NASD

Notice To Members

National Association of Securities Dealers, Inc. April 1991

Number 91-19

Suggested Routing:*

✓ Senior Management
_ Corporate Finance
_ Government Securities
_ Institutional
✓ Internal Audit
✓ Legal & Compliance
_ Municipal
_ Mutual Fund
✓ Operations
_ Options
✓ Registration
_ Research
_ Syndicate
_ Systems
_ Trading
✓ Training

*These are suggested departments only. Others may be appropriate for your firm.

MAIL VOTE

Subject: Proposed Amendment to Article V, Section 1 of the NASD Rules of Fair Practice Regarding the Suspension of the Membership of Any Member or of the Registration Of a Person Associated With a Member for a Definite Period Assessed as a Sanction For a Rule Violation; Last Voting Date: May 3, 1991

EXECUTIVE SUMMARY

Members are invited to vote on a proposed amendment to Article V, Section 1 of the NASD Rules of Fair Practice. The amendment would exclude from the rule the requirement that suspensions of membership or suspensions of the registration of associated persons be for a specific length of time. The amendment would allow the NASD to impose, as a sanction for a rule violation, a suspension either of membership or of the registration of an associated person effective until such person or member proves he or she has undertaken a certain activity required by the NASD as part of the sanction imposed. The text of the proposed amendment follows this notice.

BACKGROUND

Section 15A(b)(7) of the Securities Exchange Act of 1934 provides in part that, in order for an association to be registered as a national securities association, its rules must provide that its members and persons associated with its members will be appropriately disciplined by expulsion, suspension, limitation of activities, or other fitting sanctions. Article V, Section 1 of the NASD Rules of Fair Practice sets forth the sanctions that may be imposed by the NASD Board of Governors ("Board") or any District Business Conduct Committee (DBCC) or Market Surveillance Committee (MSC) (collectively, the "Committees") for rule violations. It states, in part, that the Committees or the Board may "suspend the membership of any member or suspend the registration of a person associated with a member, if any, *for a definite period* . . ." (emphasis added). The proposed amendment would delete the words "for a definite period," thereby allowing the Board and any DBCC or MSC to impose a suspension without specifying a definite period for the duration of the suspension.

Currently, Article V, Section 1 limits the imposition of suspensions in that it requires that all suspensions imposed by any DBCC, MSC, or the Board specify the term of the suspension. The requirement effectively precludes the imposition

of a suspension that is of indefinite duration, such as suspensions ordered to remain effective until an arbitration award is paid or until the respondent proves restitution, among others. The termination of a suspension of this type is contingent on the completion by the associated person or member of an additional requirement imposed by the Board or the Committees. Such suspensions are useful, particularly in cases involving customer losses.

In appeals of NASD disciplinary actions, the Securities and Exchange Commission has rejected suspensions imposed under similar circumstances, stating that the suspensions violated Article V, Section 1 in that their lengths were indefinite. The proposed amendment seeks to eliminate the self-imposed prohibition and provide the Board and the DBCCs and MSCs with greater leeway in crafting sanctions.

A significant number of disciplinary actions brought by the DBCCs or MSCs involve scenarios in which, as part of the sanction imposed, the DBCC or MSC seeks to require that the member or associated person perform a particular act. Suspensions contingent on receipt of proof that the member or associated person has performed the act is an alternative that will allow the Committees and the Board to formulate sanctions that meet the Association's diverse needs.

The amendment will enable the Committees and the Board to ensure that the penalties imposed in disciplinary actions afford a measure of customer protection and preclude registered individuals from associating with NASD members, and members from acting in their registered capacities, unless and until they perform the required activity.

COMMENTS RECEIVED

An amendment identical to the version published for vote here was published for comment in *Notice to Members 90-74* (November 1990). The NASD received nine comments on the proposed amendment, three generally in favor and six generally opposed. Of the six entities that expressed opposition to the amendment, most were concerned with the complications that may arise through the NASD's use of an indefinite suspension as a means of requiring restitution of customer losses. A number of the comments suggested alternatives to the rule change, and one comment expressed concern about broadening the NASD's authority.

After consideration of these comments, the Board of Governors felt that the requirement that suspensions be imposed for definite periods should be eliminated in order to enable the Board and Committees to fashion sanctions that meet the individual requirements of each disciplinary matter. The Board believes that the amendment will provide the Committees and the Board with needed flexibility in determining penalties and allow them the opportunity to require that registered persons or members undertake certain activities before being allowed to continue in their status as members or registered persons. The Board does not believe that the amendment grants the Association unlimited power in fashioning sanctions, and it believes that the amendment will better enable the NASD to meet its regulatory responsibilities successfully.

SUMMARY OF PROPOSED AMENDMENTS

The NASD is proposing to amend Article V, Section 1 of the Rules of Fair Practice to provide the NASD with the ability to impose suspensions of membership and of the registration of associated persons until the member or associated person proves that he or she has completed an additional requirement included as part of the sanction. The change would be accomplished by deleting from the rule the requirement that all suspensions imposed by the Board or any DBCC or MSC be for a definite period of time. The NASD believes it is essential that the Committees and the Board have the ability to require, as part of a disciplinary penalty, that disciplinary respondents undertake certain activities before being allowed to continue as associated persons or registered NASD members.

REQUEST FOR VOTE

The NASD Board of Governors therefore believes that this change to the Rules of Fair Practice is necessary and appropriate and recommends that members vote their approval. Please mark the enclosed ballot according to your convictions and return it in the enclosed, stamped envelope to the Corporation Trust Company. Ballots must be postmarked **no later than May 3, 1991.**

Questions concerning this notice may be directed to Carla J. Carloni, Attorney, Office of General Counsel, at (202) 728-8019.

PROPOSED AMENDMENT TO NASD RULES OF FAIR PRACTICE

Article V, Section 1

(**Note**: Deleted text is in brackets.)

