

SUGGESTED ROUTING

Legal & Compliance

Regulatory

Senior Management

Financial and Operational Principals
(FINOPs)

KEY TOPICS

SEC Rule 15c3-1 (Net Capital Rule)

SEC Rule 15c3-3
(Customer Protection Rule)

SEC Rule 17a-5 (Reports to Be Made
by Certain Brokers and Dealers)

GUIDANCE

Frequently Asked NASD Financial and Operational Questions

Executive Summary

NASD is issuing this *Notice to Members (NTM)* to provide member firms with answers to many of the frequently asked questions NASD receives on financial and operational issues. Much of the information is also available on NASD's Web site at www.nasd.com or through a firm's NASD Liaison. Additionally, NASD's Weekly Update emails sent to the Executive Representative of each NASD member firm contain valuable information about important topics of interest to NASD members, including select financial and operational information.

Questions/Further Information

Questions concerning this *Notice* may be directed to Susan M. DeMando, Associate Vice President and Director, Financial Operations, Department of Member Regulation, at (202) 728-8411.

SEC's Net Capital Rule (SEC Rule 15c3-1)

- QA-1. Are members required to maintain an appropriate amount of net capital only as of the close of each business day?
- A. No. SEC Rule 15c3-1(a), which governs net capital requirements, requires a broker or dealer to maintain its required net capital continuously.¹ Broker-dealers must be able to demonstrate moment-to-moment compliance with SEC Rule 15c3-1 (the Net Capital Rule). While perpetual computations are not required, broker-dealers must be able to demonstrate compliance with the Net Capital Rule consistent with the firm's business activities as of the date and time of the computation when requested to do so by any of its regulators.

QA2. What is the net capital treatment for unmet maintenance margin calls for “pattern day traders”?²

- A. When a “pattern day trader” fails to meet special maintenance margin calls, as required (*i.e.*, within five business days from the date the margin deficiency occurs), on the sixth business day only, a member is required to deduct from net capital the amount of unmet maintenance margin calls for its pattern day traders.³ The application of such charges is provided for in SEC Rule 15c3-1(c)(2)(xii) (*Deduction From Net Worth For Certain Undermargined Accounts*).⁴

QA-3. Do unmet minimum equity requirements for customers meeting the definition of “pattern day traders” have any impact on a firm’s net capital?

- A. No. The minimum equity requirement for the accounts of customers meeting the definition of “pattern day trader” is \$25,000. This minimum equity must be deposited in the customer’s account before he or she may day trade and must be maintained in the customer’s account at all times. Unlike unmet maintenance margin calls, broker-dealers are not subject to any additional net capital deductions if a pattern day trader does not meet the minimum equity requirement. However, once the customer’s minimum equity has declined below \$25,000, the firm can no longer permit day trading in that customer’s account until such time as the account meets the \$25,000 minimum equity requirement.

QA-4. What is the net capital treatment for payment for order flow fees receivable?

- A. Payment for order flow fees receivables are deemed to be unsecured receivables. As a result, these receivables must be treated as non-allowable assets pursuant to SEC Rule 15c3-1(c)(2)(iv) (*Assets Not Readily Convertible Into Cash*).⁵

QA-5. When a broker-dealer enters into a reverse repurchase agreement (the purchase of securities with an agreement to sell them on a future, specified date) for its own account with a non-affiliated entity, is the contract value permitted to be treated as an allowable asset for net capital purposes?

- A. A broker-dealer should treat the entire amount of the reverse repurchase agreement contract as a non-allowable asset unless the securities subject to a reverse repurchase agreement are in the possession or control of the broker-dealer and are outside the control of the counterparty.⁶ To the extent the broker-dealer has possession and control of the securities subject to the reverse repurchase agreement, the broker-dealer generally must deduct from net capital the amount of the reverse repurchase agreement deficit (which is the difference between the contract price for resale of the securities and the market value of the securities (if less than the contract price)).⁷

The broker-dealer may reduce the reverse repurchase deficit by any margin or other deposits held by the broker-dealer on account of the reverse repurchase agreement; any excess market value of the securities over the contract price for resale of those securities held by the broker-dealer under any other reverse repurchase agreement with the same party; the difference between the contract price for resale and the market value of securities subject to repurchase agreements with the same party (if the market value of the securities is less than the contract price); and calls for margin, marks to market or other required deposits that are outstanding one business day or less.⁸ In addition, members should remember that, to the extent a broker-dealer engages in reverse repurchase agreements, it must maintain additional net capital in accordance with SEC Rule 15c3-1(a)(9).

