Are your customer accounts in order? – SEC announces sweep of broker-dealers and implementation of the customer protection rule initiative

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Abstract

Purpose – *To explain the Customer Protection Rule Initiative announced by the Securities and Exchange Commission (SEC) and offer practical guidance for complying with Rule 15c3-3 under the Securities Exchange Act of 1934.*

Design/methodology/approach – *This article discusses Rule 15c3-3 under the Securities Exchange Act of 1934, related interpretative guidance, and the Customer Protection Rule Initiative announced in June 2016 by the SEC.*

Findings – *This article concludes that broker-dealers should take advantage of the Customer Protection Rule Initiative's self-reporting mechanism and use this time to review their current account arrangements with banks, existing internal policies and procedures, and account documentation.*

Originality/value – *This article contains valuable information about the SEC's Customer Protection Rule Initiative and practical compliance guidance from experienced securities lawyers.*

Keywords *Financial Industry Regulatory Authority (FINRA), Broker-dealer, US Securities and Exchange Commission (SEC), Customer Protection Rule, Reserve account, Self-reporting*

Paper type *Technical paper*

On June 23, 2016, the Securities and Exchange Commission (the "SEC") announced that it would begin a coordinated effort across divisions to identify potential violations by broker-dealers of Rule 15c3-3 (the "Rule") under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). As part of this effort, also known as the Customer Protection Rule Initiative (the "CPR Initiative"), the SEC will conduct a targeted sweep of broker-dealers and encourage firms to self-report any potential violations of the Rule[1]. The CPR Initiative is intended to address historical or ongoing violations of Section 15(c)(3) of the Exchange Act and the Rule. The CPR Initiative covers only broker-dealers and provides no assurance that individuals associated with those entities will be offered similar terms if they have engaged in violations of the federal securities laws. The SEC may also recommend an enforcement action against such individuals beyond those available under the CPR Initiative. The SEC, however, did not specify for how long the CPR Initiative would run.

This article provides a brief summary of the Rule and additional requirements set forth in Financial Industry Regulatory Authority's (FINRA) Interpretations of Financial Operational Rules handbook, which contains FINRA and SEC guidance on the Rule (the

"Interpretative Guidance")[2]. Also provided below are practice pointers to assist broker-dealers in reviewing their current conduct and future compliance with the Rule.

Customer protection – reserves and custody of securities

The Rule, which is commonly known as the "Customer Protection Rule", was first adopted by the SEC in 1972. The Rule has been amended several times, but its primary purpose remains the same: to avoid, in the event of a broker-dealer failure, a delay in returning customer securities or worse, a shortfall in which customers are not made whole, by requiring broker-dealers to safeguard both the cash and securities of their customers[3]. The Rule seeks to achieve this objective by requiring broker-dealers to comply with two primary requirements.

First, the Rule requires broker-dealers to maintain physical possession or control over customers' fully paid and excess margin securities[4]. For purposes of this requirement, physical possession or control means that (i) the broker-dealer must hold fully paid and excess margin securities in certain specified locations and (ii) the securities must remain free of any liens or other security interests.

Second, the broker-dealer must maintain a cash reserve or hold qualified securities in an account that is at least equal in value to the net cash the broker-dealer owes to its customers. The calculation of net cash requires that the broker-dealer add all customer credit items (such as an amount equal to any free cash in customer securities accounts) and deduct any customer debit items (such as margin loans). The net amount by which customer credit items exceed customer debit items, if any, must be held on deposit in the broker-dealer's customer reserve account. The cash or securities held in the account cannot be used by the broker-dealer to finance its own trades or for any other purpose except as a readily available reserve to repay customers.

Physical possession or control of securities

The Rule requires a broker-dealer to take timely steps in good faith to establish and maintain physical possession or control over a customers' fully paid and excess margin securities, subject to certain exceptions such as temporary lags in physical possession due to normal business operations[5]. Physical possession or control generally means that the broker-dealer must hold these securities in one of several locations specified in the Rule and that they be held free of liens or any other interest that could be exercised by a third party to secure an obligation of the broker-dealer.