ARTICLE V

Penalties

Penalties for Violations of the Rules

Section 1. Any District Business Conduct Committee, Market Surveillance Committee, or the Board of Governors, in the administration and enforcement of these Rules, and after compliance with the Code of Procedure, may (1) censure any member or person associated with a member and/or (2) impose a fine upon any member or person associated with a member and/or (3) suspend the membership of any member or suspend the registration of a person associated with a member, if any, [for a definite period,] and/or (4) expel any member or revoke the registration of any person associated with a member, if any, and/or (5) suspend or bar a member or a person associated with a member from association with all members, or (6) impose any other fitting penalty deemed appropriate under the circumstances, for each or any violation of any of these Rules by a member or person associated with a member or for any neglect or refusal to comply with any orders, directions or decisions issued by any District Business Conduct Committee, Market Surveillance Committee or by the Board of Governors in the enforcement of these Rules, including any interpretative ruling made by the Board of Governors, as any such Committee or Board, in its discretion, may deem to be just; provided, however, that no such sanction imposed by any District Business Conduct Committee or Market Surveillance Committee shall take effect until the period for appeal therefrom or review has expired, as provided in Article III, Section 1 of the Code of Procedure; and provided, further, that all parties to any proceeding resulting in a sanction shall be deemed to have assented to or to have acquiesced in the imposition of such sanction unless any party aggrieved thereby shall have made application to the Board of Governors for review pursuant to the Code of Procedure, within fifteen (15) days after the date of such notice.

NASD

Notice To Members

National Association of Securities Dealers, Inc. April 1991

Number 91-20

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- ✓ Senior Management
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Subject: Adoption of Amendments to SEC Rule 15c3-1 Regarding Withdrawals of Net Capital

EXECUTIVE SUMMARY

The Securities and Exchange Commission (SEC or "the Commission") has issued Release No. 34-28927, adopting amendments to Rule 15c3-1 (the "Rule") with respect to withdrawals of net capital. The amendments expand the capital withdrawal limitations in subparagraph (e) of the Rule and require, in certain instances, notification to the SEC prior to effecting the withdrawal(s) of capital directly or indirectly to benefit certain specified persons or entities related to the broker-dealer. The SEC, by order, in exceptional circumstances can prohibit such withdrawals if it determines that the withdrawal(s) could be detrimental to the financial integrity of the broker-dealer or affect the broker-dealer's ability to meet customer obligations. However, a broker-dealer subject to such an order may request a post-order hearing regarding the order. The amendments become effective May 6, 1991.The text of the amendments follows this notice.

BACKGROUND

On August 15, 1990, the SEC proposed amendments to its Net Capital Rule designed to address the issues arising from the withdrawals of capital from a broker-dealer by a parent or affiliate. (See *Notice to Members 90-66.*) The proposed amendments were intended to improve the SEC's ability to protect the customers and creditors of a broker-dealer in those circumstances where a financial problem in a holding company or other affiliate would lead to withdrawals of capital from the broker-dealer.

In response to the proposal, the SEC received a number of comment letters raising concerns about certain aspects of the proposed amendments, especially the potential negative impact they could have on a firm's capital-raising ability and the financing of its activities.

Many commenters offered alternatives or suggested changes to the proposal. Based on the comments received, the SEC has amended its original proposal to address the concerns raised. The Release notes, "The Commission believes the amendments adopted will strike an appropriate balance between the need for increased early warning protection and the ability of broker-dealers to allocate their resources efficiently."

The amendments expand the scope of current

subparagraph (e) of the Rule (limitation on withdrawal of equity capital) to provide three new parts dealing with prohibition, notification, and restriction as follows:

Prohibition

New section (e)(2)(iii) prohibits capital withdrawals if they would cause the firm's net capital to be less than 25 percent of proprietary "haircuts," unless the firm has the prior approval of the SEC to make such withdrawals.

Notification

The amendments provide for both prior and post-capital withdrawal(s) notification as follows:

(i) Prior Notification

Projected capital withdrawals, directly or indirectly, by actions of a stockholder, partner, or affiliate of the broker-dealer (insiders) require notifying the SEC and its designated examining authority at least two business days before the intended capital withdrawal if the projected withdrawal, along with other withdrawals, on a net basis, during the preceding thirty (30) calendar days, exceeds 30 percent of the firm's excess net capital.* However, a broker-dealer, in an emergency situation, may make such capital withdrawals without giving the required advance notice if it has obtained the prior approval of the Designated Examining Authority (DEA).

(ii) Post Notification

A broker-dealer must give written notification to the SEC and its DEA two business days after it has made capital withdrawals, on a net basis during the prior 30 calendar days, that exceed 20 percent of its excess net capital.*

The notification requirement does not apply to withdrawals totaling $500,000 or less. Neither does it apply to securities and commodities transactions between a firm and an affiliate if the broker-dealer is reimbursed within two business days of the transaction.

Restrictions

The amendments give the SEC the authority, by order, to restrict the withdrawal of capital by a broker-dealer to insiders for a period of twenty (20) business days if (i) the withdrawal, along with other withdrawals during a 30-day period, exceeds 30 percent of excess net capital, and (ii) the SEC finds the withdrawal may be detrimental to the financial integrity of the broker-dealer or may unduly jeopardize the firm's ability to repay customers and other creditors. The affected firm can request a hearing, which must be held within two business days of the request.

The term "capital withdrawals" includes not only return of capital contributions, but also dividend distributions, stock redemption, unsecured advances or loans to stockholders, partners, sole proprietors, affiliates, or employees. Furthermore, new section (e)(4)(iv) notes that transactions between a broker-dealer and an insider that result in a reduction of the broker-dealer's net capital, such as the purchase or transfer of a nonallowable asset, would be deemed a capital withdrawal for purposes of the Rule. But withdrawals would not include required tax payments or the payment of reasonable compensation to partners.

Questions concerning this notice may be directed to Walter Robertson, Associate Director, Financial Responsibility, at (202) 728-8236, or Samuel Luque, Associate Director, Financial Responsibility, at (202) 728-8472.

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*A broker-dealer may use the excess net capital as reported on the most recently required filed Form X-17A-5 (FOCUS Report) when calculating the effect of a proposed withdrawal, provided that the broker-dealer determine there has not been a material change since this report.

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-28927]

RIN 3235-AD79

Net Capital Rule

AGENCY: Securities and Exchange Commission.

ACTION: Final rule amendments.

