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Net Capital Requirements for Brokers and Dealers—Interpretation and Guide

The Securities and Exchange Commission today released the following staff interpretation of, and guide to computations under, its "net capital" Rule 15c3-1 under the Securities Exchange Act of 1934 (the "Act").¹ This material, which was prepared jointly by the Commission's Division of Trading and Markets (the "Division") and Office of Chief Accountant, is intended to assist brokers and dealers in complying with Rule 15c3-1.

This release is divided into two parts. Part I explains the operation of Rule 15c3-1, including the exemptions therefrom, and discusses the application of the rule with respect to questions frequently presented to the Division for interpretation. Part II of this release consists of an example of the computation of "net capital" pursuant to Rule 15c3-1 made by a hypothetical broker-dealer, and includes a detailed trial balance work sheet with explanatory notes. The work sheet is merely illustrative of the application of Rule 15c3-1.

PART I.

A. INTRODUCTION

Rule 15c3-1 was adopted to provide safeguards for public investors by setting standards of financial responsibility to be met by brokers and dealers.² The basic concept of the rule is liquidity; its object being to require a broker or dealer to have at all times sufficient liquid assets to cover

his current indebtedness.³ The applicability of the rule does not depend on whether or not a broker or dealer is required to be registered with the Commission, since the exemptive provisions of Section 15(a)(1) of the Act provide exemptions *only* from the registration requirements of that Section, and not from other applicable provisions of the Act or the rules and regulations.

Rule 15c3-1 is made up of three parts: a statement of the minimum standards of liquidity to be maintained by brokers and dealers;⁴ provisions for exemption from the rule for certain brokers or dealers;⁵ and definitions of terms for the purpose of determining liquidity under the rule.⁶ Each part will be discussed separately.

B. GENERAL REQUIREMENTS AS TO NET CAPITAL RATIO AND MINIMUM NET CAPITAL

The rule prohibits a broker or dealer from permitting his "aggregate indebtedness" from exceeding 2,000 percent of his "net capital," as those terms are defined in paragraphs (c)(1) and (c)(2) of the rule.⁷ This has often been referred to as "the twenty to one rule."

In addition, every broker or dealer subject to the rule is required to have and maintain a minimum "net capital" of \$5,000.⁸ However, the rule permits a minimum "net capital" of only \$2,500 for a broker or dealer meeting the following conditions: (i) his dealer transactions (as princi-

¹ All references to Rule 15c3-1 are to the rule as currently amended (see Securities Exchange Act Release No. 7611, dated May 26, 1965). The text of the amended rule, including an explanation of the effective dates of the amended provisions thereof, is set out in the Appendix hereto.

² The rule was adopted under Section 15c(3) which in effect prohibits any broker or dealer from using the mails or interstate facilities to effect, induce or attempt to induce any over-the-counter transaction in a nonexempted security in contravention of rules or regulations prescribed by the Commission as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to financial responsibility of brokers and dealers.

³ The need for such liquidity has long been recognized as vital to the public interest and for the protection of investors. As early as 1942, the Commission stated, "Customers do not open accounts with a broker relying on suit, judgment and execution to collect their claims—they are opened in the belief that a customer can, on reasonable demand, liquidate his cash or securities position." *Guy D. Marianne*, 11 S.E.C. 967, 970-1.

⁴ Para. (a) of the rule. (All paragraph references in the footnotes are to Rule 15c3-1.)

⁵ Para. (b).

⁶ Para. (c).

⁷ Para. (a)(1).

⁸ Para. (a)(2).

pal for his own account) are limited to the purchase, sale and redemption of redeemable shares of registered investment companies (mutual funds); (ii) his transactions as broker (agent) are limited to the sale and redemption of mutual funds the solicitation of share accounts for certain insured savings and loan associations, and the sale of securities for the account of a customer to obtain funds for immediate reinvestment in mutual funds; and (iii) he promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.⁹ In this connection, the rule provides¹⁰ that a sole proprietor broker or dealer who otherwise qualifies for the reduced minimum "net capital" requirement of \$2,500 may also effect occasional transactions in other securities for his own personal account with or through another registered broker-dealer without having to maintain a minimum "net capital" of more than \$2,500 (unless, of course, additional "net capital" is needed to comply with the ratio requirement).¹¹

C. EXEMPTIONS FROM THE RULE

An exemption from the rule is available for a *broker* who is also licensed as an insurance agent, whose securities business is limited to selling variable annuity contracts as agent for the issuer, who promptly transmits¹² all funds and delivers all variable annuity contracts, and who does not otherwise hold funds or securities for, or owe money or securities to, customers; and *only* if the

⁹ A broker or dealer must comply with *both* requirements: he must maintain a minimum "net capital" of at least \$5,000 (or \$2,500, if applicable), and such "net capital" may not be less than 1/20th of the amount of his "aggregate indebtedness." Thus, depending upon the amount of a broker or dealer's "aggregate indebtedness," his required "net capital" could be considerably greater than the specified minimum.

¹⁰ Para. (a)(2)(A).

¹¹ Such a sole proprietor broker or dealer should be aware, however, that all such transactions, whether he considers them to be part of his business or for his personal account, must be reflected in his books and records in accordance with Rule 17a-3; and that securities, so held are treated for "net capital" purposes as provided in Rule 15c3-1. (See also the separate discussion, *infra*, with respect to sole proprietor-broker-dealers.)

¹² The term "promptly transmits" is interpreted to mean as soon as reasonably possible, but not later than 4 business days after receiving the funds.

issuer files with the Commission a satisfactory undertaking that it assumes responsibility for all valid claims arising out of the securities activities of the agent.¹³ The rule also provides that this exemption will not be lost to a person conducting such a limited type of brokerage business *as a sole proprietor* simply because he effects occasional transactions in other securities for his own personal account with or through another registered broker-dealer.

An exemption from the rule is also provided for members in good standing and subject to specific capital requirements of the American, Boston, Midwest, New York, Pacific Coast, Philadelphia-Baltimore-Washington and Pittsburgh Stock Exchanges.¹⁴ The Commission has reviewed the rules, settled practices and applicable regulatory procedures of those securities exchanges and deems them to impose requirements more comprehensive than those of Rule 15c3-1. However, this exemption is not available to a member of any such exchange if he is not subject to the capital requirements of the exchange; and a suspended member of any such exchange would become subject to Rule 15c3-1, and would have to be in compliance therewith, immediately upon such suspension.¹⁵

The rule further provides that the Commission may, upon written application, exempt from the rule, either unconditionally or on specified terms and conditions, a broker or dealer who satisfies the Commission that because of (i) the special nature of his business, (ii) his financial position, and (iii) the safeguards he has established for the protection of customers' funds and securities, it is not necessary in the public interest or for the protection of investors to subject the particular broker or dealer to the provisions of the rule.¹⁶ This provision is strictly construed; it is not intended to afford an exemption to any particular class or category of brokers or dealers. Only a broker or dealer who has substantial net worth and who, because of the special nature of his business, has safeguards for the protection of customers' funds and securities should apply for this exemption. A *broker or dealer should not apply for this exemption simply because he is having difficulty in raising the*

¹³ Para. (b)(1).

¹⁴ Para. (b)(2).

¹⁵ See *Strand Investment Co.*, Securities Exchange Act Release No. 6705 (1961).

¹⁶ Para. (b)(3).

necessary capital. Any application for this exemption should contain detailed information demonstrating that the applicant can meet all the conditions mentioned above, so that the matter may ordinarily be considered on the basis of the information contained in such application.

D. DEFINITION

1. "Aggregate Indebtedness"

(a) General

As defined in the rule,¹⁷ "aggregate indebtedness" is the *total money liabilities* (except those specifically excluded as indicated below) of a broker or dealer arising in connection with any transaction whatsoever, including, among other things money borrowed, customers' free credit balances, credit balances in customers' accounts having short positions in securities, and equities in customers' commodities futures accounts.

A broker or dealer which is also engaged in some other business in addition to its business as a broker or dealer must include the money liabilities of such other business in its "aggregate indebtedness." For example, where a broker-dealer also sells life insurance and accepts payments of premiums that are deposited in a special account pending transmission to the insurance company or return to the applicant, the premium represents a liability of the broker-dealer during the time the funds are in its possession, and therefore should be included in "aggregate indebtedness."¹⁸ In fact, where two partners have exactly the same interest in two partnerships, one partnership conducting a securities business and the other conducting another business, the liabilities and assets of both partnerships should be taken into consideration in determining whether the broker or dealer is in compliance with the "net capital" requirements.

However, not all liabilities of a broker or dealer are taken into account in determining his "aggregate indebtedness"; certain items are specifically excluded, as discussed below.¹⁹

¹⁷ Para. (c)(1).

¹⁸ The question of whether the assets of such other business may be included in "net capital" depends on the nature of such assets. (See discussion of "net capital," *infra*.)