Securities under the control of the broker-dealer can take many forms and be held in certain types of accounts or locations, such as securities:

- represented by certificates in the custody or control of a clearing corporation or national securities exchange;
- carried in an omnibus credit account in the name of such broker-dealer with another broker-dealer in compliance with the requirements of Section 7(f) of Regulation T;
- subject to bona fide items of transfer;
- held in the custody of foreign depositaries, foreign clearing agencies or foreign custodian banks;
- in the custody or control of a bank as defined in Section 3(a)(6) of the Securities Act of 1933, as amended;
- held or are in transit between offices of the broker-dealer; and
- held in such other locations approved by the SEC upon written application from the broker-dealer[6].

Each of the above has particular nuances as specified in the Rule. For example, with respect to securities held in a bank, the delivery of such securities must not require the payment of money or value. The bank must also acknowledge, in writing, that the securities in its custody or control are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank for its own account or the account of a customer[7]. Furthermore, a broker dealer must obtain and keep in its records a written notification from each bank with which it maintains an account (subject to the Rule), stating that the bank was informed that all cash and/or qualified securities deposited in such account are being held by the bank for the exclusive benefit of the customers and account holders of the broker-dealer in accordance with applicable SEC rules, and are being kept separate from any other accounts maintained by the broker-dealer with the bank. The broker-dealer must have a written contract with the bank, which provides that the cash and/or qualified securities will at no time be used directly or indirectly as security for a loan to the broker-dealer by the bank and will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the bank for its own account or the account of a customer[8]. These requirements are often satisfied by the parties executing a "no-lien" letter with respect to the applicable accounts.

One of the primary purposes of the Rule is to ensure that a broker-dealer in possession of customer funds either deploys those funds in safe areas of the broker-dealer's business related to servicing its customers or, if not deployed in such areas, deposits the funds in a reserve bank account to prevent commingling of customer and firm funds[9].

The special reserve account and reserve account computations

The Rule also requires a broker-dealer to calculate what amount, if any, it must deposit on behalf of customers in the reserve bank account, referred to as the "Special Reserve Bank Account for the Exclusive Benefit of Customers" ("Reserve Account"), under the formula set forth in Exhibit A to the Rule ("Reserve Formula")[10]. Broker-dealers must create and maintain records of such computations, as well as any deposits or withdrawals made from any Reserve Account[11].

Although the Reserve Formula is complex, its main purpose is to ensure that if a broker-dealer owes its customers cash it has sufficient reserves. In simple terms, a broker-dealer must calculate any amounts it owes its customers and the amount of funds generated through the use of customer securities, called credits, and compare this amount to any amounts its customers owe it, called debits. Therefore, any device, window dressing or restructuring of transactions that is made solely to reduce an excess of credits over debits, and that is not otherwise a normal business transaction, may be treated as a circumvention of the Rule[12]. Such computations generally are required to be performed on a weekly basis as of the close of the last business day of the week[13]. Broker-dealers that meet certain requirements under the Rule, such as indebtedness to net capital ratios and aggregate customer fund amounts, may compute the formula on a monthly basis[14]. If credits exceed customer debits, the broker-dealer must deposit that net amount in the Reserve Account to be in compliance with the Rule. Any deposits required to be made, or any withdrawal requested, must be completed no later than one hour after the opening of banking business on the second business day following the relevant computation[15]. These deposits may include, with certain exceptions, money market deposits, time deposits, Individual Retirement Account (IRA) and Employee Retirement Income Security Act (ERISA) contributions, offshore deposits, borrowed treasury securities and certain qualified securities, among others. At any time, if a broker-dealer fails to make a deposit or fails to maintain the minimum required amount in the Reserve Account, the broker-dealer must notify the SEC and the FINRA[16]. This self-reporting is in addition to other general Exchange Act reporting requirements under Section 17(a) of the Exchange Act relating to accurate record keeping, filing of monthly Financial and Operational Combined Uniform

Single (FOCUS) reports and supporting schedules, and notifying the SEC of any material compliance weaknesses.

