

SEC Announces Customer Protection Rule Initiative

Broker-dealers with historical or ongoing instances of non-compliance with the SEC's Customer Protection Rule are encouraged to self-report by November 1, 2016.

On June 23, 2016, the Securities and Exchange Commission's (SEC) Division of Trading and Markets and Division of Enforcement (the Divisions) announced a two-part initiative to identify historical and ongoing violations of Section 15(c)(3) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 15c3-3 thereunder (the Customer Protection Rule).¹

The first part of the initiative — labelled the Customer Protection Rule Initiative (CPR Initiative) — encourages broker-dealers to proactively report to the SEC any potential violations of the Customer Protection Rule, and will provide cooperation credit for firms that self-report. The CPR Initiative outlines a process for self-reporting similar to the SEC's 2014 Municipalities Continuing Disclosure Cooperation Initiative (the MCDC Initiative),² and provides for "favorable" settlement terms in any enforcement recommendation against the self-reporting firm. To be eligible for the CPR Initiative, a broker-dealer must self-report to the SEC by November 1, 2016. Notably, broker-dealers that the Division of Enforcement has already contacted, either as part of the risk-based sweep or otherwise, regarding possible past or continuing non-compliance with the Customer Protection Rule may still be eligible for the CPR Initiative.

Under the second part of the initiative, the Divisions, in coordination with the SEC's Office of Compliance Inspections and Examinations (OCIE), will conduct risk-based sweep examinations of certain broker-dealers to assess their compliance with the Customer Protection Rule. After the SEC staff reviews the information provided in response to the examination, the staff will then consider whether additional information is necessary to ensure the firm's compliance with the Customer Protection Rule, including whether to schedule a further examination of the firm or to initiate an enforcement investigation.

Firms that had experience with the MCDC Initiative will recognize the similar "Hobson's choice" the SEC is presenting. In the MCDC Initiative, firms were forced to self-report even instances the firm believed were relatively immaterial in an effort to avoid what was threatened to be aggressive enforcement with respect to any failures to so report.³ The CPR Initiative will likewise essentially force broker-dealers subject to the Customer Protection Rule to conduct an extensive review of their Customer Protection Rule practices, to assess whether they have violated or are currently violating any Customer Protection Rule requirements and, if so, to consider whether self-reporting such violations to the Divisions pursuant to the CPR Initiative is appropriate.

Overview of the Customer Protection Rule

In general, the Customer Protection Rule is intended to protect customer funds and securities held by broker-dealers, and to prohibit broker-dealers from using such funds and securities to finance their

businesses. In the event of a broker-dealer failure, the Customer Protection Rule seeks to avoid a delay in returning customer securities, or a shortfall in which customers are not made whole, by requiring broker-dealers to safeguard both the cash and securities of their customers. The Customer Protection Rule requires a broker-dealer that maintains custody of customer securities and cash (a “carrying broker-dealer”) to take two primary steps to safeguard these assets.

First, the Customer Protection Rule requires a carrying broker-dealer to maintain a reserve of funds and/or certain qualified securities in an account at a bank (Reserve Account) that is at least equal in value to the net cash owed to customers. The amount of net cash owed to customers is computed under a pre-determined formula in the Customer Protection Rule (the Reserve Formula), which most carrying broker-dealers calculate on a weekly basis. Under the Reserve Formula, the carrying broker-dealer adds up customer credit items that it owes its customers (*e.g.*, cash in customer securities accounts), and then subtracts from that amount customer debit items that the carrying broker-dealer’s customers owe it (*e.g.*, margin loans). If credit items exceed debit items, that net amount must be deposited, or already be on deposit, in the Reserve Account in the form of cash and/or qualified securities.

Second, the Customer Protection Rule requires a carrying broker-dealer to promptly obtain and thereafter maintain physical possession or control over customers’ fully paid and excess margin securities. This generally means that the broker-dealer must hold these securities in one of several locations specified in the Customer Protection Rule, and that the securities be held free of liens or any other interest that a third-party could exercise to secure an obligation of the broker-dealer.

If a broker-dealer fails to maintain the minimum required amount in its customer Reserve Account, the broker-dealer must immediately notify the SEC and the Financial Industry Regulatory Authority, Inc. (FINRA) of the failure. In addition, Section 17(a)(1) of the Exchange Act and Rule 17a-5 thereunder require broker-dealers to certify annually as to their compliance with the Customer Protection Rule.