SUMMARY: The Securities and Exchange Commission is amending that provision of its net capital rule under the Securities Exchange Act which deals with limitations on withdrawal of equity capital. The amendments will require a registered broker-dealer to notify, in writing, the Commission and certain other described persons two business days before making withdrawals of equity capital directly or indirectly to benefit certain described persons related to the broker-dealer if those withdrawals would exceed, in any 30 day period, 30 percent of the broker-dealer's excess net capital. A broker-dealer will also be required to notify the Commission within two business days after any withdrawals, advances or loans as described above that would exceed, in any 30 day period, 20 percent of the broker-dealer's excess net capital. Withdrawals of $500,000 or less are exempt from the notification requirements of the rule amendments. In addition, the amendments will also prohibit withdrawals of equity capital, unless the broker-dealer has the prior consent of the Commission, if the effect of the withdrawals would cause the broker-dealer's net capital to be less than 25 percent of its deductions required by the net capital rule as to its readily marketable securities. Finally, the amendments would permit the Commission, by order, to prohibit withdrawals of capital from a registered broker-dealer for a period of up to twenty business days, if the withdrawals would be in an amount greater than 30 percent of the broker-dealer's excess net capital and the Commission believes such withdrawals would be detrimental to the financial integrity of the firm or would unduly jeopardize the broker-dealer's ability to pay its customer claims or other liabilities. A broker-dealer subject to an order restricting withdrawals of capital may request a post-order hearing regarding the order. Although the amendments have been substantially modified to respond to several concerns raised by the commentators, the Commission does not believe it is necessary to re-propose the amendments for comment because all the changes relate to issues that were raised for public comment.

EFFECTIVE DATE: The amendments become effective May 6, 1991.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, (202) 272-2904, Michael P. Jamroz, 272-2372 or Roger G. Coffin, (202) 272-2396, Division of Market Regulation, 450 Fifth Street NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. Introduction

On August 15, 1990, the Commission published a release requesting comment on proposed amendments to the net capital rule which would place new limits on the withdrawal of equity capital from a broker-dealer.[1] The proposal was a response to the Commission's concerns that significant amounts of equity capital could be withdrawn from a broker-dealer between reporting periods and that the early warning levels established in the net capital rule were set too low for certain broker-dealers. Currently, the owners of registered broker-dealers may cause substantial amounts of capital to be withdrawn from the broker-dealer without notifying the Commission or its examining authority if the withdrawal does not cause the broker-dealer's net capital to decline below the levels established under the rule.

The proposal had three parts. First, the proposal would have required a broker-dealer to give two business days advance written notice to the Commission and its examining authority if the broker-dealer planned to withdraw more than the greater of $50,000 or 20 percent of its excess net capital in a 30 day period or 30 percent of its excess net capital in a 90 day period. Second, the Commission's proposal would have created an additional restriction against the withdrawal of capital when the effect of the withdrawal would have been to lower a broker-dealer's net capital below 30 percent of the firm's deductions related to its readily marketable securities if that number was greater than the broker-dealer's present early warning level. Third, the proposal would have permitted the Commission to restrict the withdrawal of capital from a specific broker-dealer for a period of up to twenty business days when the Commission believed the withdrawal would be detrimental to the financial integrity of the broker-dealer or might unduly jeopardize the firm's ability to pay its customers or creditors.

[1] Securities Exchange Act Release No. 28347 (August 15, 1990), 55 FR 34027 (August 21, 1990).

In response to the proposal, the Commission received many thoughtful comments from industry representatives. Generally, the commentators to the proposal raised a number of concerns with the proposed amendments and their effect on the ability of firms to attract capital and to finance their activities. To lessen the effect on their business activities, the commentators also suggested alterations to the proposal. The writers also commented on several technical aspects of the proposal. The Commission believes that many of the comments were appropriate and has substantially amended its original proposal. The Commission also believes, however, that the basic concerns articulated in the proposing release are valid. The Commission believes the amendments as adopted will strike an appropriate balance between the need for increased early warning protection and the ability of broker-dealers to allocate their resources efficiently.

II. The Net Capital Rule

The primary purpose of the net capital rule (Securities Exchange Act Rule 15c3-1; 17 CFR 240.15c3-1) is to protect customers and creditors of registered broker-dealers from monetary losses and delays when a broker-dealer fails. In this way, the rule acts to prevent systemic risk from the failure of a financial intermediary. The net capital rule requires registered broker-dealers to maintain sufficient liquid assets to enable firms that fall below the minimum net capital requirements set forth in the rule to liquidate in an orderly fashion without the need for a formal proceeding and at a reduced risk of customer loss.

A broker-dealer's net capital requirement is computed by deducting from net worth, among other things, the book value of illiquid assets and certain prescribed percentages from the market value of securities held in the proprietary accounts of the broker-dealer. These latter deductions are referred to as "haircuts." In the case of many firms, haircuts are substantial and require the broker-dealer to maintain significant amounts of capital (either in the form of equity capital or debt subordinated in accordance with the rule) to carry the positions in order to maintain net capital compliance.

Presently, the net capital rule requires a registered broker-dealer conducting a general securities business to maintain net capital in excess of the greater of $25,000 or 6⅔ percent of its liabilities and other obligations ("basic or aggregate indebtedness method"). If the broker-dealer makes an election under paragraph (f) of the net capital rule, it

must maintain net capital in excess of the greater of $100,000 or 2 percent of its so called aggregate debit items ("alternative method"). These aggregate debit items generally may be thought of as a broker-dealer's customer-related receivables.[2]

Paragraph (e) of the net capital rule limits the withdrawal of equity capital from a registered broker-dealer by any stockholder or partner, or the making of unsecured advances or loans to any stockholder, partner or employee if the effect of such withdrawal, advance or loan would reduce the broker-dealer's net capital below certain specified levels, which are set at levels higher than the required minimums. These levels, in effect, serve as early warning levels to alert regulatory authorities that a broker-dealer is experiencing financial difficulty. The early warning levels also prevent the broker-dealer from favoring owners of the firm to the detriment of its customers or other creditors by placing restrictions on the withdrawal of equity capital. For example, the withdrawals cannot cause the broker-dealer's net capital to be less than, among other things, 120 percent of the applicable minimum dollar amount required under Rule 15c3-1. If the broker-dealer is computing its net capital requirement under the basic method, paragraph (e) prohibits the firm from making an unsecured loan, advance or withdrawal to benefit insiders if the effect thereof would cause the firm's aggregate indebtedness to exceed 1000 percent of its net capital. If the broker-dealer calculates its net capital requirement under the alternative method, it may not allow its net capital to be reduced by withdrawals, advances or unsecured loans to insiders to an amount lower than 5 percent of its aggregate debit items.