¹⁹ "Aggregate indebtedness" is not a factor in the computation of "net capital"; it is merely one element in computing "the twenty to one" ratio. Therefore, while certain liabilities are specifically excluded from the definition of "aggregate

(b) Exclusions from "Aggregate Indebtedness"

(1) Collateralized Indebtedness

The rule specifically excludes from "aggregate indebtedness" any indebtedness adequately collateralized²⁰ by securities (including exempted securities²¹) or spot commodities owned by the broker or dealer.²² In this connection, since time deposit certificates of a bank are securities within the meaning of Section 3(a)(10) of the Act, bank loans adequately collateralized by such certificates owned by the broker or dealer may ordinarily be excluded from "aggregate indebtedness."²³

Fixed liabilities which are adequately secured by real estate or any other asset which is not included in the computation of "net capital" under paragraph (c)(2) of the rule²⁴ are also excluded from "aggregate indebtedness."²⁵

(2) Securities Loaned and Securities Failed to Receive

Amounts payable against securities loaned which securities are owned by the broker or dealer are excluded from "aggregate indebtedness."²⁶ Also, amounts payable against securities "failed to receive" which were purchased for the account of, and have not been sold by, the broker or dealer are

indebtedness," they are not ordinarily excluded from total liabilities for the purposes of computing "net capital" under para. (c)(2).

²⁰ Para. (c)(6) provides that indebtedness shall be deemed to be "adequately collateralized" when the difference between the amount of the indebtedness and the market value of the collateral is sufficient to make the loan acceptable as a fully secured loan to banks regularly making comparable loans to brokers or dealers in the community.

²¹ However, as to exempted securities, the exclusion applies only to indebtedness arising from loans where exempted securities are given as collateral; not to indebtedness arising out of the failure to receive exempted securities. Securities "failed to receive" are discussed in the text. The term "exempted securities" is defined in para. (c)(3) to mean those securities specifically defined as "exempted securities" in Section 3(a)(12) of the Act.

²² Para. (c)(1)(A), (c)(1)(B) and (c)(1)(E).

²³ The treatment of time deposit certificates for purposes of computing "net capital" is discussed in n. 49, *infra*.

²⁴ Para. (c)(2) excludes from the computation of "net capital" fixed assets and assets which are not readily convertible into cash, including, among other things, real estate, furniture and fixtures, etc. (This is discussed separately in the section dealing with the definition of "net capital.")

²⁵ Para. (c)(1)(G).

²⁶ Para. (c)(1)(C).

excluded from "aggregate indebtedness."²⁷ Except for these two exclusions, the amounts payable against other securities loaned and securities "failed to receive" are specifically *included* in "aggregate indebtedness."

(3) Contractual Commitments²⁸

The rule also excludes from "aggregate indebtedness" liabilities on open contractual commitments.²⁹ This exclusion is intended generally to apply to liabilities in connection with firm commitment underwriting contracts, because in computing "net capital" any securities position contemplated by a firm commitment underwriting contract would be subject to a deduction from "net worth" based on the market value of the securities.³⁰ Therefore, it is not considered necessary to require a broker-dealer to maintain additional "net capital" under the "twenty to one rule" to carry that commitment.

In addition, since a traditional "best-efforts" underwriting ordinarily imposes no obligation on a broker-dealer to pay for the securities being offered until certain events occur (e.g., the sale of the security) the broker-dealer does not ordinarily incur a liability to pay for such securities for purposes of computing his "aggregate indebtedness" until such time as he is under a legally binding obligation to pay funds to the issuer (or to the managing underwriter).³¹ However, if the broker-dealer receives advances from the issuer (e.g., for expenses) in connection with a best-efforts underwriting, any liability of the broker-dealer to return the unexpended portion of such advances is not excluded from "aggregate indebtedness."

(4) Satisfactorily Subordinated Debt; Amounts Segregated under the Commodity Exchange Act

Other items specifically excluded from "aggregate indebtedness" are: indebtedness subordinated to the claims of general creditors pursuant to a "satisfactory subordination agreement"³² (how-

ever, any interest on such satisfactorily subordinated debt, whether in arrears or currently due, should be included in "aggregate indebtedness" unless the debt arising from failure to pay the interest is also subordinated under the subordination agreement); and amounts segregated in accordance with the Commodity Exchange Act and the rules and regulations thereunder.³³

(5) Other Excludable Items

(i) Funds held as Agent or Trustee; Escrow Accounts

Questions have frequently arisen as to whether funds held either (1) in a separate account by a broker-dealer as agent or trustee, or (2) in an escrow account by a bank, pursuant to Rule 15c2-4 of the Act,³⁴ are part of "aggregate indebtedness." Where funds are held in a separate bank account by a broker-dealer as agent or trustee, the amount due to the issuer or the purchasing customers is an obligation of the broker-dealer which must be considered as part of his "aggregate indebtedness." If, on the other hand, the funds are promptly transmitted to an escrow bank under an agreement which contains the provisions contemplated by Rule 15c2-4 that the funds will be transmitted *directly* to the persons entitled thereto at the appropriate time, and the broker-dealer has no control over such funds, the funds held by the escrow bank are not treated as part of "aggregate indebtedness."

(ii) Contingent Liabilities

Questions also arise occasionally with respect to whether various items of contingent liabilities are to be included in "aggregate indebtedness." Where a judgment has been rendered against a

is defined in para. (c)(7) of the rule, is discussed separately, *infra*.

²⁷ Title 17, Ch. I, Code of Federal Regulations ("CFR").

²⁸ Rule 15c2-4 requires, in effect, that where a broker or dealer participates in the distribution of securities on any basis other than a firm-commitment underwriting, any money received for such securities on any basis whereby payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs must be (A) promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, and promptly transmitted or returned to such persons upon the occurrence of the appropriate event or contingency, or (B) promptly transmitted to a bank which has agreed in writing to hold such funds in escrow for the persons having beneficial interests therein and to transmit or return such funds to such persons when the appropriate event or contingency occurs.

²⁹ Para. (c)(1)(D).

³⁰ This term is defined in para. (c)(5). (See also n. 52, *infra*.)

³¹ Para. (c)(1)(H).

³² See discussion under "Haircuts," *infra*.

³³ See *Investment Bankers of American, Inc.*, Securities Exchange Act Release Nos. 6886 (August 16, 1962) and 6994 (January 21, 1963). See also discussion under "Other Excludable Items," *infra*, with respect to funds held by a broker-dealer as agent or trustee.

³⁴ The term "satisfactory subordination agreement," which

broker or dealer, the amount of the judgment would have to be included in "aggregate indebtedness" even though an appeal from that judgment may be pending.³⁶ Whether claims which have not been reduced to judgment are to be included in "aggregate indebtedness" would depend on the particular facts. No general rule can be given that would be applicable to all cases. Accordingly, situations involving contingent liabilities should be presented to the Division for consideration on the basis of the facts in the particular case.

2. "Net Capital"

(a) General

The "net capital" of a broker or dealer is essentially his adjusted "net worth." As defined in the rule,³⁶ it is the excess of his *total* assets over his *total* liabilities,³⁷ adjusted by adding unrealized profits (or deducting unrealized losses) in the accounts of the broker or dealer, or if such broker or dealer is a partnership, by adding the equities (or deducting the deficits) in the accounts of partners.³⁸

As pointed out in the introductory material, the principal purpose of the rule is to require that the capital position of a broker or dealer will always be sufficiently liquid to cover his current indebtedness, in order to be able at all times to promptly meet the demands of customers. Therefore, the rule provides that certain assets not readily convertible into cash, although saleable by negotiation, are excluded from "net capital" even though such assets are part of "net worth." Also, certain other assets, although liquid, are valued at less than their market value in order to provide a cushion for market fluctuations. (The required percentage deductions from "net worth" for those assets are referred to as "haircuts." These are discussed separately.)³⁹

³⁶ Any claim for indemnity that such broker or dealer might have would not be considered to be an asset readily convertible into cash for purposes of computing "net capital."

³⁷ Para. (c)(2).

³⁸ As noted earlier, liabilities which are excluded from the definition of "aggregate indebtedness" are included in total liabilities for the purpose of computing "net capital."

³⁹ "Accounts of partners" are defined in para. (c)(4) as the accounts of partners who have agreed in writing that the equities in such accounts maintained with such partnership shall be included as partnership property.

⁴⁰ Para. (c)(2) also contains provisions excluding liabilities

(b) Fixed and Other Assets not Really Convertible into Cash

In computing "net capital," a broker or dealer must deduct from his "net worth" all fixed assets and all other assets not readily convertible into cash, to the extent that such assets do not constitute bona fide collateral for actual bona fide indebtedness.⁴⁰ The rule contains specific examples⁴¹ of some of the assets which for purposes of computing "net capital" are considered as not readily convertible into cash, including: real estate; furniture and fixtures; exchange memberships; prepaid rent, insurance and expenses; goodwill; organization expenses; deficits in customer's accounts, except in bona fide cash accounts within the meaning of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System;⁴² all unsecured advances and loans; and customers' unsecured notes and accounts. Thus, unsecured insurance accounts receivable of a broker-dealer also engaged in the insurance business would be deducted from "net worth" in computing "net capital." Similarly, a broker-dealer's earned commissions receivable, being generally unsecured, would also be excluded from "net capital."⁴³

Of course, the specific exclusion from "net capi-

in connection with "satisfactory subordination agreements" when computing "net capital," and relating to the treatment of liabilities of sole proprietor-broker-dealers where such liabilities were not incurred in the course of business as a broker or dealer. These will be discussed *infra* in those sections dealing separately with "sole proprietor-broker-dealers" and "satisfactory subordination agreements."