Process for Self-Reporting

To be eligible for the CPR Initiative, a broker-dealer must provide the following information to the Divisions by November 1, 2016:

- Name of the broker-dealer
- Provision of the Customer Protection Rule implicated in the self-report
- The period during which the non-compliance has occurred and whether the non-compliance is ongoing
- Description of the possible non-compliance
- Amount of customer cash and/or customer securities implicated in possible non-compliance
- Remedial efforts, if any, undertaken to address possible non-compliance
- Any other facts that the self-reporting entity would like to provide to assist the SEC staff in understanding the circumstances that may have led to the possible non-compliance

The Divisions, in coordination with OCIE, will then assess the submission, consult with the broker-dealer, and determine a response. The Divisions may not necessarily recommend an enforcement action against every broker-dealer that files a self-report. Instead, the SEC has laid out three options it will consider for

every self-report of non-compliance with the Customer Protection Rule: guidance from the Division of Trading and Markets; an examination of the firm by OCIE; or an investigation by the Division of Enforcement.

Favorable Settlement Terms

If the Division of Enforcement decides to recommend an enforcement action against a broker-dealer for any violation that is self-reported under the CPR Initiative, it will recommend that the SEC accept a settlement under which the broker-dealer consents to the institution of a cease-and-desist proceeding. The recommendation will also include the following terms:

- The broker-dealer neither admits nor denies the SEC's findings
- The SEC finds that the broker-dealer violated the Customer Protection Rule, and any applicable books and records and reporting charges
- The broker-dealer undertakes to (i) establish appropriate policies and procedures and training; (ii) cooperate with any subsequent investigation concerning the violation, including the roles of individuals and other parties; and (iii) if warranted, retain an independent consultant to conduct a compliance review
- The broker-dealer will pay disgorgement of any ill-gotten gains and penalties

Although the Divisions note that “meaningful cooperation credit,” including in the form of reduced penalties, will be given, the CPR Initiative — unlike the MCDC Initiative — does not include a cap on the amount of civil penalties a broker-dealer may be required to pay as a result of violating the Customer Protection Rule. We can expect that programmatically, the SEC will want to highlight the benefits of self-reporting and thus provide a greater discount for that, as compared with any cooperation after the fact. Nonetheless, the lack of an actual cap or a quantified cooperation credit could make the self-reporting calculus quite difficult in certain situations. Importantly, when deciding whether to self-report, broker-dealers should consider that in the most recent SEC action charging violations of the Customer Protection Rule, which the agency instituted at the same time it announced the initiative, the relief included required admissions of misconduct and a fine exceeding US\$300 million.

For broker-dealers that would be eligible for the terms of the CPR Initiative but that do not self-report pursuant to those terms, the Division of Enforcement offers no assurances that it will recommend the terms outlined above in any subsequent enforcement recommendation. The Divisions have also cautioned that enforcement actions outside of the CPR Initiative could result in the Division of Enforcement or the SEC seeking remedies beyond those described in the CPR Initiative.

No Assurances with Respect to Individual Liability

As under the MCDC Initiative, the Division of Enforcement provides no assurance that individuals associated with entities that self-report under the CPR Initiative will be offered favorable settlement terms if the individuals have violated the federal securities laws. The Division of Enforcement may, therefore, recommend an enforcement action against such individuals, and may seek remedies beyond those available through the CPR Initiative.

Conclusion

Since the Customer Protection Rule already requires broker-dealers to self-report certain violations and material weaknesses in controls that can lead to such violations, failure to report under the CPR Initiative could result in a significant enforcement action. Accordingly, carrying broker-dealers would be well-advised to promptly undertake a review of their previous and ongoing compliance with the requirements of the Customer Protection Rule. To the extent that a carrying broker-dealer is aware of any current or past violations of the Customer Protection Rule, the carrying broker-dealer should carefully consider and weigh the potential costs and benefits of participating in the CPR Initiative.

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Endnotes

¹ Customer Protection Rule Initiative, US Securities and Exchange Commission, Division of Trading and Markets and Division of Enforcement, *available* at: <https://www.sec.gov/divisions/enforce/customer-protection-rule-initiative.shtml>

² Municipalities Continuing Disclosure Cooperation Initiative, US Securities and Exchange Commission, Division of Enforcement, *available* at: <https://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml>

³ See, e.g., SEC Won't be Pinned Down on MCDC Continuing Disclosure Violations, Bond Buyer, Sept. 11, 2015.