The problems unique to broker-dealers that operate within a holding company organization have come into focus in recent years and were dramatically illustrated in the failure of Drexel Burnham Lambert Group Inc. ("Drexel"), the holding company parent of the registered broker-dealer Drexel Burnham Lambert, Inc. ("DBL"). Drexel, like other large investment banking concerns, developed an organizational structure in which the registered broker-dealer DBL was one member of a number of subsidiaries and affiliates of Drexel conducting financial and securities activities, some of which were regulated by the Commission, others were regulated by other agencies or were unregulated. Many broker-dealer holding companies rely on short-term unsecured financing to fund their activities. Drexel had over $1 billion in commercial paper and other short-term borrowings outstanding which it needed to fund it day to day operations. As a result of significant losses and a decline in the rating of its commercial paper, Drexel found it difficult to renew its short-term borrowings. Drexel was then forced to look to the only liquid sources of capital in its assets—the excess net capital of DBL and an affiliated government securities dealer.

In a period of approximately three weeks, and without the knowledge of the Commission or the New York Stock Exchange Inc., (the "NYSE") DBL's designated examining authority, since no notice was required under then existing rules, approximately $220 million was transferred from the broker-dealer to the holding company in the form of short-term loans. This action occurred during a period in which the default or financial problems of a number of issuers had adversely impacted the liquidity and pricing reliability in the high-yield securities market and raised difficulties in valuing a substantial portion of DBL's portfolio of securities for the purposes of determining capital compliance. Moreover, at the time the Commission became aware of Drexel's financial dilemma, Drexel or its affiliates had more than $400 million in short-term liabilities coming due in the next two weeks and an additional $330 million scheduled to mature in the next month.

Prior to the chapter 11 bankruptcy filing by Drexel, the Commission advised Drexel and DBL of its concerns regarding the previous withdrawals of capital by Drexel from DBL and an affiliated government securities dealer. Additionally, the Division of Market Regulation and the NYSE each sent letters to Drexel and DBL which resulted in Drexel's ceasing to withdraw further capital from DBL. However, had the Commission and the NYSE not intervened when they did, Drexel could have continued to extract funds from DBL until DBL's early warning level was reached. Especially in light of Drexel's precarious financial position and the uncertainty surrounding DBL's valuation of its high-yield portfolio, this would have created the risk that the broker-dealer's customers and counterparties would have been subjected to a liquidation under the Securities Investor Protection Act.

III. The Rule Amendments

A. General Comments

Several commentators questioned whether the amendments are necessary or an appropriate alternative to the effective enforcement of existing regulatory requirements. Some commentators pointed to the successful liquidation of DBL as evidence for the proposition that the Commission's financial responsibility rules already provide a satisfactory mechanism for monitoring and reacting to financial difficulties in a registered broker-dealer. Others argued that the amendments, insofar as they stem from the Drexel failure, are an overboard solution to a unique problem. The Drexel situation was distinctive, according to these commentators, because of the combination of a weak capital and financing structure at the holding company level with liquidity and pricing concerns relative to DBL's high-yield securities portfolio.

The Commission believes that, while the Drexel situation was ultimately resolved without any customer loss, it underlined the critical importance of providing the Commission with the necessary regulatory tools to prevent a repetition of similar events. In the case of Drexel, the Commission became aware of the nature and the severity of Drexel's financial problems after the staff of the Commission was informed by outside sources that a government securities dealer was prepared to inform government securities broker's brokers that the dealer would no longer trade in government securities with Drexel's government securities subsidiary. Such a step by a major securities firm relating to a primary dealer in the government securities market was highly unusual, and triggered the ensuing review by the Commission which identified the precarious financial condition of Drexel, DBL and the government securities dealer. The Commission believes the net capital rule should operate to provide assured notice of significant and sudden changes in the amount of capital that a firm has committed to supporting its operations and should contain provisions that will enable the Commission to respond to situations that arise in the future that raise similar concerns.

B. Early Warning Level Based on Haircuts

In proposing an early warning level based on 30 percent of a broker-dealer's haircuts, the Commission was concerned that the levels set in paragraph (e) of the net capital rule were not sufficient for broker-dealers

[2] More specifically, the broker-dealer must maintain net capital in excess of its aggregate debit items as computed in accordance with the Formula for Determination of Reserve Requirement for Brokers and Dealers contained in Securities Exchange Act Rule 15c3-3 (17 CFR 240.15c3-3).

conducting a dealer business. The theory underlying the alternative method of calculating net capital is that the amount of customer debits a firm has will provide an approximation of its needs for a capital base. However, a broker-dealer conducting a dealer business may have relatively few customer debits. Therefore, its net capital requirement under the alternative method may be relatively low and not related to the size or risk of its dealer business. Because the early warning levels currently contained in paragraph (e) of the net capital rule are based on minimum net capital requirements, they too may be relatively low and not related to the risks inherent in the dealer business.

While some commentators recognized that the overall risk exposure of certain broker-dealers may be accurately reflected by an early warning level based on haircuts, other commentators argued that the haircuts test would, in effect, operate as a minimum net capital requirement instead of an early warning level because it would prohibit firms from distributing capital to affiliates once the threshold is reached. They argued that such a restriction was unnecessary because the haircuts on proprietary positions required by the rule already ensure that firms primarily engaged in proprietary trading are adequately capitalized. Those commentators also argued that creating an early warning level based on 30 percent of haircuts would unduly restrict broker-dealers' ability to apportion capital as business opportunities presented themselves. For this reason, a number of commentators suggested incorporating the 30 percent test into paragraph (e)(1) calling for notification only. These commentators also argued that 30 percent of haircuts was too high and that a lower number would sufficiently address the Commission's concerns about the potential liquidation of a failing broker-dealer.