⁴⁰ Where additional collateral is used to secure the indebtedness, it would be up to the broker-dealer to prove the extent to which the assets not readily convertible into cash, are collateral for the indebtedness.

⁴¹ Para. (c)(2)(B).

⁴² 12 C.F.R. 220.4(c).

⁴³ For example, some dealers sell shares of a mutual fund pursuant to a program whereby the customers make their checks payable to a custodian bank which (1) acts as agent for the various parties in effecting the sale of such shares, (2) confirms the transactions to the customers, and (3) periodically forwards to the dealer the commissions due him. Under those circumstances, the commissions due the dealer, but not yet forwarded by the bank, are treated as an unsecured account which should be deducted from the dealer's "net worth." (However, if a dealer can submit an unequivocal written statement from a custodian bank that the sums due the dealer are payable on demand, such receivables would not be deducted from "net worth" when computing that dealer's "net capital.")

tal" of *unsecured* loans and advances and of customers' *unsecured* notes and accounts does not mean that *every secured* loan, advance, note or account is included as part of a broker-dealer's "net capital." A secured receivable may be excluded from "net capital" if, because of the nature of the collateral or for some other reason, the broker-dealer cannot demonstrate that the account is readily convertible into cash.⁴⁴ For example, advances made by a broker-dealer to his sales representatives against their commissions to be earned upon monthly payments by planholders of contractual plans for the accumulation of shares of a mutual fund are excluded from "net capital" (on the basis that they are not adequately secured), even though the sales representatives signed loan agreements providing (1) that the amounts owed by them are payable on demand, and (2) that the broker-dealer has liens on all commissions due and to become due to such sales representatives until the indebtedness is satisfied. In addition, notes receivable secured by titles on house trailers, by insurance premium finance contracts, and by second mortgages or second deeds of trust are excluded from a broker-dealer's "net capital" unless the broker-dealer is able to furnish convincing evidence to demonstrate that the notes are readily convertible into cash (i.e., that there is a ready market for the securities—notes).⁴⁵

Securities for which there is no independent market,⁴⁶ and securities which cannot be publicly offered and sold by the broker or dealer because of contractual arrangements or other restrictions, also fall within the category of assets which are not readily convertible into cash, and are given no value when computing "net capital." In this connection, the Commission held, in *Whitney-Phoenix Co., Inc.*, 39 S.E.C. 245 (1959), that securities which can be publicly offered or sold by the broker or dealer only after registration under the Securities Act of 1933 or pursuant to some exemption

⁴⁴ See n. 40, *supra*.

⁴⁵ If it can be demonstrated that there is such a market for the notes, then instead of the exclusion under clause (B) of paragraph (c)(2) for the amount of the receivable, there would be a "haircut" applied to the market value of the security (the note) in accordance with the provisions of clause (C) of that para. (See discussion of "haircuts," *infra*.)

⁴⁶ See *S.E.C. v. C. H. Abraham & Co., Inc.*, 136 F. Supp. 19 (S.D. N.Y. 1960); *Pioneer Enterprises, Inc.*, 36 S.E.C. 199, 207 (1955).

under Section 3(b) of that Act should be given no value for "net capital" purposes until such securities have been effectively registered or there has been compliance with an appropriate exemption under Section 3(b).⁴⁷

Other examples of assets ordinarily considered to be assets not readily convertible into cash include a "good faith" deposit by a broker-dealer in connection with a bid for exempted or non-exempted securities; a cash deposit in lieu of, or as security for, statutory or other required bonds of a broker-dealer; oil royalties (unless it can be demonstrated that there is a ready market for such oil royalties); a bank account in which a sole proprietor-broker-dealer is a joint tenant; and the cash surrender value of a life insurance policy, unless such cash surrender value and the face amount of such policy are payable (1) to the estate of a sole proprietor-broker-dealer, or (2) to the broker-dealer, if a partnership or corporation.

Questions have been raised as to how to treat deposits in savings and loan associations which are ordinarily considered to be securities in the form of shares in the association. Generally, if such deposits are in a solvent, federally insured savings and loan association and the broker-dealer can furnish assurances to the Division that the particular federally insured association has been paying such deposits on demand, such deposits may be treated for "net capital" purposes as though they were cash in a bank.

(c) "Haircuts"

In computing "net capital," the rule requires deductions from "net worth" of certain specific percentages of the market values of marketable securities and future commodity contracts, long and short, in the capital and proprietary accounts of the broker or dealer, and in the "accounts of partners." (These deductions are generally referred to in the industry as "haircuts.") It also requires a deduction with respect to total long or total short futures contracts in each commodity carried for all

⁴⁷ However, as discussed earlier, where any of the securities discussed above are in fact pledged as bona fide collateral to secure a bona fide indebtedness, the amount to be deducted from "net worth" in computing "net capital" is the difference between the book value of such securities and the amount of the indebtedness actually secured thereby. See n. 41, *supra*. (In such a situation the borrower would ordinarily be expected to tell the lender of restrictions on their sale.)

customers.⁴⁸ The purpose of these deductions from "net worth," is to provide a margin of safety against losses incurred by a broker or dealer as a result of market fluctuations in the prices of such securities or future commodity contracts.

(1) "Haircuts" for Marketable Securities

The amount of the "haircut" required with respect to marketable securities depends on the nature of the particular security, as follows: (a) in the case of a nonconvertible debt security having a fixed interest rate and a fixed maturity date, and which is not in default, the "haircut" ranges between 5 and 30 percent, depending of the percentage by which the market value is less than the face value of such security; (b) in the case of cumulative, nonconvertible, preferred stock not in arrears as to dividends and ranking prior to all other classes of stock of the same issuer the "haircut" is 20 percent of market value; and (c) in the case of all other marketable securities, the "haircut" is 30 percent of market value.⁴⁹

The above "haircuts" are also applicable to securities loaned to a broker or dealer pursuant to a "satisfactory subordination agreement,"⁵⁰ and to other marketable securities owned by a broker or dealer which he has pledged as collateral to secure his indebtedness to another. However, no "haircut" need be taken with respect to securities which belong to a person other than the broker or dealer and which are in his possession as collateral for an indebtedness to such broker or dealer. Also, the rule provides⁵¹ that no "haircut" need be taken with respect to the following: (i) a security which is convertible into or exchangeable for other securities within a period of 30 days, subject to no conditions

other than the payment of money, if the other securities into which such security is convertible, or for which it is exchangeable, are short in the accounts of such broker or dealer or in the "accounts of partners"; or (ii) a security which has been called for redemption and which is redeemable within 90 days. However, this latter exemption is not ordinarily available for redeemable investment company shares for two reasons: first, because they are not "called for redemption"; and second, even though they may be redeemable within 90 days, their redemption value is subject to fluctuation with changes in the market value of the portfolio securities held by the investment companies.

The rule applies the above "haircut" provisions to securities positions contemplated by open contractual commitments.⁵² In this connection, a firm commitment underwriting is a contractual commitment, and the required "haircut" is applied to the net long position contemplated by the commitment. This "haircut" is applicable even though there is no public market for the security until after the offering begins. (If, however, no market has developed for the security after the offering has begun, and the underwriter has a position in the security, consideration would then have to be given to whether the securities should be given no value as assets not readily convertible into cash.) As the underwriter sells shares to customers, the number of shares which he is obligated to take down decreases, and the "haircut" is reduced *pro tanto*.⁵³ However, the rule provides that no "haircut" shall apply to "exempted securities" as defined in Section 3(a)(12) of the Act.⁵⁴

(2) "Haircuts" for Futures Commodity Contracts

The rule requires that "haircuts" also be taken

⁴⁸ Clauses (C) and (E) of para. (c)(2) in the case of securities, and Clauses (D) and (F) in the case of future commodity contracts.

⁴⁹ Subclauses (i), (ii) and (iii) of para. (c)(2)(C). A negotiable time certificate of deposit issued by a bank is considered to be a debt security, and if there is a ready, independent market for such security, and if it is not in default, it is subject to the "haircut" required by subclause (i). A nonnegotiable time certificate of deposit would ordinarily be treated as an asset not readily convertible into cash, but if the broker-dealer can demonstrate that the bank will pay the certificate on demand before maturity it may be given substantial value, depending on all the surrounding circumstances in the particular case.

⁵⁰ See n. 58, *infra* and related textual discussion.

⁵¹ Para. (c)(2)(C).

⁵² Para. (c)(2)(E). The term "contractual commitments" is defined in paragraph (c)(5) to include underwriting, when-issued, when-distributed and delayed delivery contracts; endorsement of puts and calls; commitments in foreign currencies; and spot (cash) commodities contracts; but does not include uncleared regular way purchases and sales of securities and contracts in commodities futures.

⁵³ In a "rights" offering where the underwriter has a firm commitment to take down the unsubscribed portion of the underlying securities if the underwriter can demonstrate that less than 50 percent of the underlying securities will remain unsubscribed he may be permitted to deduct only 50 percent of the required "haircut" during the "rights" offering period.