QA-6. If a broker-dealer has been the subject of an adverse arbitration award, when should the award be deducted from the firm's net capital?

- A. A broker-dealer that is the subject of an adverse award in an arbitration proceeding should, for net capital purposes, deduct the award at the time the award is made, even though the appeal process has not been exhausted and no judgment has been rendered, because grounds for revision on appeal are very limited. In addition, the award would be included in Aggregate Indebtedness, as there is no exclusion for adverse arbitration awards under SEC Rule 15c3-1(c)(1).⁹

QA-7. When does the undue concentration haircut apply to equity securities?

- A. An undue concentration haircut applies to equity securities upon the initial recognition of the securities as an asset. If, however, the broker-dealer acquired the securities in connection with its capacity as an underwriter in the distribution of the securities, the undue concentration charge is applied on the eleventh business day following the date that the securities are first available for sale.¹⁰

QA-8. What documentation is a broker-dealer required to maintain with respect to capital contributions or distributions?

- A. At a minimum, broker-dealers are required to record the date(s) and amount(s) of all capital contributions or distributions on their general ledger, and have readily available bank statements and other documentation supporting the transfer of assets that describe the source and purpose of the infusion or distribution. The main purpose of this requirement is to assist the SEC and the firm's designated examining authority (DEA) in determining if a capital withdrawal is a reportable event under SEC Rule 15c3-1(e). All capital infusions and distributions must be reflected in the quarterly Statement of Changes in Ownership Equity section of the FOCUS II or IIA Reports. All agreements between broker-dealers and their investors should be in writing.

QA-9. The definition of “dealer” for purposes of determining a firm’s minimum net capital requirements includes “any broker or dealer that effects more than 10 transactions in any one calendar year for its own investment account.”¹¹ Are corrections, cancellations and errors included in determining the 10-transactions total?

A. Corrections, cancellations and errors *generally are not* included in the 10-transactions limitation described under Dealers in SEC Rule 15c3-1(a)(2)(iii)(B). However, because there have been instances, for example, where broker-dealers have attempted to circumvent the dealer requirement of the net capital rule by trading in their error account, as opposed to the error account containing legitimate corrections, the 10-transactions total must be determined on a case-by-case basis.

QA-10: Do proprietary transactions involving the sale of shares of one mutual fund and the purchase of shares of another mutual fund that are part of the same fund family count toward the “more than 10 transactions in any one calendar year” that would make a firm a “dealer” (and impose a \$100,000 net capital requirement) under the net capital rule?

A. Yes. Transactions involving mutual funds (excluding money market mutual funds) within the same family of funds count toward the 10-transactions limitation described under *Dealers* in SEC Rule 15c3-1(a)(2)(iii)(B). A sale and a purchase count as two transactions.¹²

QA-11: Should monthly investments into a mutual fund by a member firm be counted in determining the “more than 10 transactions in any one calendar year” that would make a firm a “dealer” under the net capital rule?

A. In general, yes. However, SEC staff has advised that a *single monthly investment of \$1,000 or less* into a proprietary mutual fund account does not have to be counted in determining whether a firm has exceeded the 10-transactions limitation described under *Dealers* in SEC Rule 15c3-1(a)(2)(iii)(B).¹³

QA-12: If a broker-dealer guarantees an obligation of a subsidiary or an affiliate, what is the impact to the broker-dealer’s net capital?

A. Where the broker-dealer is guaranteeing the financial obligations of a subsidiary or an affiliate, it must consolidate into a single computation all assets and liabilities of the guaranteed entity (Paragraph (a) of Appendix C of the Net Capital Rule). If the broker-dealer is guaranteeing a particular obligation or set of financial obligations of a subsidiary or affiliate, the broker-dealer needs to deduct the notional value of the guarantee when computing its net capital, in accordance with paragraph (d) of same appendix.

QA-13. For net capital purposes, what is the proper treatment of an amount offered by a broker-dealer to settle a formal disciplinary action with NASD?

- A. The broker-dealer must record the loss and related liability when the offer is accepted by NASD's Office of Disciplinary Affairs or is otherwise deemed final under NASD's *Code of Procedure*.