The Commission believes that the net capital rule should be structured in a manner that would limit the ability of a broker-dealer that is holding proportionately large amounts of proprietary securities positions to its equity capital from withdrawing significant amounts of capital without reducing the risk related to those positions. However, unlike a minimum net capital requirement, the amendment would allow the broker-dealer to continue operations if its net capital declines below the specified percentage of haircuts. Moreover, a firm that is at or approaching the threshold level may begin to sell off some of its positions, which will decrease the amount of its haircuts and tend to increase the amount of its net capital. Therefore, a firm wishing to make withdrawals may do so, once it has voluntarily reduced the amount of its securities positions.

The Commission has considered the arguments put forth by the commentators and has decided to lower the threshold percentage of haircuts from 30 percent to 25 percent. While the Commission acknowledges that any selection of a quantitative standard in this regard is necessarily imprecise, the Commission considers capital equal to 25 percent of haircuts to be a reasonable level at which a broker-dealer should be required to liquidate positions before withdrawing additional capital. As noted in the release proposing these amendments for comment, the Commission examined the net capital and haircut numbers of the twenty largest NYSE member firms in order to determine the appropriate percentage of haircuts to use as a restriction. However, the Commission recognizes that there may be instances where it may be appropriate to allow a broker-dealer to withdraw funds in an amount that would reduce the firm's capital below 25 percent of the firm's haircuts. Therefore, the Commission is adopting the early warning level based on 25 percent of haircuts with a modification that permits the Commission to waive this restriction. Under the provision, as modified, a broker-dealer may obtain approval of the Commission in advance of any withdrawals that would lower the firm's net capital below 25 percent of its haircuts.[3] This will, the Commission believes, afford broker-dealers the necessary flexibility to conduct their businesses, while at the same time satisfying the Commission's regulatory objectives.

It should be noted that the Commission is adopting a new paragraph (e)(4)(iv) that clarifies a question raised by the commentators and specifies that any transaction between a broker-dealer and an affiliate or insider that results in a diminution of the broker-dealer's net capital would be considered a loan or an advance and would therefore be covered by the amendments.[4] The Commission believes that this clarification is necessary to cover those instances where a broker-dealer seeks to transfer funds to an affiliate by selling or otherwise transferring assets to the affiliate.

C. Notification Requirement

As proposed, the amendments to Rule 15c3–1 would have required broker-dealers to notify the Commission two days prior to any withdrawals that would exceed, in any 30 day period, the greater of $50,000 or 20 percent of excess net capital or in any 90 day period, 30 percent of excess net capital. Several commentators argued that this requirement may provide an incentive for holding companies to minimize the amount of excess net capital maintained in the broker-dealer. Inducing a holding company to reduce the amount of excess net capital it maintains in its broker-dealer subsidiary would, it was asserted, diminish the ability of the broker-dealer to remain competitive in the securities markets, particularly in equity underwritings or government securities auctions. Furthermore, these commentators expressed the concern that a restriction on the ability of a holding company to access the excess net capital of a broker-dealer subsidiary would adversely impact rating agencies' perception of holding company liquidity and therefore, the market's evaluation of such organization's credit.

The Commission wishes to emphasize that the net capital maintained in a broker-dealer should be permanent capital and not merely a temporary infusion of funds from an affiliate or other sources. For example, there are instances where a broker-dealer receives funds from an affiliate in an amount that would enable the broker-dealer to engage in a transaction that it would otherwise be prohibited from doing because of minimum net capital requirements. If the funds are transferred back to the affiliate within a relatively short period of time after the transaction, the Commission questions whether the funds transferred into the broker-dealer entity could properly be characterized as capital of the firm. Instead, the transaction could be viewed as a loan by the affiliate to the broker-dealer, with the result that the broker-dealer would have to treat the transaction as a liability. Moreover, the Commission does not believe it is appropriate for holding companies to temporarily transfer funds into their broker-dealer subsidiaries for reporting

[3] The Commission does not anticipate granting waivers of the haircut restriction in the ordinary course of business. This provision is intended to apply in situations where a firm has commenced or is about to liquidate its securities positions. In these cases, the Commission anticipates that it will respond quickly to a request for a waiver in order to assist the expeditious wind-up of the broker-dealer's business.

[4] The Commission realizes that there may be instances where the registered broker-dealer makes payments to employees or other persons affiliated with the broker-dealer. Since those payments could be considered expenses, and would thereby reduce the net worth and the net capital of the broker-dealer, they may fall within the scope of paragraph Continued (e)(4)(iv). It should be noted that the new paragraph (e)(4)(iv) will not apply to and prevent broker-dealers' from paying such expenses incurred in the ordinary course of business.

or other purposes.[5]

The Commission is, however, sensitive to the concerns raised by the commentators concerning the impact of the amendments on the ability of firms to remain competitive both in the national and international markets. Furthermore, the Commission does not wish to unnecessarily interfere with or increase the costs of obtaining capital at the holding company level. In order to address these concerns, the Commission is adopting the notification provisions of the proposal in a modified form. The Commission has decided to employ the approach suggested by some of the commentators and create two notification categories. Under the final amendments, broker-dealers will be required to provide two business days advance notice of withdrawals that exceed, in any 30 day period, 30 percent of the broker-dealer's excess net capital. Broker-dealers will be required to provide notice within two business days after withdrawals that exceed, in any 30 day period, 20 percent of the broker-dealer's excess net capital.[6] The Commission notes that the time periods specified for calculating withdrawals under paragraph (e)(1) of the amendments have been standardized at 30 days. Additionally, the proposal has been altered to allow a broker-dealer to make withdrawals that would exceed 30 percent of its excess net capital without giving the advance notice required by the amendments if its designated examining authority approves the withdrawal in advance. This latter provision is intended to apply in emergency situations and will provide a procedure whereby broker-dealers will be allowed to withdraw capital in order to take advantage of opportunities or respond to events that could not have been foreseen two business days in advance.

