Morgan Lewis

alert

financial services lawflash

March 12, 2014

SEC Issues FAQs on Financial Responsibility Rules

The guidance addresses expense arrangements, buy-in procedures, free credit balances, sweep programs, and bulk transfers, among other things.

On March 6, the staff of the Securities and Exchange Commission (SEC) issued long-awaited guidance in the form of frequently asked questions (FAQs)[1] on the financial responsibility rule amendments adopted on July 30, 2013.[2] The FAQs provide guidance on (1) the effective dates of the Financial Responsibility Rules Amendments; (2) amendments to Rule 15c3-1 (the Net Capital Rule); (3) amendments to Rule 15c3-3 (the Customer Protection Rule), including (i) the allocation of customers' fully paid and excess margin securities to short positions, (ii) proprietary accounts of broker-dealers, (iii) the treatment of free credit balances outside a sweep program, (iv) certain sweep program questions, and (v) questions regarding the bulk transfer of customer accounts; and (4) amendments to Rule 17a-11.

Effective Dates

The FAQs clarify the following effective dates:

- **March 3, 2014** is the effective date for
  - all amendments to Rule 15c3-3, except for Rule 15c3-3(j)(1);
  - the amendments to Rule 15c3-3a;
  - the amendments to Rule 17a-3;
  - the amendments to Rule 17a-4; and
  - the amendment to Rule 15c3-1(c)(2)(iv)(E)(2).
- **October 31, 2013** is the effective date for all other amendments.

Amendments to the Net Capital Rule—Rule 15c3-1

Third-Party Expense-Sharing Arrangements

The FAQs clarify, for purposes of Rule 15c3-1(c)(2)(i)(F), that the guidelines set forth in a July 11, 2003 letter (Third-Party Expense Letter)[3] still apply to third-party expense-sharing arrangements. The Third-Party Expense Letter sets forth nine points concerning the application of the financial responsibility rules when a third party—

1. View the FAQs at http://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-financial-responsibility-rule-faq.htm.

2. *See* Financial Responsibility Rules for Broker-Dealers, Release No. 34-70072, 78 Fed. Reg. 51,824 (Aug. 21, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-08-21/pdf/2013-18734.pdf [hereinafter Financial Responsibility Rules Amendments or Amendments]. For more information on the Financial Responsibility Rules Amendments, see our August 27, 2013 LawFlash, "SEC Amends Financial Responsibility Rules for Broker-Dealers," available at http://www.morganlewis.com/pubs/IM_LF_FinancialResponsibilityRulesForBrokerDealers_27aug13. The Financial Responsibility Rules Amendments were originally scheduled to take effect on October 21, 2013. However, on October 17, 2013, the SEC issued an order providing a temporary exemption for broker-dealers from certain of the Financial Responsibility Rules Amendments until March 3, 2014. For more information on the order, see our October 18, 2013 LawFlash, "Temporary Exemption from Certain SEC Financial Responsibility Rules Amendments," available at http://www.morganlewis.com/pubs/IM_LF_TempExemptionFromSECFinancialResponsibilityRules_18oct13.

3. View the Third-Party Expense Letter at http://www.sec.gov/divisions/marketreg/mr-noaction/macchiaroli071103.pdf.

such as a parent holding company or an affiliate of a broker-dealer—agrees to assume responsibility for the payment of the broker-dealer's expenses. The staff clarifies that these nine points are still relevant staff guidance, even though they contain a condition that has been codified into Rule 15c3-1. The staff indicates that a broker-dealer for which the Financial Industry Regulatory Authority (FINRA) is the designated examining authority must demonstrate to FINRA that the third party has adequate resources independent of the broker-dealer as set forth in the National Association of Securities Dealers (NASD) (n/k/a FINRA) Notice to Members 03-63 (Expense-Sharing Agreements).[4]

Amendments to the Customer Protection Rule—Rule 15c3-3

Banks Where Special Reserve Deposits May Be Held

For purposes of Rule 15c3-3(e)(5)—which requires a broker-dealer to exclude the total amount of any cash deposited with an affiliated bank when determining whether the broker-dealer maintains the minimum reserve account deposits under Rule 15c3-3—broker-dealers should refer to the term "affiliated person" in Rule 15c3-3(a)(13) when determining whether a bank is an affiliate.[5]