QA-14. *NASD NTM 03-47*¹⁴ provides guidelines for firms to follow when calculating refunds to customers and accounting for their anticipated refund liabilities. Firms determined their probable or estimated liability based upon currently available information in accordance with generally accepted accounting principles. Firms needed to reflect the balance of the breakpoint refund liability and fund such balances (by segregating funds in a reserve bank account or a "(k)(2)(i)" account) until they believed that all customers who did not receive applicable breakpoint discounts had been compensated, or until the time limit for customers to present claims had expired in accordance with applicable law. Since three years have passed since the issuance of the *Notice*, assuming a firm has satisfactorily communicated to its customers the possibility of the overcharge, at what point may a firm discontinue reserving for possible refunds?

- A. The current absence of customers' claims does not on its own support removal of the liability. Prior to reducing or removing this liability, a firm should determine, to the satisfaction of (1) those responsible for the financial management of, and reporting for, the firm and (2) the firm's outside auditors, that such a reduction of the current balance/value, with respect to the firm's securities business and operating practices, is accurate. Firms reducing or removing the liability should maintain workpapers and make such documentation available to NASD staff for review, if requested. Also, firms that reduce or remove the liability may not rely on the reduction/removal as a justification for failing to compensate a customer upon presentation of a bona fide claim, simply because the claim was presented after the reduction/removal of the liability/funds segregation.

Financial Reporting

QB-1. What is the filing due date for a broker-dealer's annual audited financial statements?

- A. Pursuant to SEC Rule 17a-5(d)(5), the annual audit report shall be filed not more than sixty (60) days from the broker-dealer's fiscal year end. SEC Rule 17a-5(d)(6) further states that one copy of the annual audit report shall be filed at the regional or district office of the Commission for the region or district in which the broker or dealer has its principal place of business and the principal office of the designated examining authority for said broker or dealer. Two copies of the annual audit report must be filed at the Commission's principal office in Washington, DC. Copies must also be provided to all self-regulatory organizations of which the broker or dealer is a member.

QB-2. What address should a broker-dealer use to submit its annual audited financial statements to the principal office of NASD?

- A. The annual audit must be filed in hard copy with the NASD Systems Support Department at 9509 Key West Avenue, Rockville, MD 20850. Copies of the annual audited financial statements must also be submitted to the SEC in Washington, DC, and to the appropriate Regional/District Office of the SEC.¹⁵

QB-3. Is my broker-dealer required to have its annual audit prepared by an accounting firm registered with the Public Company Accounting Oversight Board (PCAOB)?

- A. On December 12, 2006, the SEC extended the deadline by which non-public broker-dealers must file financial statements that have been certified by a registered public accounting firm. As a result, all non-public broker-dealers may file with the SEC a balance sheet and income statement and may send to their customers a balance sheet that has been certified by an independent public accountant, instead of by a registered public accounting firm, for fiscal years ending before January 1, 2009.¹⁶

QB-4. What is an oath or affirmation that is attached to the annual audit report?¹⁷

- A. As described in SEC Rule 17a-5(e)(2), the oath or affirmation attached to the annual audit report is an acknowledgement by the broker-dealer that to the best knowledge and belief of the person making such oath or affirmation: (1) the financial statements and schedules are true and correct, and (2) neither the broker or dealer, nor any partner, officer or director, as the case may be, has any proprietary interest in any account classified solely as that of a customer. The oath or affirmation must be made by a person authorized to administer such oaths or affirmations. If the broker or dealer is a sole proprietorship, the oath or affirmation must be made by the proprietor; if a partnership, by a general partner; and if a corporation, by a duly authorized officer.

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- QB-5. When and where should a request for an extension of time for filing a FOCUS II/IIA Report, including Schedule I, or an annual audit be sent?**
- A. A member firm must submit its written request for an extension to its local NASD District Office. Such requests must be received by the local NASD District Office no later than three business days prior to the required filing date for each such FOCUS Report or annual audit. Extensions will only be granted for delays outside the control of the member, e.g. technical difficulties, third-party contractor delays, and auditor delays.¹⁸
- QB-6. Is there a late fee if a FOCUS II/IIA Report, including Schedule I, or annual audit is received by NASD after the due date (or the revised due date, if the firm requested and was granted an extension)?**
- A. Yes. An administrative fee of \$100 for late filings will be imposed for each day that each report was late. The fee will be assessed for a period not to exceed 10 business days.¹⁹ Additionally, a member firm could be subject to formal or informal disciplinary proceedings and fines depending on the circumstances.²⁰
- QB-7. Does NASD recommend specific independent public accountants, service bureaus, clearing firms, consulting firms or law firms?**
- A. No. NASD does not recommend or endorse individuals or entities that provide professional services.
- QB-8. What are the appropriate fields on the FOCUS II and IIA Reports to reflect haircut deductions pursuant to SEC Rule 15c3-1(c)(2)(iv)(J) (*All Other Securities*)?**
- A. Haircut deductions pursuant to SEC Rule 15c3-1(c)(2)(iv)(J) must be reflected in field 3720 for FOCUS II fliers and field 3734 for FOCUS IIA fliers in the Computation of Net Capital sections.
- QB-9. Who should a broker-dealer contact regarding technical problems in submitting a FOCUS Report and/or the annual Schedule I?**
- A. Members should contact the NASD Technical Help Desk at (800) 321-6273.