⁵⁴ It also provides that the "haircut" with respect to any individual commitment shall be reduced by the unrealized

with respect to future commodity contracts, as follows: a "haircut" of 30 percent with respect to the market value of all long and all short future commodity contracts (other than those contracts representing spreads or straddles in the same commodity and those contracts offsetting or hedging any "spot" commodity positions) carried in the capital, proprietary or other accounts of the broker or dealer, and if a partnership, in the "accounts of partners"; and a "haircut" of 1½ percent with respect to the total long or total short futures contracts in each commodity, whichever is greater, carried for all customers.

3. Subordinated Debt; "Satisfactory Subordination Agreement"⁵⁶

It was previously pointed out that indebtedness subordinated to the claims of general creditors pursuant to a "satisfactory subordination agreement" is excluded from "aggregate indebtedness,"⁵⁶ and from total liabilities in the computation of "net capital."⁵⁷ The combined effect of these exclusions is to treat such subordinated loans as if they were part of the broker-dealer's capital⁵⁸ in computing his "net capital."

In substance, the rule requires that in order to be considered a "satisfactory subordination agreement," a binding and enforceable written agreement must be executed by *both* the broker-dealer and the lender, whereby a specific amount of cash or specific securities are loaned to the broker-dealer for a period of not less than 1 year (and giving the broker-dealer the right to the use of such cash or securities as though they were in fact his own) under conditions which effectively subordinate any right of the lender to demand or receive

repayment to the claims of all present *and* future creditors of the broker-dealer. The agreement must provide that it may not be cancelled by either party, and that the loan may not be repaid or the agreement in any way be terminated, rescinded or modified by mutual consent or otherwise if the effect would be to put the broker-dealer out of compliance with the "net capital" requirements of the rule. The agreement must also provide that no default of any kind shall have the effect of accelerating the maturity of the indebtedness; and that any note or other written instrument evidencing the indebtedness shall bear on its face an appropriate legend stating that it is issued subject to the provisions of a subordination agreement which shall be adequately referred to and incorporated by reference.

Thus, the rule contemplates that, if the proceeds of a subordinated loan are to be considered as part of the capital of a broker-dealer, cash or securities will be turned over to the broker-dealer for his use as part of his capital and subject to the risks of his business, and subject further only to an obligation of repayment at the end of the term of the loan.⁵⁹ Accordingly, the agreement must contemplate that if repayment cannot be made without reducing the broker-dealer's "net capital" below the amount required by the rule, the subordination must continue, even though the indebtedness is not repaid at maturity. However, the loan may be repaid and the subordination agreement terminated *by mutual consent* if, after repayment, the broker-dealer's required "net capital" is not impaired.

The rule also requires that two copies of the subordination agreement, and of any notes or written instruments evidencing the indebtedness, must be filed, within 10 days after the agreement is entered into, with the Regional Office of the Commission for the region in which the broker-dealer maintains his principal place of business, together with a statement of the name and address of the lender, the business relationship of the lender to the broker-dealer, and information as to whether the bro-

profit (or increased by the unrealized loss) in such commitment; except that the amount of such reduction shall not exceed the amount of the required "haircut," and in no event shall an unrealized profit on any closed transaction operate to increase "net capital." A series of contracts of purchase or sale of the same security conditioned, if at all, only upon issuance may be treated as an individual commitment.

⁵⁶ The term "satisfactory subordination agreement" is defined in para. (c)(7).

⁵⁶ Para. (c)(1)(I).

⁵⁷ Para. (c)(2)(G).

⁵⁸ If the loan consists in whole or in part of securities, such securities would, of course, be subject to the applicable "haircuts" required by para. (c)(2)(C) of the rule.

⁵⁹ Where funds or securities are loaned under *any* conditions which permit the lender to retain domination or control over, or otherwise inhibit the broker-dealer's unrestricted use of, such funds or securities, the agreement would not be a "satisfactory subordination agreement" within the meaning of the rule.

ker-dealer carried funds or securities for the lender at or about the time the agreement was entered into. (If each copy of the agreement is bound separately and marked "Non-Public", such agreements will be maintained in a nonpublic file.) A broker-dealer should give notice of any proposed repayment of the loan, or of termination of or any other change in the agreement, to the Regional Office with which the agreement is filed so that the information on file with that Regional Office is always current and accurate.⁶⁰

E. SOLE PROPRIETOR-BROKER-DEALER

As indicated earlier, there are special considerations under the rule with respect to determining the "net capital" position of a sole proprietor-broker-dealer. For purposes of computing "aggregate indebtedness" and "net capital," a broker or dealer who is a sole proprietor must also take into account his personal assets and liabilities not related to the business;⁶¹ and where he conducts some other business in addition to the securities business, the assets and liabilities of such other business must also be taken into account.⁶²

A sole proprietor-broker-dealer who is also engaged in some other business activity as a sole proprietor may record the assets and liabilities and transactions of such other business in the same books of account as he uses for his broker-dealer business or in a separate set of books. A consistent test of protection for the customer of such a sole proprietor requires that "aggregate indebtedness" in this situation must include all the money liabilities in connection with his business as a broker-dealer and all money liabilities in connection with

⁶⁰ If a broker-dealer has any question concerning whether he may properly effect any such repayment, or termination or other change in the agreement, he should request interpretive assistance from that Regional Office with which the agreement is filed.

⁶¹ See n. 11, *supra*, with respect to recordkeeping requirements.

⁶² These assets and liabilities must be taken into account whether or not reflected in the records of his business as a broker or dealer. For example, where a sole proprietor-broker or dealer also is engaged in the insurance business, any insurance accounts payable would be included in "aggregate indebtedness," notwithstanding the fact that the sole proprietor maintains a separate bank account and separate books and records for each business. Also, his insurance accounts receivable, being ordinarily unsecured, would be excluded from "net capital."

any other business in which he is engaged as a sole proprietor, less the specific exclusions provided by Clauses (A) through (I) of paragraph (C) (1) of the rule. In computing, "net capital," his "net worth" must be determined from the combined assets and liabilities of all of his businesses as a sole proprietor; and, in addition to the adjustments to "net worth" required of all brokers or dealers, whether or not sole proprietors, he is required by Clause (H) of paragraph (c) (2) to make a further deduction from "net worth" of any excess of his *personal* liabilities over his *personal* assets.

This situation suggests the advisability of the formation of one or more corporations to carry on the securities business or any other business conducted by the sole proprietor. The separate incorporation of the other business will tend to relieve the securities business of the jeopardy from the liabilities of the other business and eliminate the question of whether the assets and liabilities of such other business should be taken into account in determining aggregate indebtedness and net capital.

F. AVAILABILITY OF INTERPRETATIVE ADVICE

While this release endeavors to answer questions frequently raised, it is not possible to cover every question which may arise under Rule 15c3-1. Moreover, the general opinions expressed herein will not necessarily be applicable to situations which differ factually from those on which such opinions are based. Consequently, a broker or dealer who has a question as to the application of Rule 15c3-1 to a specific matter may request interpretative assistance from the Division of Trading and Markets. While the Commission provides such interpretative assistance through its staff wherever possible, the responsibility for compliance rests with the broker or dealer.

PART II

The following example based on the trial balance of a hypothetical broker-dealer shows the evaluation of the assets and liabilities required to be made in the determination of aggregate indebtedness and net capital. The example includes many situations frequently found in calculations made by small and medium sized broker-dealers. The trial balance work sheet shows (a) money balances of ledger accounts, (b) long and short security valuations related to certain ledger ac-

counts, (c) net losses or gains in commodity contracts, (d) ledger balances included in aggregate indebtedness, and (e) and (f) adjusted balances of assets and liabilities and percentage deductions.

Explanatory notes following the example are referenced to certain of the captions and details of open commodity contracts in both customers' and firm accounts are shown on a separate schedule.