Additional restrictions apply to cash Reserve Accounts. Broker-dealers are prohibited from maintaining Reserve Accounts containing cash deposits at any affiliated bank and must limit the amount of cash deposits maintained at any single unaffiliated bank to 15% of the bank's equity capital, as reported by the bank in its most recent Call Report. Also, US branches of foreign banks are not eligible to hold the cash deposits unless a specific exemptive order is obtained from the SEC.

Broker-dealers who meet certain requirements may be exempted from maintaining a Reserve Account. These include, but are not limited to, the following:

- broker-dealers whose transactions as dealer are limited to the purchase, sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account;
- broker-dealers whose transactions as broker (agent) are limited to (i) the sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company, (ii) the solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States, and (iii) the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies; and
- broker-dealers who promptly transmit all funds and deliver all securities received in connection with their activities as brokers or dealers, and do not otherwise hold funds or securities for, or owe money or securities to, customers[17].

CPR initiative – self-reporting

As part of the CPR Initiative, the staff of the SEC's Division of Trading and Markets and the staff of the SEC's Division of Enforcement will jointly review any self-reporting submissions received. Submissions should include the following:

- name of the broker-dealer;
- provision of the Rule implicated;
- the period during which the non-compliance has occurred and whether it is ongoing;
- description of the non-compliance;
- amount of customer cash and/or customer securities implicated in the non-compliance;
- remedial efforts, if any, undertaken to address the noncompliance; and
- any other facts that the self-reporting entity would like to provide to assist the staff in understanding the circumstances that may have led to the non-compliance[18].

The Division of Trading and Markets and the Division of Enforcement, in coordination with the SEC's Office of Compliance Inspections and Examinations, will assess the submissions, consult with the broker-dealers, and determine appropriate responses. If there appears to be non-compliance with the Rule, the response may take the form of guidance from the Division of Trading and Markets, an examination of the broker-dealer by the Office of Compliance Inspections and Examinations, or an investigation by the Division of Enforcement.

If the Division of Enforcement decides to recommend enforcement action for any violation reported, it will recommend that the SEC accept a settlement pursuant to which the broker-dealer consents to a cease-and-desist order. The recommendation will include the following terms:

- the broker-dealer neither admits nor denies the findings of the SEC;
- the SEC finds that the broker-dealer violated the 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; and
- the broker-dealer will pay disgorgement of any ill-gotten gains and penalties, and meaningful cooperation credit, including in the form of reduced penalties, will be granted.

Practice pointers

Since compliance with the Rule is the responsibility of every broker-dealer, it is important for a broker-dealer to understand all of the requirements and confirm that the bank it uses to maintain the required Reserve Accounts also has the requisite knowledge of the Rule and the systems and documentation in place to ensure compliance.

Internal policies and procedures

Internal policies and procedures should be adopted to ensure compliance with the Rule, including policies and procedures covering the following:

- how and when to perform Reserve Formula computations;
- parameters for treating "grey area" transactions under the Reserve Formula and internal procedures for approving such transactions;
- creating, maintaining and filing necessary records and reports; and
- procedures for self-reporting in the event there is a Rule violation.

Reserve account bank capabilities

Due diligence. Prior to opening a Reserve Account with a bank, a broker-dealer should confirm that the bank is familiar with the Rule, is an eligible "Bank" under the Rule, and has the systems in place to comply with the Rule. If the bank is a US branch of a foreign bank and the broker-dealer is opening a cash account, a copy of the exemptive order from the SEC permitting the branch to accept cash accounts pursuant to the Rule should be obtained and maintained for the broker-dealer's records.