Allocation of Customers' Fully Paid and Excess Margin Securities to Short Positions

Rule 15c3-3(d)(4) requires a broker-dealer to take prompt steps to obtain physical possession or control of a customer's fully paid and excess margin securities of the same issue and same class as those included on the broker-dealer's books and records that allocate to a short position for more than 30 calendar days. The FAQs explain the following:

- The 30-calendar-day period begins to run when a broker-dealer identifies a segregation deficit in fully paid and excess margin securities that allocates to a short position (e.g., when the deficit is created).
- Broker-dealers are not required to buy in securities and, instead, may borrow securities to meet the requirements of Rule 15c3-3(d)(4).

Proprietary Accounts of Broker-Dealers (PAB Accounts)

Rule 15c3-3(b)(5) states that "[a] broker or dealer is required to obtain and thereafter maintain the physical possession or control of securities carried for a PAB account, unless the broker or dealer has provided written notice to the account holder that the securities may be used in the ordinary course of its securities business, and has provided an opportunity for the account holder to object." The FAQs explain the following:

- On or after March 3, 2014, a broker-dealer should provide the notice to new PAB account holders at the time a PAB account is opened.
- On or after March 3, 2014, if a broker-dealer has not yet sent the written notice to a PAB account holder, then the carrying broker-dealer must treat the PAB account holder's securities in accordance with the possession or control requirements of Rule 15c3-3 until such time as the carrying broker-dealer provides the notice to the account holder and affords the account holder an opportunity to object.
- A carrying broker-dealer may rely on notices sent prior to March 3, 2014 for purposes of compliance with Rule 15c3-3(b)(5).
- The possession and control requirements of Rule 15c3-3(b)(5) are applicable to all securities carried for a PAB account, unless the account holder has not objected to the use of its securities by the carrying broker-dealer.

4. View Notice to Members 03-63 at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003103.pdf.

5. Rule 15c3-3(a)(13) defines an "affiliated person" as "[a]ny person who directly or indirectly controls a broker or dealer or any person who is directly or indirectly controlled by or under common control with the broker or dealer. Ownership of 10% or more of the common stock of the relevant entity will be deemed prima facie control of that entity for purposes of [paragraph (a)(13)]."

- If a PAB account holder whose fully paid and excess margin securities are being used by the carrying broker-dealer under an existing account agreement objects to the continued use of such securities, the carrying broker-dealer should take immediate steps to retrieve the securities, in accordance with the requirements of paragraph (d) of Rule 15c3-3, and maintain them in accordance with the possession or control requirements of paragraph (b) of Rule 15c3-3.

Treatment of Sweep Credit Balances Outside of Sweep Program

Rule 15c3-3(j)(2)(i)—non-sweep programs—allows a broker-dealer to invest or transfer free credit balances in a customer's account to another account or institution only upon a specific order, authorization, or draft from the customer and only as specified by the customer in said order, authorization, or draft. The FAQs state the following:

- A customer's oral communication could meet the requirements of paragraph (j)(2)(i), both for one-time transfers and for transfers to be made on a continuing basis, if (a) the oral communication constitutes a specific order or authorization and (b) specifies (i) the account from which the customer's cash is to be transferred and (ii) the account or institution to which the cash is to be transferred.[6]
- In circumstances where a customer grants control, via a written authorization, over his or her accounts to an agent or pledgee and orders or authorizes his or her broker-dealer to act on orders of the agent or pledgee, the broker-dealer may accept an order, authorization, or draft from the agent or pledgee.

Sweep Program Questions

Rule 15c3-3(j)(2)(ii)—sweep programs—establishes customer disclosure, notice, and affirmative consent requirements for programs where a customer's free credit balances in a securities account are "swept" into a money market mutual fund or an account at a bank whose deposits are insured by the Federal Deposit Insurance Corporation. The FAQs clarify the following:

- In the context of carrying agreements, where a carrying agreement is otherwise compliant with FINRA Rule 4311, the carrying firm may rely on a representation from the introducing broker that the customer has given the introducing broker the required "written" consent to include the customer's free credit balances in the carrying broker-dealer's sweep program under Rule 15c3-3(j)(2)(ii))(A).
- The requirement to provide notice to a customer, as part of the customer's quarterly statement of account, that the balance in the bank deposit account or shares of the money market mutual fund in which the customer has a beneficial interest can be liquidated on the customer's order and the proceeds returned to the securities account or remitted to the customer **is not** inconsistent with money market mutual fund documents that allow the fund a specified period of time to pay redemption proceeds or any applicable rules that would permit money market mutual funds to limit redemptions in certain circumstances. A broker-dealer that sweeps a customer's free credit balances into a money market mutual fund must instruct the fund to redeem the customer's investment when ordered to do so by the customer. When the broker-dealer receives the proceeds, it must return them to the customer's account or remit them to the customer. The redemption itself is subject to the terms and conditions of the money market mutual fund and to applicable laws and regulation.

Bulk Transfer Questions

In connection with bulk transfers, the FAQs clarify the following:

- Broker-dealers that are FINRA members may continue to rely on the guidance provided in FINRA's Notice to Members 02-57 (Bulk Transfer of Customer Accounts)[7] in order to effect a bulk transfer of customers'

6. The FAQs caution, however, that any broker-dealer relying on such an oral communication will bear the burden of demonstrating compliance with the rule.

7. View Notice to Members 02-57 at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003486.pdf.

accounts, including the transfer of free credit balances in the securities accounts of customers at a delivering firm to a receiving firm, without being deemed in violation of Rule 15c3-3(j)(2)(i).

- Broker-dealers receiving bulk transfers may rely on the negative response letters that were used to effect the bulk transfer of customers' accounts as permitted by FINRA NTM 02-57 (for bulk transfers that occur on or after March 3, 2014) to immediately invest customers' free credit balances in products offered through a sweep program at the receiving firm if the following criteria are met:
  - The negative response letter used to effect the bulk transfer of such accounts contains the information and disclosures required by Rule 15c3-3(j)(2)(ii)(A)(1) and (2) and (j)(2)(ii)(B)(1).
  - The customers' free credit balances are invested in a different money market mutual fund at the receiving firm than the one available through the sweep program of the delivering firm. The negative response letters also must comply with the disclosure and notice requirements of NASD Rule 2510(d)(2).
  - The customers' free credit balances were previously invested in a product (either a money market mutual fund or an FDIC-insured bank deposit account) in the sweep program of the delivering firm. The receiving firm must reinvest customers' free credit balances in a substantially similar product in its sweep program to the extent practicable.
- Where there is a bulk exchange at net asset value of money market mutual funds, either outside of a sweep program or in a sweep program, as a result of a merger or acquisition of the money market mutual funds, broker-dealers that are FINRA members may continue to rely on NASD Rule 2510(d)(2) without violating Rule 15c3-3(j)(2)(i) or (ii), **provided that**, where the bulk exchange involves money market mutual funds in a sweep program, the negative response letter used to effect such bulk exchange satisfies NASD Rule 2510(d)(2) and contains the information required by Rule 15c3-3(j)(2)(ii)(B)(3).

Amendments to Rule 17a-11

Rule 17a-11(c)(5) establishes new notification requirements for when a broker-dealer's repurchase and securities lending activities exceed a certain threshold. In lieu of the notification requirement, the final rule provides that a broker-dealer may report monthly its stock loan and repurchase activity to its designated examining authority (DEA) in a form acceptable to its DEA. The FAQs clarify that Rule 17a-11(c)(5) covers only cash (cash-for-collateral) transactions and does not include non-cash (collateral-to-collateral) transactions.

Implications

The FAQs clarify certain interpretive questions raised by broker-dealers throughout the rulemaking process. In other instances, the FAQs may have inadvertently injected further interpretive issues. The FAQs also, in some instances, highlight the need for firms to evaluate their current processes and procedures to fit within such clarifying positions conveyed by the SEC staff.