	Trial balance	Security valuations		Commodity contracts losses (Gains)	Aggregate indebtedness	Adjusted Balances	
		Long	Short			Assets	Liabilities and deductions
	(a)	(b)	(b)	(c)	(d)	(e)	(f)
ASSETS							
Cash:							
In banks and on hand.....	\$25,000					\$25,000	
Good faith deposit.....	2,800						
Segregated under Commodity Exchange Act.....	6,900					6,900	
Deposits on future commodity contracts.....	1,100					1,100	
Failed to deliver.....	3,000	\$3,100				3,000	
Deposit against securities borrowed.....	10,000	10,200				10,000	
Customers' securities accounts:							
Cash..... (h)	10,000	11,000				10,000	
Fully secured..... (h)	81,500	112,000				81,500	
Partly secured..... (i)	5,000	3,000				3,000	
Unsecured..... (j)	200						
Customers' commodity accounts:							
Future commodity contracts..... (k)	(5,700)			\$ (350)			\$5,700
Spot (cash) commodities..... (h)	4,500	35,300				4,500	
Accounts of partners..... (l)	5,000	8,000				8,000	
Firm trading accounts:							
Exempted securities—(long)..... (m)	3,000	3,200				3,200	
Nonexempted securities—(long)..... (m)	12,000	18,000				18,000	
“ “ —(short)..... (m)	(2,000)		\$1,600				1,600
Securities not readily marketable..... (n)	2,000						
Future commodity contracts..... (o)				(500)		500	
Land and building..... (p)	48,000						
Furniture and fixtures..... (p)	6,000						
Exchange memberships..... (q)	10,000						
Notes receivable (unsecured)..... (q)	1,500						
Advances (unsecured)..... (q)	900						
Dividends receivable..... (q)	500						
Earned commissions receivable..... (q)	1,400						
Prepaid expenses..... (q)	500						
Other assets..... (q)	1,500						
	\$234,600						
LIABILITIES AND NET WORTH							
Bank loans collateralized by:							
Firm securities..... (r)	\$10,000		20,000				10,000
Customers' securities.....	75,000		105,000		\$75,000		75,000
Failed to receive:							
Firm securities (long)..... (s)	1,000		1,100				1,000
Customers' securities.....	5,000		5,200		5,000		5,000
Deposits against securities loaned:							
Firm securities..... (s)	3,000		3,200				3,000
Customers' securities.....	2,000		2,100		2,000		2,000
Customers' free credit balances.....	21,000				21,000		21,000
Accounts payable.....	7,350				7,350		7,350
Accrued expenses and taxes.....	6,500				6,500		6,500
Dividends payable.....	1,400				1,400		1,400
Mortgage payable on land and building..... (p)	30,000						
Commodity "difference" account..... (t)	850			850			850
Valuation of securities and spot (cash) commodities in "box" and transfer..... (u)			77,600				
Contractual commitment..... (v)							
	163,100						
Subordinated borrowings:							
Loan payable..... (w)	13,000					4,000	
Nonexempted securities..... (w)		4,000					
Capital:							
Ledger balances.....	50,000						
Nonexempted securities..... (x)		8,000				8,000	
Profit and loss.....							
	234,600	215,800	215,800				

SECURITIES AND EXCHANGE COMMISSION

	Trial balance	Security valuations		Com- modity con- tracts losses (Gains)	Aggre- gate indebted- ness	Adjusted Balances	
		Long	Short			Assets	Liabili- ties and deduc- tions
	(a)	(b)	(b)	(c)	(d)	(e)	(f)
LIABILITIES AND NET WORTH—Continued							
“Haircuts”:							
Firm securities..... (y)							11,880
Firm commodities..... (z)							7,755
Contractual commitments..... (aa)							7,500
Customers' commodities..... (bb)							780
Aggregate Indebtedness.....					118,250		
Net Capital..... (cc)						186,700	168,315
Total.....						186,700	186,700

“Net capital” required—greater of \$5,000 or
1/20th of “aggregate indebtedness” of
\$118,250.....

\$5,913

“Net capital” as computed.....
Ratio of “aggregate indebtedness” to “net
capital” ($\$118,250 \div 18,385$).....

18,385

643%

The "net capital" of \$18,385 is the result of the following adjustments:

Capital.....	\$50,000	
Profit and loss.....	8,500	
Securities contributed as capital.....	8,000	\$66,500
Subordinated borrowings:		
Loan payable.....	13,000	
Securities.....	4,000	17,000
		<u>83,500</u>
Add:		
Unrealized profits:		
Partners' accounts.....	3,000	
Exempted securities—long.....	200	
Nonexempted securities—long.....	6,000	
Nonexempted securities—short.....	400	
Future commodity contracts.....	500	10,100
		<u>93,600</u>
Deduct:		
Land and building.....	48,000	
Mortgage payable.....	30,000	
	<u>18,000</u>	
Furniture and fixtures.....	6,000	
Cash—good faith deposit.....	2,800	
Deficits in partly secured customers' accounts.....	2,000	
Unsecured customers' accounts.....	200	
Securities not readily marketable.....	2,000	
Exchange memberships.....	10,000	
Notes receivable—unsecured.....	1,500	
Advances—unsecured.....	900	
Dividends receivable.....	500	
Earned commissions receivable.....	1,400	
Prepaid expenses.....	500	
Other assets.....	1,500	
"Haircuts":		
Firm securities.....	11,800	
Firm commodities.....	7,755	
Contractual commitments.....	7,500	
Customers' commodities.....	780	75,215
		<u>75,215</u>
"Net Capital".....		<u><u>18,385</u></u>

(a) The trial balance column includes the ledger balances of all asset, liability and capital accounts. One account, profit and loss, represents the net balance of all income and expense accounts for the period.

(b) The market value of security and spot (cash) commodity positions is entered in these two columns. Generally, long positions indicate ownership or right of possession (customers' securities; firm trading accounts) and short positions indi-

cate location or responsibility to deliver (pledged as collateral on bank loans; sold short; in physical possession—"box"). In order to show a balanced securities position, in this example values have been shown for all accounts in which there is a securities position although not all such values are used in making the evaluations necessary for determination of "aggregate indebtedness" and "net capital." Valuations used in making the "net capital" computation should be supported by

schedules showing for each security or spot (cash) commodity: title of issue or other description, market price and total market value.

(c) Balance in this column represent the net unrealized appreciation or depreciation (market value compared to cost) of future commodity contracts and the offset of such amounts to the commodity "difference" account.

(d) All liabilities are included as "aggregate indebtedness," except those specifically excluded by paragraph (c)(1).

(e) The asset balances extended to column (e) reflect certain of the adjustments specified in paragraph (c)(2) for determining "net capital."

(f) Column (f) includes all liabilities, except those specifically excluded by provisions of paragraph (c)(2), and the "haircut" on marketable securities, future commodity contracts, and contractual commitments.

(g) A good faith deposit made in connection with an underwriting is considered a balance not readily convertible into cash and is not assigned any value in the "net capital" computation.⁶⁵

(h) Customers' cash accounts, fully secured accounts, and spot (cash) commodities accounts are included in the computation of "net capital" at the amount of their ledger balances. Although such accounts also contain securities or commodities which have a market value greater than the balance due to the broker-dealer, no consideration is given to such excess since these assets belong to the customers.

(i) Partly secured customers' accounts are assigned a value no greater than the market value of the security collateral. In this case, receivables of \$5,000 are taken into account at the liquidating value of the related securities, \$3,000.⁶⁶

(j) Unsecured customers' accounts are not assigned any value.⁶⁷

(k) The credit balance in customers' future commodity accounts, properly segregated in accordance with the Commodity Exchange Act and the rules and regulations thereunder, is excluded from "aggregate indebtedness" but included in liabilities considered in determining "net capital."⁶⁸

(l) Recognition is given to unrealized profits or losses in the accounts of partners who have agreed

in writing that the equity in their accounts with the firm shall be included as partnership property. In the example the ledger balances of these accounts is \$5,000, but in determining "net capital" the accounts are included at the amount of the market value of the securities, \$8,000. If the accounts were not subject to these signed agreements they would be considered as customers' accounts and evaluated only at the amount of the ledger balance, \$5,000.⁶⁵

(m) Recognition is given to unrealized profits or losses in the firm securities and investment accounts. In the example the ledger balances of firm trading accounts are stated at book value; consequently, in determining "net capital," security valuations are substituted. The long position in exempted securities is increased from \$3,000 to market value of \$3,200 and that in nonexempted securities from \$12,000 to market value of \$18,000. The credit balance in the short position is decreased from \$2,000 to \$1,600 because the market value of securities necessary to cover the liability is less than the ledger balance.⁶⁶

(n) Securities not readily marketable because no independent public market exists, or which are subject to some restriction as to their sale, are considered as assets not readily convertible into cash and are not assigned any value in determining "net capital."⁶⁷

(o) The unrealized gain of \$500 on future commodity contracts in firm trading accounts is taken into consideration in the "net capital" computation since this equity applies to partnership property.⁶⁸

(p) Fixed assets such as land and building, and furniture and fixtures, which in the example are stated net of related reserves for depreciation, are not assigned any value in determining "net capital." The mortgage payable, a fixed liability adequately secured by the land and building, is excluded from both "aggregate indebtedness" and liabilities considered in determining "net capital."⁶⁹

(q) Assets which cannot be readily converted

⁶⁵ Para. (c)(2)(A) and (c)(4).

⁶⁶ Para. (c)(2)(A).

⁶⁷ Para. (c)(2)(B).

⁶⁸ Para. (c)(2)(A).

⁶⁹ Para. (c)(1)(G) and (c)(2)(B).

⁶⁵ Para. (c)(2)(B).

⁶⁶ Para. (c)(1)(F).

into cash are not assigned any value in determining "net capital."⁷⁰

(r) Indebtedness adequately collateralized by securities owned by the firm is excluded from "aggregate indebtedness" but is included in liabilities considered in determining "net capital."⁷¹

(s) Amounts payable against securities "failed to receive," which were purchased for the account of the firm and have not been sold, are excluded from "aggregate indebtedness" but are included in liabilities considered in determining "net capital."⁷² Similarly, amounts payable against securities loaned, which are owned by the firm, are excluded from "aggregate indebtedness" but not from liabilities considered in determining "net capital."⁷³

(t) The commodity "difference" account represents the balance of daily settlements with clearing houses on open future commodity contracts which customarily are not allocated to the customers' and firm accounts until final settlement of the contract. Of the balance of \$850 a portion, \$350, represents net gains on contracts in customer's accounts (see (k) above), and the remainder, \$500, applies to net gains on contracts in firm accounts (see (o) above). Since sufficient funds have been segregated in a separate bank account or deposited with clearing houses the amount is excluded from "aggregate indebtedness."⁷⁴

(u) The amount of \$77,600 in column (b) represents the valuation of securities and spot (cash) commodities in customers' accounts (\$49,000) and firms and partners' accounts (\$28,600) held in "box" or in transfer.