Miscellaneous

QC-1. Where may a firm locate interpretative issues relating to financial and operational matters?

- A. NASD provides guidance on NASD and SEC rule interpretations on its Web site through the Publications and Guidance > Rules and Interpretations path, which may be directly accessed at www.nasd.com/RulesRegulation/PublicationsGuidance/index.htm. Additionally, NASD routinely sponsors educational programs, webcasts and compliance conferences that are announced on the NASD Web site. As previously noted, NASD also issues weekly update emails to all NASD executive representatives. NASD encourages member firms to use these resources.

QC-2. Where can a firm locate contact information for NASD and SEC offices?

- A. The addresses, telephone numbers and facsimile numbers for NASD and SEC offices are at www.nasd.com/ContactUs/index.htm and www.sec.gov/contact.shtml.

QC-3. How can a member firm remit payment for its CRD/IARD account?

- A. Payments can be made through Electronic Payment via Web CRD/IARD E-Pay, Wire Transfer or check. Checks must be made payable to "NASD." Please include the firm's CRD number on the check.²¹

Endnotes

- 1 See NASD Interpretation of Financial Operational Rules, Net Capital Rule, SEC Rule 15c3-1, *Minimum Net Capital Requirement, "Moment-to-Moment Net Capital Requirement,"* available at: www.nasd.com/finops/moment
- 2 NASD Rule 2520(f)(8)(B)(ii) defines the term "pattern day trader" as "any customer who executes four or more day trades within five business days. However, if the number of day trades is 6% or less of total trades for the five business day period, the customer will not be considered a pattern day trader..."
- 3 See NASD Rule 2520(f)(8)(C).
- 4 SEC Rule 15c3-1(c)(2)(xii) reads as follows: "Deducting the amount of cash required in each customer's or non-customer's account to meet the maintenance margin requirements of the Examining Authority for the broker or dealer, after application of calls for margin, marks to the market or other required deposits which are outstanding five business days or less."
- 5 See *NASD Regulatory & Compliance Alert*, April 1995.
- 6 See SEC Letter to Chicago Board Options Exchange (CBOE), August 21, 1981.
- 7 See SEC Rule 15c3-1(c)(2)(iv)(F)(2)(i). With respect to reverse repurchase agreements with Government Securities Clearing Corporation (GSCC); see also SEC Letter to GSCC, April 1998.
- 8 See SEC Rule 15c3-1(c)(2)(iv)(F)(2)(ii).
- 9 See also *Fox & Co., Inc.*, Exchange Act Release No. 52697, 2005 SEC LEXIS 2822 (October 28, 2005) at www.sec.gov/litigation/opinions/34-52697.pdf.
- 10 See SEC Rule 15c3-1(c)(2)(vi)(M)(1).
- 11 See SEC Rule 15c3-1(a)(2)(iii)(B).
- 12 See *NASD NTM 93-30* (NASD Provides SEC-Approved Clarifications and Interpretations to Recent Net Capital Rule Amendments).
- 13 See *NASD NTM 93-46* (SEC Provides Additional Clarifications and Interpretations to Recent Net Capital Rule Amendments).
- 14 Styled *Refunds to Customers Who Did Not Receive Appropriate Breakpoint Discounts in Connection with the Purchase of Class A Shares of Front-End Load Mutual Funds and the Capital Treatment of Refund Liability*.
- 15 See www.sec.gov/contact/addresses.htm.
- 16 See SEC Order at www.sec.gov/rules/other/2006/34-54920.pdf.
- 17 See www.sec.gov/about/forms/formx-17a-5_3.pdf.
- 18 See *NASD NTM 01-54* (Minor Violations of Rules and Late Fees).
- 19 See NASD By-Laws, Schedule A, Section 4(g).
- 20 See NASD Rule 9216 and *NASD NTM 01-54* (Minor Violations of Rules and Late Fees).
- 21 See www.nasd.com/crd/payments.

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