Buy-in procedures. The FAQs relating to buy-in procedures provide helpful guidance regarding the calculation of the 30-calendar-day period under Rule 15c3-3(d)(4) and a broker-dealer's option to borrow securities to cure any deficit. However, broker-dealers should be wary of regulators' review of potential sham transactions designed to reset certain calculation periods. Broker-dealers should ensure that any buy-in or borrow effected by the broker-dealer to obtain possession or control under the Customer Protection Rule is legitimate and could not be construed as designed to improperly reset the 30-day period. Further, broker-dealers should be aware that, in the event of a trading halt by the SEC, FINRA, or an applicable exchange or a Depository Trust Company "chill," "freeze," or "global lock," an extension of the 30-calendar-day period may be available upon request pursuant to amended Rule 15c3-3(n). We expect the SEC and FINRA to update the Interpretations of Financial and Operational Rules guidance available on FINRA's website to reflect this. In addition, while not discussed in the FAQs, buying in securities, whether to comply with Rule 15c3-3 or otherwise, may be a taxable event and could subject a customer to unforeseen capital gains. Broker-dealers should consider this when determining whether to buy in or borrow securities to comply with Rule 15c3-3(d)(4).

Free credit balance transfers. In connection with free credit balance transfers, broker-dealers that elect to follow the guidance provided in the FAQs will have to develop policies and procedures to ensure that customers' oral communications relating to the transfer of free credit balances are properly documented. Broker-dealers should

consider (i) employing similar procedures to those currently used to document a customer's direction to transfer assets into a money market fund in order to help alleviate the burden of implementing entirely new policies and procedures or (ii) using an order ticket to reflect the transaction that is created contemporaneously with the customer's instruction.

Sweep programs and bulk transfers. The FAQs relating to sweep programs and bulk transfers generally provide that broker-dealers that are FINRA members may continue to rely on certain FINRA rules and guidance relating to the Customer Protection Rule. Broker-dealers should continue to monitor FINRA rules relating to both the Net Capital and Customer Protection Rules as FINRA may update its rules and related guidance to reflect the Financial Responsibility Rules Amendments. However, while the FAQs indicate that NTM 02-57 and Rule 2510(d)(2) still apply, the SEC added the notion that the receiving firm in the case of a bulk transfer should reinvest customers' free credit balances in a "substantially similar product in its Sweep Program to the extent practicable." This statement appears to be tailored more narrowly than the plain text of the rule amendments, which should allow for changes between money market funds and FDIC-insured bank deposit accounts within a sweep program.

In addition, the FAQs note that carrying firms may rely on an introducing broker's representations regarding a customer's "written" consent to include the customer's free credit balances in a sweep program. However, as discussed in no-action guidance issued by the SEC on February 26, 2014, broker-dealers may rely on a customer's verbal consent to have his or her free credit balances included in a sweep program until March 3, 2015, provided that, among other things, the customer's written consent is obtained no later than 90 calendar days after account opening.[8] Carrying broker-dealers should consider whether any such introducing broker's representation—at least during the relevant no-action period—includes that the introducing broker properly documented the verbal consent and obtained the subsequent written consent in the prescribed time period.

We will continue to monitor the issuance of any additional guidance in this area, whether issued by the SEC or FINRA.

Contacts

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis lawyers:

Washington, D.C.

John V. Ayanian	202.739.5946	jayanian@morganlewis.com
Mark D. Fitterman	202.739.5019	mfitterman@morganlewis.com
Steven W. Stone	202.739.5453	sstone@morganlewis.com
Ignacio A. Sandoval	202.739.5201	isandoval@morganlewis.com

New York

Robert C. Mendelson	212.309.6303	rmendelson@morganlewis.com
William J. "Bill" Barbera	212.309.6746	wbarbera@morganlewis.com

About Morgan, Lewis & Bockius LLP

Founded in 1873, Morgan Lewis offers more than 1,600 legal professionals—including lawyers, patent agents, benefits advisers, regulatory scientists, and other specialists—in 25 offices across the United States, Europe, Asia, and the Middle East. The firm provides comprehensive litigation, corporate, transactional, regulatory, intellectual property, and labor and employment legal services to clients of all sizes—from globally established industry leaders to just-conceived start-ups. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

8. View the no-action letter at http://www.sec.gov/divisions/marketreg/mr-noaction/2014/sifma-022614-15c3.pdf. For more information on this no-action letter, as well as certain no-action guidance concerning the use of certain nonaffiliated U.S. branches of foreign banks, see our February 28, 2014 LawFlash "SEC Issues Relief from Certain Financial Responsibility Rule Requirements," available at http://www.morganlewis.com/pubs/IM_LF_SECIssuesReliefFinancialResponsibilityRuleReqs_28feb14.