(v) Liabilities on open contractual commitments are usually not recorded in the ledger accounts and are not included in either "aggregate indebtedness" or in liabilities considered in determining "net capital."⁷⁵ In the example a contractual commitment to purchase for \$26,750 common

stock which has a current market value of \$27,500 has not been recorded in the ledger accounts.

(w) A loan payable of \$13,000 and non-exempted securities borrowed under "satisfactory subordination agreements" are considered as if they were capital and consequently are excluded from "aggregate indebtedness" and liabilities considered in determining "net capital."

(x) In determining "net capital," securities contributed to capital are considered as assets of the firm.

(y) In the example, as a quick test of compliance, a "haircut" is taken at the maximum rate of 30 percent on the aggregate market value of all nonexempted securities in long and short positions in firm capital and proprietary accounts, including securities in accounts of partners and securities borrowed pursuant to "satisfactory subordination agreements."

The "haircut" is determined in the following manner:

Firm trading accounts:	
Nonexempted securities:	
Long	\$18,000
Short	1,600
Partners' accounts	8,000
Subordinated borrowings:	
Nonexempted securities	4,000
Capital:	
Nonexempted securities	8,000
	<hr/>
Aggregate market value	39,600
	<hr/>
30 percent	11,880
	<hr/>

Since the use of the maximum rate of 30 percent does not result in a "haircut" which reduces "net capital" below the amount required, no further computation is necessary. If schedules of securities are prepared in accordance with the classifications of paragraph (c)(2)(C) then "haircuts" of lesser amounts may be applied as appropriate.⁷⁶

(z) A "haircut" is taken on the aggregate market value of all future commodity contracts in long

⁷⁶ If, for example, the firm trading account included long positions in nonconvertible debt securities with face and market values of \$4,000, and cumulative, nonconvertible pre-

⁷⁰ Para. (c)(2)(B).

⁷¹ Para. (c)(1)(A).

⁷² Para. (c)(1)(D).

⁷³ Para. (c)(1)(C).

⁷⁴ Para. (c)(1)(F).

⁷⁵ Para. (c)(1)(H) and (c)(5).

and short positions in firm accounts. As shown on Schedule A, short positions amount to \$19,250 and long positions are \$6,600 for an aggregate of \$25,850, and consequently the "haircut" at 30 percent equals \$7,755.⁷⁷

(aa) A "haircut" of \$7,500 is based on the contractual commitment to purchase for \$26,750, common stock which has a current market value of \$27,500 (see (v) above). The "haircut" repre-

ferred stocks with market values of \$2,000, the computation could be made in the following manner:

	Market Value	Rate Percent	"Haircut"
Nonconvertible debt securities	\$ 4,000	5	\$ 200
Cumulative, non-convertible preferred stocks	2,000	20	400
All other securities	33,600	30	10,080
Aggregate market value	39,600		
"Haircut"			10,680

⁷⁷ Para. (c)(2)(D).

sents 30 percent of market value, \$8,250, reduced by the unrealized profit of \$750.⁷⁸

(bb) The "haircut" of \$780 on customers' commodities represents 1½ percent of the market values of the greater of the total long or total short future commodity contracts in each commodity carried in customers' accounts. Analysis of the market values of customers' accounts on Schedule A shows that short contracts in wheat of \$14,000 exceed long contracts in that commodity, and that short contracts in corn of \$38,000 exceed long contracts in that commodity. Thus the "haircut" of \$780 is based on the aggregate of \$52,000.⁷⁹

(cc) As developed in the example the application of the adjustments and "haircuts" converts "net worth," including subordinated borrowings, of \$83,500 into "net capital" of \$18,385; "aggregate indebtedness" is \$118,250; and the ratio of "aggregate indebtedness" to "net capital" is 643 percent. Since the ratio does not exceed 2,000 percent and "net capital" exceeds the required minimum of \$5,000, the firm is in compliance with the rule.

⁷⁸ Para. (c)(2)(E).

⁷⁹ Para. (c)(2)(F).

SCHEDULE OF OPEN FUTURE AND SPOT (CASH) COMMODITY CONTRACTS

	Delivery month	Cost		Market value		Losses	Ledger balance	
		Short	Long	Short	Long	(Gains)	Debit	Credit
Customers' accounts:								
Future commodities—								
Wheat								
2 contracts—short.....	Sept.	\$14,400		\$14,000		\$ (400)		\$1,500
1 contract—long.....	Sept.		\$7,100		\$7,000	100		850
Corn								
3 contracts—short.....	July	18,750		19,800		1,050		750
2 contracts—long.....	July		12,500		13,200	(700)		500
1 contract—short.....	Sept.	6,200		6,300		100		250
2 contracts—long.....	Sept.		12,400		12,600	(200)		550
2 contracts—short.....	Dec.	12,200		11,900		(300)		1,300
Total.....		51,550	32,000	52,000	32,800	(350)		5,700
Spot (cash) commodities—								
Wheat								
2 contracts—long.....			14,200		14,600		\$2,000	
Corn								
3 contracts—long.....			18,750		20,700		2,500	
Total.....			32,950		35,300		4,500	
Firm trading accounts—								
Future commodities								
Wheat								
1 contract—short.....	Sept.	7,100		7,000		(100)		
Corn								
1 contract—long.....	July		6,250		6,600	(350)		
1 contract—short.....	Sept.	6,200		6,300		100		
1 contract—short.....	Dec.	6,100		5,950		(150)		
Total.....		19,400	6,250	19,250	6,600	(500)		

APPENDIX

The following amended text of Rule 15c3-1 under the Securities Exchange Act of 1934 became effective, with two exceptions, on July 1, 1965. The exceptions are that the minimum net capital requirements of paragraph (a)(2) did not become effective until December 1, 1965, and that the amendment of the exemptive provisions of paragraph (b)(1) did not become effective until September 1, 1965.

Rule 15c3-1. Net Capital Requirements for Brokers and Dealers

(a) Every broker or dealer shall have the net capital necessary to comply with all the following conditions:

(1) His aggregate indebtedness to all other persons shall not exceed 2,000 per centum of his net capital; and

(2) He shall have and maintain net capital of not less than \$5,000; except that the minimum net capital to be maintained by a broker or dealer meeting all of the following conditions shall be \$2,500:

(A) His dealer transactions (as principal for his own account) are limited to the purchase, sale and redemption of redeemable shares of registered investment companies; except that a broker or dealer transacting business as a sole proprietor may also effect occasional transactions in other securities for his own account with or through another registered broker-dealer;

(B) His transactions as broker (agent) are limited to: (i) the sale and redemption of redeemable securities of registered investment companies; (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

(C) He promptly transmits all funds and delivers, all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.

(b) **Exemptions.** (1) The provisions of this rule shall not apply to any broker who is also a licensed insurance agent under the laws of any State or the

District of Columbia, whose securities business is limited to effecting transactions in variable annuity contracts as general agent for the issuer, who promptly transmits all funds and delivers all variable annuity contracts received in connection therewith, and who does not otherwise hold funds or securities for or owe money or securities to customers, if the issuer files with the Commission an undertaking satisfactory to it that the issuer will assume responsibility for all valid claims arising out of all activities of such agent in effecting transactions in such variable annuity contracts: *Provided, however,* That a broker transacting business as a sole proprietor who meets all other conditions of this subparagraph (b)(1) may also effect occasional transactions in other securities for his own account with or through another registered broker-dealer.

(2) The provisions of this rule shall not apply to any member in good standing and subject to the capital rules of the American Stock Exchange, the Boston Stock Exchange, the Midwest Stock Exchange, the New York Stock Exchange, the Pacific Coast Stock Exchange, the Philadelphia-Baltimore-Washington Stock Exchange, or the Pittsburgh Stock Exchange, whose rules, settled practices and applicable regulatory procedures are deemed by the Commission to impose requirements more comprehensive than the requirements of this rule: *Provided, however,* That the exemption as to the members of any exchange may be suspended or withdrawn by the Commission at any time, by sending ten (10) days written notice to such exchange, if it appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors so to do.

(3) The Commission may, upon written application, exempt from the provisions of this rule, either unconditionally or on specified terms and conditions, any broker or dealer who satisfies the Commission that, because of the special nature of his business, his financial position, and the safeguards he has established for the protection of customers' funds and securities, it is not necessary in the public interest or for the protection of investors to subject the particular broker or dealer to the provision of this rule.