The amendments as proposed exempted withdrawals of capital of $50,000 or less from the notification provisions of paragraph (e) without regard to the firm's excess net capital. The Commission believes that the $50,000 exemption may generate an excessive amount of notices in instances where there is no substantial danger of systemic exposure and accordingly, has raised the number to $500,000.

Various commentators pointed out that the proposed amendments might obstruct the ability of broker-dealers to transact commodities and securities transactions with affiliates. For example, commentators indicated that there are occasions when a registered broker-dealer will enter into a securities or commodities transaction with a foreign affiliate when the amount of the transaction would be greater than 20 percent of the broker-dealer's excess net capital. Because of time-zone differences or other reasons, the broker-dealer may not receive the securities or commodities until the following day, even though it has already made payment to its affiliate for the transaction. To the extent that these transactions would be considered loans or advances, and thus fall within the purview of paragraph (e) of the net capital rule, the broker-dealer would be unable to comply with the notification requirement because it will not know of the existence or status of the transaction two business days in advance. Because these types of transactions are beyond the scope of the amendments, the Commission has decided to exclude these transactions from the rule. Therefore, the rule provides that commodities and securities transactions between a broker-dealer and an affiliate are excluded from the notification provisions, if the broker-dealer receives payment for the transaction within two business days from the date of the transaction. The Commission believes two business days will provide ample time for firms to resolve these transactions.

The commentators also suggested other refinements to the proposed amendments that the Commission has decided to implement. Specifically, a number of commentators pointed out that the Commission's proposal would require broker-dealers to calculate excess net capital on a current basis in order to determine whether a projected withdrawal would trigger the notification requirement. While broker-dealers are required to maintain compliance with the net capital rule at all times, broker-dealers with sufficient excess net capital perform on a daily basis only a general testing of positions, losses or other events that might result in a decrease of net capital from that which was previously reported. For the purposes of meeting daily net capital requirements, broker-dealers generally resolve questions in favor of maintaining additional capital, a practice the Commission encourages. Nonetheless, several commentators expressed concern that the proposed amendments would result in substantial implementation costs. These writers recommended that broker-dealers be permitted to use the amount of excess net capital and haircuts reported on the broker-dealer's most recent FOCUS report.[7] The Commission agrees with this approach and the rule as amended provides that broker-dealers may base their calculations, for the purposes of calculating the effect of a proposed withdrawal, on the amount of excess net capital and haircuts set forth in the most recently filed FOCUS report. The broker-dealer must assure itself however, that the numbers reported thereon have not materially changed.[8]

The Commission also has revised the language of the amendments in response to suggestions made by the commentators to clarify that the amount of withdrawals that should be used for comparison to the broker-dealer's excess net capital should be calculated on a net rather than on a gross basis. A broker-dealer would be entitled to offset the amount of loans, advances or withdrawals made to any of its insiders by the amount of payments received from any of those parties.

D. The Order Provision

The third amendment to the net capital rule proposed by the Commission would have given the Commission the authority, by order, to restrict the withdrawal of capital from a broker-dealer by an insider of the firm for a period of up to twenty business days when the Commission believed that the withdrawal would be detrimental to the financial integrity of the broker-dealer or would unduly jeopardize the firm's ability to pay its customers or creditors. The Commission

[5] The Commission expressed its concern about the temporary nature of broker-dealer capital in its Study of Unsafe and Unsound Practices of Brokers and Dealers. *See* Study of Unsafe and Unsound Practices of Brokers and Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 231, 92d Cong., 1st Sess. 54 (1971). Additionally, the Division of Market Regulation has taken the position that funds temporarily deposited into a broker-dealer entity and withdrawn within a short period of time should be regarded as a loan and considered a liability of the broker-dealer. Under paragraph (c)(2)(ii) of Rule 15c3-1, only liabilities properly subordinated under appendix (D) can be added back to net worth in determining the net capital of the broker-dealer. *See* Letter from Nelson Kibler, Assistant Director, Division of Market Regulation to John Pinto, National Association of Securities Dealers, Inc. (September 8, 1980).

[6] However, under the final amendments, in those cases where a broker-dealer intends to withdraw capital in excess of 30 percent of its excess net capital, the firm will be required to provide the Commission two notices: The first two business days before the anticipated withdrawal and the second, two business days after the withdrawal has been made.

[7] Under Securities Exchange Act Rule 17a-5 (17 CFR 240.17a-5), registered broker-dealers are required to file reports containing certain financial and operational information with both their designated examining authority and the Commission. These reports are filed on the Financial and Operational Combined Uniform Single Report (commonly referred to as the FOCUS report).

[8] A broker-dealer may continue to rely on the most recently filed FOCUS report if it reasonably assures itself that the only change has been to either decrease the amount of deductions required by paragraph (c)(2)(vi), (f) and appendix A or to increase the amount of net capital.

intended this section to be an emergency provision, applicable to only the most exigent of circumstances where the continued viability of a broker-dealer appeared to be at stake. The Commission believed it needed this power, in part to respond to future scenarios that are presently impossible to predict. Notwithstanding the need for the provision, the Commission, when it proposed the amendments, recognized the potential procedural problems that may be caused by the issuance of an order restricting withdrawals of capital, and specifically requested comment on this aspect of the rule.

The commentators expressed various concerns about the Commission's powers under this paragraph. Generally, the commentators had three objections to this paragraph.

As a threshold matter, it was questioned whether the Commission has the authority under sections 23(a) and 15(c)(3) of the Securities Exchange Act to adopt a rule amendment that would authorize the Commission to issue orders restricting the withdrawal of capital from a particular broker-dealer. The Commission, however, believes that there is ample authority under the Securities Exchange Act to adopt an amendment that would enable the Commission to, in emergency situations, temporarily restrict the withdrawal of capital from a broker-dealer. Congress has given the Commission broad authority under the Securities Exchange Act to establish safeguards with respect to the financial integrity of broker-dealers. The Drexel failure illustrates the type of development in which swift, emergency remedial powers are appropriate and necessary to protect the public interest. Some commentators argued that the Commission's authority to issue adjudicative orders under section 15(b)(4) of the Securities Exchange Act implies an absence of rulemaking authority to issue orders under sections 23(a) and 15(c)(3). However, unlike adjudicative orders issued by the Commission after notice and opportunity for hearing, an order temporarily restricting the withdrawal of capital from a broker-dealer in an emergency situation is not in the nature of an enforcement or disciplinary proceeding, but rather is intended to carry out the Commission's mandate under section 15(c)(3) of the Securities Exchange Act to protect the financial responsibility of broker-dealers and the markets.

