



Amendments to Financial Responsibility Rules for Broker-Dealers Impact Net Capital

On July 31, 2013, the Securities and Exchange Commission (SEC) announced amendments to Financial Responsibility Rules for Broker-Dealers (Release No. 34-70072; File No. S7-08-07). The amendments impact the net capital rule, customer protection, books and records, and notification rules for broker-dealers. In the 300 plus page release, the SEC stated that the amendments were created to better protect a broker-dealer's customers. Moreover, they will enhance the SEC's ability to monitor and prevent unsound business practices. The rule amendments become effective October 21, 2013.

Key Amendments

Several of the amendments to the Net Capital Rule (Rule 15c3-1) have been pending since 2007, and will have an impact on the computation of net capital by a majority of broker-dealers. The three key amendments to the Net Capital Rule now require (i) deductions from net worth for liabilities or expenses assumed by third parties; (ii) deductions from net worth for non-permanent capital contributions; and (iii) deductions for excess fidelity bonds as established by an SRO.

Assumption of Liabilities and Expenses by Third Parties

Rule 15c3-1(c)(2)(i)(F) sets forth the requirement for a broker-dealer to adjust its net worth when calculating net capital by deducting liabilities or expenses assumed by a third party, if the member cannot demonstrate that the third party has the resources independent of the broker-dealer's income and assets to pay liabilities. This Rule explicitly states that "an expense of a broker-dealer assumed by a third party will be considered a liability for net capital purposes unless the broker-dealer can demonstrate that the third part has adequate resources independent of the broker-dealer to pay liabilities or expenses." This amendment is actually a codification of Notice to Members 03-63, and firms will be able to demonstrate adequacy of the third party's financial resources by maintaining records such as a copy of the third party's tax return, audited financial statements or regulatory filings containing financial reports within the previous 12 months.

Capital Contributions

Rule 15c3-1(c)(2)(i)(G) codifies the requirement for broker-dealers to ensure that capital contributions are in fact true capital contributions and not loans to the broker-dealer. Amounts deposited as capital and withdrawn in less than 1 year will be treated as a liability unless the broker-dealer receives permission in writing from its designated examining authority (DEA). Additionally, broker-dealers allowing investors the option

to withdraw contributed capital within one year of the contribution, will be required to treat the funds as a liability instead of an asset.

Fidelity Bond Deductible

SEC Rule 15c3-1(c)(2)(xiv) codifies FINRA Rule 4360, which requires a deduction of excess fidelity bond coverage from net capital as required by the firm's self-regulatory organization (SRO).

Action Items

In preparation for the Rule becoming effective, firms should consider taking the following action in the near future:

- Review expense sharing agreements to ensure that language regarding the adequacy of the third party's financial resources is clearly discussed, and that the broker-dealer has access to proof of the adequacy of the financial resources.

Maintain a record of all capital contributions and distributions, and review same to ensure that funds are not withdrawn in less than one year.
- Review all agreements with investors in the broker-dealer to make sure that agreements do not contain a provision allowing for the withdrawal of investment capital in less than 1 year.
- Review all fidelity bond coverage, and the current deductible so as to make sure the correct deduction from net capital is taken, if necessary.

We hope that this information has been helpful to you. Should you have any additional questions or concerns, please feel free to contact Daniel E. LeGaye or Michael Schaps by e-mail or phone, at 281-367-2454, or consult with your legal counsel or compliance consultant.

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