(c) **Definitions.** For the purpose of this rule:

(1) The term "aggregate indebtedness" shall be deemed to mean the total money liabilities of a broker or dealer arising in connection with any transaction whatsoever, including, among other things: money borrowed; money payable against securities loaned and securities "failed to receive"; the market value of securities borrowed (except for delivery against customers' sales) to the extent to which no equivalent value is paid or credited; customers' free credit balances; credit balances in customers' accounts having short positions in securities; and equities in customers' commodities futures accounts; but excluding

(A) indebtedness adequately collateralized, as hereinafter defined, by securities or spot commodities owned by the broker or dealer;

(B) indebtedness to other brokers or dealers adequately collateralized, as hereinafter defined, by securities or spot commodities owned by the broker or dealer;

(C) amounts payable against securities loaned which securities are owned by the broker or dealer;

(D) amounts payable against securities failed to receive which securities were purchased for the account of, and have not been sold by, the broker or dealer;

(E) indebtedness adequately collateralized, as hereinafter defined, by exempted securities;

(F) amounts segregated in accordance with the Commodity Exchange Act and the rules and regulations thereunder;

(G) fixed liabilities adequately secured by real estate or any other asset which is not included in the computation of "net capital" under this rule;

(H) liabilities on open contractual commitments; and

(I) indebtedness subordinated to the claims of general creditors pursuant to a satisfactory subordination agreement, as hereinafter defined.

(2) The term "net capital" shall be deemed to mean the net worth of a broker or dealer (that is, the excess of total assets over total liabilities), adjusted by

(A) adding unrealized profits (or deducting unrealized losses) in the accounts of the broker or dealer and, if such broker or dealer is a partnership, adding equities (or deducting deficits) in accounts of partners, as hereinafter defined;

(B) deducting fixed assets and assets which can-

not be readily converted into cash (less any indebtedness secured thereby) including, among other things, real estate; furniture and fixtures; exchange memberships; prepaid rent, insurance and expenses; good will; organization expenses; all unsecured advances and loans; customers' unsecured notes and accounts; and deficits in customers' accounts, except in bona fide cash accounts within the meaning of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System;

(C) deducting the percentages specified below of the market value of all securities, long and short (except exempted securities) in the capital, proprietary and other accounts of the broker or dealer, including securities loaned to the broker or dealer pursuant to a satisfactory subordination agreement, as hereinafter defined, and if such broker or dealer is a partnership, in the accounts of partners, as hereinafter defined:

(i) in the case of nonconvertible debt securities having a fixed interest rate and a fixed maturity date which are not in default, if the market value is not more than 5 percent below the face value, the deduction shall be 5 percent of such market value; if the market value is more than 5 percent but not more than 30 percent below the face value, the deduction shall be a percentage of market value, equal to the percentage by which the market value is below the face value; and if the market value is 30 percent or more below the face value, such deduction shall be 30 percent;

(ii) in the case of cumulative, nonconvertible preferred stock ranking prior to all other classes of stock of the same issuer, which is not in arrears as to dividends, the deduction shall be 20 percent;

(iii) on all other securities, the deduction shall be 30 percent: *Provided, however,* That such deduction need not be made in the case of (1) a security which is convertible into or exchangeable for other securities within a period of 30 days, subject to no conditions other than the payment of money, and the other securities into which such security is convertible, or for which it is exchangeable, are short in the accounts of such broker or dealer or partner, or (2) a security which has been called for redemption and which is redeemable within 90 days;

(D) deducting 30 percent of the market value of all "long" and all "short" future commodity contracts (other than those contracts representing

spreads or straddles in the same commodity and those contracts offsetting or hedging any "spot" commodity positions) carried in the capital, proprietary or other accounts of the broker or dealer and, if such broker or dealer is a partnership, in the accounts of partners as hereinafter defined;

(E) deducting, in the case of a broker or dealer who has open contractual commitments, the respective percentages specified in subparagraph (C) above of the value (which shall be the market value whenever there is a market) of each net long and each net short position contemplated by any existing contractual commitment in the capital, proprietary and other accounts of the broker or dealer and, if such broker or dealer is a partnership in accounts of partners, as hereinafter defined: *Provided, however,* That this deduction shall not apply to exempted securities, and that the deduction with respect to any individual commitment shall be reduced by the unrealized profit, in an amount not greater than the percentage deduction provided for in subparagraph (C), (or increased by the unrealized loss) in such commitment; and that in no event shall an unrealized profit on any closed transaction operate to increase net capital;

(F) deducting an amount equal to 1½ percent of the market values of the total long or total short futures contracts in each commodity, whichever is greater, carried for all customers;

(G) excluding liabilities of the broker or dealer which are subordinated to the claims of general creditors pursuant to a satisfactory subordination agreement, as hereinafter defined; and

(H) deducting, in the case of a broker or dealer who is a sole proprietor, the excess of (1) liabilities which have not been incurred in the course of business as a broker or dealer over (2) assets not used in the business.

(3) The term "exempted securities" shall mean those securities specifically defined as exempted securities in Section 3(a) of the Act;

(4) The term "accounts of partners" where the broker or dealer is a partnership, shall mean accounts of partners who have agreed in writing that the equity in such accounts maintained with such partnership shall be included as partnership property;

(5) The term "contractual commitments" shall include underwriting, when-issued, when-distributed and delayed delivery contracts, endorse-

ment of puts and calls, commitments in foreign currencies, and spot (cash) commodities contracts, but shall not include uncleared regular way purchases and sales of securities and contracts in commodities futures; a series of contracts of purchase or sale of the same security conditioned, if at all, only upon issuance may be treated as an individual commitment;

(6) Indebtedness shall be deemed to be "adequately collateralized" within the meaning of this rule, when the difference between the amount of the indebtedness and the market value of the collateral is sufficient to make the loan acceptable as a fully secured loan to banks regularly making comparable loans to brokers or dealers in the community;

(7) The term "satisfactory subordination agreement" shall mean a written agreement duly executed by the broker or dealer and the lender, which agreement is binding and enforceable in accordance with its terms upon the lender, his creditors, heirs, executors, administrators, and assigns, and which agreement satisfies all of the following conditions:

(A) it effectively subordinates any right of the lender to demand or receive payment or return of the cash or securities loaned to the claims of all present and future creditors of the broker or dealer;

(B) the cash or securities are loaned for a term of not less than 1 year;

(C) it provides that the agreement shall not be subject to cancellation by either party, and that the loan shall not be repaid and the agreement shall not be terminated, rescinded or modified by mutual consent or otherwise if the effect thereof would be to make the agreement inconsistent with the conditions of this rule or to reduce the net capital of the broker or dealer below the amount required by this rule;

(D) it provides that no default in the payment of interest or in the performance of any covenant or condition by the broker or dealer shall have the effect of accelerating the maturity of the indebtedness;

(E) it provides that any notes or other written instruments evidencing the indebtedness shall bear on their face an appropriate legend stating that such notes or instruments are issued subject to the provisions of a subordination agreement

which shall be adequately referred to and incorporated by reference;

(F) it provides that any securities or other property loaned to the broker or dealer pursuant to its provisions may be used and dealt with by the broker or dealer as part of his capital and shall be subject to the risks of the business; and

(G) two copies of such agreement, and of any notes or written instruments evidencing the indebtedness, are filed, within 10 days after such agreement is entered into, with the Regional Office of the Commission for the region in which the broker or dealer maintains his principal place of business, together with a statement of the full name and address of the lender, the business relationship of the lender to the broker or dealer, and whether the broker or dealer carried funds or se-

curities for the lender at or about the time the agreement was entered into. If each copy of such agreement is bound separately and clearly marked "Non-Public" such agreements shall be maintained in a nonpublic file: *Provided, however,* That they shall be available, for official use, to any official or employee of the United States or any State; to any national securities exchange and any registered national securities association of which the broker or dealer filing such agreements is a member; and to any other person to whom the Commission authorizes disclosure in the public interest;

(8) the term "customer" shall mean every person except the broker or dealer: *Provided, however,* That partners who maintain "accounts of partners" as herein defined shall not be deemed to be customers insofar as such accounts are concerned.

RELEASE NO. 108

February 9, 1967

Order In the Matter of Nicolas J. Raftery, A Certified Public Accountant

On the basis of information furnished to the Commission in a nonpublic investigative proceeding, the Commission has reason to believe that there may have been a lack of adherence to generally accepted auditing standards and its minimum audit requirements by Nicolas J. Raftery, a certified public accountant, in connection with the preparation and submission to the Commission of certain financial statements in accordance with the requirements of Rule 240.17a-5.

The information furnished the Commission indicates that the questioned audits were deficient in respect of one or more of the following matters: (1) the failure to obtain written confirmation of bank balances and obtain the bank statements and cancelled checks from the depositaries and reconcile the bank balances at the audit date; (2) the failure to obtain the bank statements and cancelled checks from the depositaries and reconcile the balances shown thereon with the balances shown by the records at an appropriate date subsequent to the audit date; (3) the failure to obtain written confirmations of customers' accounts, open contractual commitments, etc., as at the audit date; (4) the failure to review and on a test basis obtain written confirmation of customers' accounts closed during the period under review; (5) the failure to examine and obtain written confirmation of subordination agreements covering indebtedness shown as subordinated in the financial statements; (6) the failure to secure a written statement

signed by the proprietor, a responsible partner, or an officer, as appropriate, as to the assets, liabilities, and accountabilities, contingent or otherwise, not recorded on the respondent's books; or (7) the acceptance by Raftery of employment to perform an audit when he was not independent in that he had indebtedness to the respondent or an officer thereof; (8) the alteration, in at least two instances, of the audit working papers after our investigation began.