Additionally, it should be noted that the Commission has the authority to adopt a considerably more restrictive approach to equity capital withdrawals than contemplated by the amendments. The Commission could, for example, raise the current restriction on withdrawals of capital by insiders or affiliates under paragraph (e) of the net capital rule from 120 percent of the firm's minimum net capital requirement to 200 percent or higher, which would be applicable to all broker-dealers. Similarly, the Commission could restrict all withdrawals of capital by insiders or affiliates where the withdrawal exceeds 30 percent of the firm's excess net capital. The Commission believes the amendments, by authorizing temporary restrictions on capital withdrawal in emergency situations on a case-by-case basis (with the right to a post-order hearing), provides a more flexible and less burdensome means of accomplishing the Commission's regulatory objectives.[9] The Commission therefore believes that the authority conferred upon it by sections 23(a) and 15(c)(3) of the Securities Exchange Act is sufficiently broad to adopt the new paragraph (e)(3).[10]

Second, the commentators asserted that the Commission should more clearly articulate the standards under which an order could be granted. These commentators were concerned that the lack of a specifically defined set of circumstances under which the Commission could issue an order would provide the Commission with unlimited discretion. The Commission acknowledges that an unfettered ability to order restrictions on the withdrawal of capital would be undesirable. At the same time, the Commission believes that there is a need for a flexible provision that will be available when the specific early warning levels already set forth in the rule prove to be, for some reason, unsatisfactory.

Therefore, in order to balance the opposing needs for flexibility and certainty, the Commission is adopting a revised order paragraph. The Commission's ability to enter an order restricting a firm from withdrawing capital to benefit its insiders will only apply in those instances where a firm is about to make a withdrawal of capital that, along with other withdrawals during a 30 day period, exceeds 30 percent of the broker-dealer's excess net capital, and may be used only to prevent a withdrawal in excess of that 30 percent. This requirement coincides with the advance notification threshold under paragraph (e)(1) of the net capital rule. Even where this threshold is reached, the Commission must make a separate finding that the withdrawal may be detrimental to the financial integrity of the broker-dealer or may unduly jeopardize the firm's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker-dealer to loss. To continue to restrict withdrawals, however, additional orders will have to be issued by the Commission, each with a term of no more than twenty business days. Additionally, the power of issuing an order resides with the Commission and has not been delegated to the staff of the Commission.

The Commission believes that this standard is adequately refined in order to allow registered broker-dealers a level of certainty in their business affairs while maintaining the essential flexibility needed by the Commission to respond to future financial emergencies involving broker-dealers.

The commentators also recommended that the Commission expressly provide for a post-order hearing. The Commission is sensitive to the due process and procedural considerations of the order procedure. The Commission believes that a broker-dealer subject to an emergency order restricting the withdrawal of capital should be entitled to a hearing that would satisfy due

[9] The Commission currently has the authority under the net capital rule to exercise a form of adjudication. Paragraph (b)(1) of Rule 15c3–1 contains a general exemption for certain specialists while reserving to the Commission the authority to suspend or revoke the exemption as it applies to a particular specialist upon ten days written notice if the Commission deems it appropriate in the public interest.

[10] The dissent refers to a proposed amendment to section 15(c)(3) contained in H.R. 4111, the House version of the bill that became the Securities Acts Amendments of 1975, that would have given the Commission authority "to order any broker or dealer or class thereof to restrict any of its activities[.]" and suggests that the fact that it was not enacted demonstrates that the Commission lacks authority to adopt paragraph (e)(3) of the rule. There is very little legislative history relating to the House's proposed amendments to section 15(c)(3), which are referred to in one place as "largely technical amendments", 121 Cong. Rec. 1744 (1975), and there is no explanation of the reason for the deletion of the portion of the amendments noted by the dissent. There is thus no basis for inferring that the provision was deleted because Congress did not intend for the Commission to adopt a provision such as the one considered here. *See Rastelli* v. *Warden, Metropolitan Correctional Center*, 782 F.2d 17, 24 n.3 (2d Cir. 1986) (court declined to draw any conclusion regarding Congressional intent from deletion of legislative language); *U.S.* v. *Stauffer Chemical Co.*, 684 F.2d 1174, 1184 (6th Cir. 1982) ("[T]he language of rejected alternative legislation is not entitled to great weight in construing legislation that was finally passed, since the court has no way of knowing what motivated the legislature to take such action.") Moreover, the earlier legislative history of section 15(c)(3) indicates a particular Congressional concern with broker-dealer capital withdrawals. *See* Senate Securities Study, Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Securities, 93d Cong., 1st Sess. at 184 (Comm. Print 1973).

process requirements. Accordingly, the Commission has revised the rule to provide for a post-order hearing to be held within two business days from the request for a hearing by the affected firm. In the hearing, broker-dealers will be able to present information concerning their financial condition or any other information they deem relevant to the Commission's decision. The order prohibiting the withdrawal of capital will be rescinded if the Commission determines, after the hearing, that the prohibition should not continue in effect.

IV. Summary of Final Regulatory Flexibility Analysis

The Commission has prepared a Final Regulatory Flexibility Analysis ("Analysis") in accordance with 5 U.S.C. 604 regarding the amendments to Rule 15c3-1. The Analysis notes that the objective of the amendments is to further the purposes of the various financial responsibility rules which provide safeguards with respect to the financial responsibility and related practices of broker-dealers. Smaller broker-dealers will generally not be affected because the new early warning level based on a percentage of haircuts will usually not be greater than their present early warning levels. Moreover, a broker-dealer may withdraw capital of up to $500,000 without triggering the notice provisions provided that the withdrawal would not pull the firm below its other early warning levels. In sum, the Analysis states that the amendments would affect the ability of broker-dealers to distribute capital to related parties. The amendments are designed to prevent insiders from withdrawing capital from the registered broker-dealer in order to benefit the parent or its ultimate owners to the detriment of the customers and creditors of the broker-dealer. A copy of the Analysis may be obtained by contacting Roger G. Coffin, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549, (202) 272-2396.