Systems. Any bank that is holding Reserve Accounts should have the following system capabilities:

- the ability to flag an account in its system as a Reserve Account;
- the ability to facilitate deposits and withdrawals within the first hour of the relevant business day as required by the Interpretative Guidance; and
- the ability to notify regulators and courts if a lien is placed on an account pursuant to court order or similar action as required by the Interpretative Guidance.

Documentation. A broker-dealer firm should closely review all account documentation provided by the Reserve Account bank. The following should be considered when opening a Reserve Account:

1. Does the bank have a standard no-lien letter? If so, does it contain the necessary language set forth in the Rule?[19]
2. Does the bank have specialized Reserve Account documentation? If so, do any provisions need to be amended or revised to comply with the Rule and the Interpretative Guidance?
3. Does the bank have specialized Reserve Account documentation? If not, amendments to either the existing general account documentation or standard no-lien letter will need to be made to address any problematic provisions.
4. Certain problematic provisions should be avoided, including:
   - the right to set-off;
   - the ability to deduct fees from Reserve Account[20];
   - the assignment of Reserve Account without prior notice; and
   - the notice requirement to the SEC, FINRA, and the broker-dealer in the event that the bank receives notice of any third-party liens or similar action with respect to the Reserve Account[21].

Conclusion

The Rule, along with its related computation formulas, is complex and nuanced. This article provides only a broad overview of the Rule, interpretive guidance and high-level practice pointers. Since it is the obligation of every broker-dealer to comply with the Rule and self-report any prior or current violations, broker-dealers should take advantage of the CPR Initiative. Broker-dealers should review their current account arrangements with banks, existing internal policies and procedures, and account documentation. Any internal weaknesses should be addressed. Non-compliant or poorly drafted documentation should be revised. Broker-dealers also should report any concerns or violations, along with remedial action plans, while the CPR Initiative is in effect.

Notes

1. *See* SEC Customer Protection Rule Initiative (June 23, 2016), available at: www.sec.gov/divisions/enforce/customer-protection-rule-initiative.shtml
2. *See* FINRA's Interpretations of Financial Operational Rules, Customer Protection – Reserves and Custody of Securities, SEA Rule 15c3-3 (the "FINRA Handbook").
3. *See supra* note 1.
4. "Excess margin securities" are those securities carried for the account of a customer having a market value in excess of 140% of the total of the debit balances in the customer's account or accounts for which the broker-dealer identifies as not constituting margin securities. *See* 17 CFR 240.15c3-3(a)(5).
5. *See* 17 CFR 240.15c3-3(b).
6. *See* 17 CFR 240.15c3-3(c)(1) through (7).
7. *See* 17 CFR 240.15c3-3(c)(5).
8. *See* 17 CFR 240.15c3-3(f).
9. *See* SEC Release No. 34-50295 (Aug. 31, 2004), available at: www.sec.gov/rules/final/34-50295.htm
10. *See* 17 CFR 240.15c3-3a.
11. *See* 17 CFR 240.17a-4.

12. *See* FINRA's Handbook, at 2422.

13. *See* 17 CFR 240.15c3-3(d).

14. *See* 17 CFR 240.15c3-3(e)(3).

15. *See* 17 CFR 240.15c3-3(e)(3). *See also* FINRA's Handbook, at 2431, 2462.

16. *See* 17 CFR 240.15c3-3(i).

17. *See supra* note 1.

18. *Id.*

19. *See* 17 CFR 240.15c3-3(f).

20. Deduction of fees "for safe custody and administration" is permitted only with respect to accounts of foreign securities held abroad. *See* SEC Release 34-10429 (Oct. 12, 1973).

21 If account documentation states that the bank will comply with judicial orders or other similar actions with respect to liens on the account, additional language must be added to provide notice of such order to the broker-dealer and its regulators and any relevant court. *See* FINRA's Handbook, at 2452.

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