Nicolas J. Raftery, without admitting or denying any such lack of adherence to generally accepted auditing standards or the minimum audit requirements, has tendered to the Commission his resignation in which he agrees that he will not appear or practice before the Commission in the future; and the Commission being satisfied that by reason of such resignation no proceeding pursuant to Rule 2(e) of the Commission's Rules of Practice is necessary; and it being determined by the Commission that it is not inconsistent with the public interest;

IT IS ORDERED that Nicolas J. Raftery's resignation from practice before this Commission be and hereby is accepted, and that no further proceeding be had in this matter.

By the Commission.

ORVAL L. DuBOIS,
Secretary.

RELEASE NO. 109

September 25, 1967

Order In the Matter of Edwin Aronowitz, a Public Accountant

On the basis of information furnished to the Commission, it appears to the Commission that there may have been a lack of adherence to generally accepted auditing standards and the Commission's minimum audit requirements by Edwin Aronowitz, a public accountant, in connection with the preparation and submission to the Commission of certain financial statements required by Rule 240.17a-5.

Edwin Aronowitz has tendered to the Commission his resignation in which he agrees that he will not appear or practice before the Commission in the future; and the Commission being satisfied

that by reason of such resignation no proceeding pursuant to Rule 2(e) of the Commission's Rule of Practice is necessary; and that such disposition of the matter is not inconsistent with the public interest;

IT IS ORDERED that the resignation from practice before this Commission by Edwin Aronowitz be and hereby is accepted.

By the Commission.

ORVAL L. DuBOIS,
Secretary.

RELEASE NO. 110

January 18, 1968

Order In the Matter of Meyer Weiner, a Certified Public Accountant

On the basis of information obtained in a non-public investigative proceeding, the staff has charged (a) that Meyer Weiner of Reading, Pennsylvania, acting in his capacity as a certified public accountant, willfully aided and abetted in violations of Section 17(a) of the Securities Exchange Act of 1934 and Rule 17 CFR 240.17a-5 thereunder in that (1) he certified without qualification or exception a materially false and misleading statement of financial condition filed with the Commission by William P. Mackay, a broker-dealer doing business as Mackay and Company (Securities Exchange Act Release No. 7343, June 15, 1964), and (2) when he was not in fact independent, he certified without qualification or exception a statement of financial condition filed with the Commission by Jacob Luther Hain, another broker-dealer doing business as J. L. Hain & Co.; and (b) that, in connection with the preparation of the statements of financial condition mentioned above, there was a lack of adherence by Weiner to generally accepted auditing standards and the Commission's minimum audit requirements as set forth in Form X-17A-5.

The information obtained in the investigation

indicates that Weiner's audits were deficient in respect of one or more of the following matters: (1) Mackay did not maintain a general ledger and therefore Weiner did not compare the "ledger accounts" with a trial balance obtained from the general ledger and did not compare the aggregates of subsidiary ledgers with their respective control accounts; (2) Weiner did not balance securities positions as at the audit date; (3) Weiner did not balance and confirm customers' money balances and securities positions; (4) loans to Mackay totaling about \$525,496, including about \$34,000 payable to banks, were omitted from the statement of financial condition, and the statement of financial condition thereby improperly showed a capital position of \$38,311; (5) Weiner failed to check the proceeds of such loans into bank accounts and to verify expenditures therefrom; and (6) Weiner was not, in fact, independent.

Meyer Weiner, without admitting or denying any lack of adherence to generally accepted auditing standards or the minimum audit requirements or any of the other staff charges, has tendered to the Commission his resignation in which he agrees that he will not appear or practice before the

Commission in the future. The Commission has determined that by reason of such resignation no proceeding pursuant to Rule 2(e) of its Rules of Practice is necessary, and that such disposition of the matter is not inconsistent with the public interest.

Accordingly, It Is ORDERED that Meyer Weiner's

resignation from appearance and practice before this Commission be and it hereby is accepted.

For the Commission (pursuant to delegated authority).

ORVAL L. DuBOIS,
Secretary.

RELEASE NO. 111

March 20, 1968

SECURITIES ACT OF 1933
Release No. 4899

HOLDING COMPANY ACT OF 1935
Release No. 16010

SECURITIES EXCHANGE ACT OF 1934
Release No. 8274

INVESTMENT COMPANY ACT OF 1940
Release No. 5315

Amendment to Rule 1-01 of Article 1 of Regulation S-X

Purpose of Amendment

This amendment to Rule 1-01 of Article 1 brings this rule up to date and makes unnecessary amendments to this rule each time an existing form is rescinded or a new form is added.

Text of Amended Rule

Rule 1-01. Application of Regulation S-X.

(a) This regulation (together with the Accounting Series Releases) states the requirements applicable to the form and content of all financial statements required to be filed as a part of—

(1) Registration statements under the Securities Act of 1933, except as otherwise specifically provided in the forms which are to be used for registration under this Act;

(2) Registration statements under Section 12 and annual or other reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934, except as otherwise specifically provided in the forms which are to be used for registration and reporting under these Sections of this Act;

(3) Registration statements and annual reports filed under the public Utility Holding Company Act of 1935 by public utility holding companies registered under such Act; and

(4) Registration statements and annual reports

under the Investment Company Act of 1940.

(b) The term "financial statements" as used in this regulation shall be deemed to include all supporting schedules.

Statutory Basis

The foregoing action is taken pursuant to the Securities Act of 1933, particularly Sections 6, 7, 8, 9, 10, and 19(a) thereof, the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d) and 23(a) thereof, the Public Utility Holding Company Act of 1935, particularly Sections 5(b), 14 and 20(a) thereof, and the Investment Company Act of 1940, particularly Sections 8, 30, 31(c) and 38(a) thereof.

Since the foregoing action merely deletes reference to specific forms to which Regulation S-X applies, this action reduces the number of or obviates amendments to this rule when a form is rescinded or a new form is added. For these reasons the Commission finds that notice and procedure pursuant to the Administrative Procedure Act is not necessary. For the same reasons the foregoing action may be made effective immediately. Accordingly, such action shall become effective upon publication March 20, 1968.

ORVAL L. DuBOIS,
Secretary.

RELEASE NO. 112

August 12, 1968

SECURITIES ACT OF 1933

Release No. 4918

SECURITIES EXCHANGE ACT OF 1934

Release No. 8379

HOLDING COMPANY ACT OF 1935

Release No. 16137

INVESTMENT COMPANY ACT OF 1940

Release No. 5462

Independence of Accountants Examining a Nonmaterial Segment of an International Business

The Securities and Exchange Commission today announced the publication of a release in its Accounting Series dealing with independence of accountants. The release is concerned with a matter which tends to arise more frequently as United States corporations doing business on an international scale increase in number and their respective operations are conducted in an ever-growing number of geographical areas.

In matters of independence, the Commission has continued to give recognition to the increasing complexities in the business field and the impracticability of attempting to identify in advance all the circumstances under which an accountant might be considered not independent or which would result in a determination not to question his independence.¹

This approach has had the effect of providing needed flexibility where the decision in any particular situation can be made only after taking into consideration all known relevant circumstances. In Accounting Series Release No. 81 we indicated that in any case where doubt exists the accountant should discuss the facts with the staff. In general this has proved a satisfactory method to administer a segment of the Commission's statutory responsibility which is of significant importance in the public interest and the protection of the investors.

Where a company is engaged in international operations, it requires auditing services in those countries where its divisions or subsidiaries own properties or otherwise conduct business. A division or subsidiary of a United States com-

pany (hereafter the "parent company") may conduct business abroad in a geographical area where the parent company's independent public accountants do not practice. Frequently, the importance to the parent company's total enterprise of the division or subsidiary is small, and another accounting firm² (hereafter the "other accounting firm") acceptable to the independent accountants of the parent company may be engaged to examine the financial statements of the division or subsidiary.

Inquiry has been made whether in the situation where the financial statements of a division or subsidiary which represents a non-material segment of an international business are examined by another accounting firm or its affiliated firm, Rule 2-01 of Regulation S-X³ is construed so as to preclude all the partners of such other accounting firm or its affiliated firm from owning any securities of the parent company or the subsidiary in order for the other accounting firm to be considered independent as to the parent company or the subsidiary.

We believe that the purposes of Rule 2-01 would be adequately served by a less restrictive construction. Insofar as ownership of securities by partners is concerned, the other accounting

² In many cases the other accounting firm which has been retained to do the examination will do so through one of its affiliated firms operating abroad.

³ Rule 2-01 of Regulation S-X provides that "an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest." Where the "accountant" is a firm, the Commission has construed the restriction to apply to each partner of the firm whether or not he has any connection with the examination.

¹ Accounting Series Releases No. 47, January 25, 1944; No. 79, April 8, 1958; and No. 81, December 11, 1958.

firm would be held to be not independent only if securities of the parent company or the subsidiary are owned by any of the partners of the other accounting firm or its affiliated firm who are located in the office which makes the ex-

amination of the division or subsidiary or who are otherwise engaged in such examination.

This interpretation relates exclusively to the ownership of securities and does not extend to any other relationship proscribed by Rule 2-01.