V. Statutory Analysis

Pursuant to the Securities Exchange Act of 1934 and particularly sections 15(c)(3), 17 and 23 thereof, 15 U.S.C. 78o(c)(3), 78q and 78w, the Commission is amending 240.15c3-1 of title 17 of the Code of Federal Regulations in the manner set forth below.

VI. List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements; Securities.

VII. Text of the Amendments

In accordance with the foregoing, title 17, chapter II, part 240 of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 is amended by adding the following citation:

Authority: 15 U.S.C. 77c, 77d, 77s, 78c, 78d, 78i, 78j, 78l, 78m, 78n, 78o, 78p, 78s, 78w, 78x, 79q, 79t, 80a-29, 80a-37, unless otherwise noted. * * * 240.15c3-1 is also issued under secs. 15(c)(3), 15 U.S.C. 78o(c)(3).

2. By revising paragraph (e) to § 240.15c3-1 as follows:

§ 240.15c3-1 Net capital requirements for brokers or dealers.

* * * * *

(e)(1) *Notice provisions relating to limitations on the withdrawal of equity capital.* No equity capital of the broker or dealer or a subsidiary or affiliate consolidated pursuant to appendix C (17 CFR 240.15c3-1c) may be withdrawn by action of a stockholder or a partner or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, sole proprietor, employee or affiliate without written notice given in accordance with paragraph (e)(1)(iv) of this section:

(i) Two business days prior to any withdrawals, advances or loans if those withdrawals, advances or loans on a net basis exceed in the aggregate in any 30 calendar day period, 30 percent of the broker or dealer's excess net capital. A broker or dealer, in an emergency situation, may make withdrawals, advances or loans that on a net basis exceed 30 percent of the broker or dealer's excess net capital in any 30 calendar day period without giving the advance notice required by this paragraph, with the prior approval of its Examining Authority. Where a broker or dealer makes a withdrawal with the consent of its Examining Authority, it shall in any event comply with paragraph (e)(1)(ii) of this section; or

(ii) Two business days after any withdrawals, advances or loans if those withdrawals, advances or loans on a net basis exceed in the aggregate in any 30 calendar day period, 20 percent of the broker or dealer's excess net capital.

(iii) This paragraph (e)(1) does not apply to:

(A) Securities or commodities transactions in the ordinary course of business between a broker or dealer and an affiliate where the broker or dealer makes payment to or on behalf of such affiliate for such transaction and then receives payment from such affiliate for the securities or commodities transaction within two business days from the date of the transaction; or

(B) Withdrawals, advances or loans which in the aggregate in any thirty calendar day period, on a net basis, equal $500,000 or less.

(iv) Each required notice shall be effective when received by the Commission in Washington, DC, the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the broker or dealer's Examining Authority and the Commodity Futures Trading Commission if such broker or dealer is registered with that Commission.

(2) *Limitations on Withdrawal of equity capital.* No equity capital of the broker or dealer or a subsidiary or affiliate consolidated pursuant to appendix C (17 CFR 240.15c3-1c) may be withdrawn by action of a stockholder or a partner or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, sole proprietor, employee or affiliate, if after giving effect thereto and to any other such withdrawals, advances or loans and any Payments of Payment Obligations (as defined in appendix D (17 CFR 240.15c3-1d)) under satisfactory subordination agreements which are scheduled to occur within 180 days following such withdrawal, advance or loan if:

(i) The broker or dealer's net capital would be less than 120 percent of the minimum dollar amount required by paragraph (a) of this section;

(ii) The broker-dealer is registered as a futures commission merchant, its net capital would be less than 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account);

(iii) The broker-dealer's net capital would be less than 25 percent of deductions from net worth in computing net capital required by paragraphs (c)(2)(vi), (f) and appendix A, of this section, unless the broker or dealer has the prior approval of the Commission to make such withdrawal;

(iv) The total outstanding principal amounts of satisfactory subordination agreements of the broker or dealer and

any subsidiaries or affiliates consolidated pursuant to appendix C (17 CFR 240.15c3–1c) (other than such agreements which qualify as equity under paragraph (d) of this section) would exceed 70% of the debt-equity total as defined in paragraph (d) of this section;

(v) The broker or dealer is subject to the aggregate indebtedness limitations of paragraph (a) of this section, the aggregate indebtedness of any of the consolidated entities exceeds 1000 percent of its net capital; or

(vi) The broker or dealer is subject to the alternative net capital requirement of paragraph (f) of this section, its net capital would be less than 5 percent of aggregate debit items computed in accordance with 17 CFR 240.15c3–3a.

(3)(i) *Temporary Restrictions on Withdrawal of Net Capital.* The Commission may by order restrict, for a period up to twenty business days, any withdrawal by the broker or dealer of equity capital or unsecured loan or advance to a stockholder, partner, sole proprietor, employee or affiliate if such withdrawal, advance or loan:

(A) When aggregated with all other withdrawals, advances or loans on a net basis during a 30 calendar day period exceeds 30 percent of the broker or dealer's excess net capital; and

(B) The Commission, based on the facts and information available, concludes that the withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection Act.

(ii) An order temporarily prohibiting the withdrawal of capital shall be rescinded if the Commission determines that the restriction on capital withdrawal should not remain in effect. The hearing will be held within two business days from the date of the request in writing by the broker or dealer.

(4)(i) *Miscellaneous provisions.* Excess net capital is that amount in excess of the amount required under paragraph (a) of this section. For the purposes of paragraphs (e)(1) and (e)(2) of this section, a broker or dealer may use the amount of excess net capital and deductions required under paragraphs (c)(2)(vi), (f) and appendix A of this section reported in its most recently required filed Form X–17A–5 for the purposes of calculating the effect of a projected withdrawal, advance or loan relative to excess net capital or deductions. The broker or dealer must assure itself that the excess net capital or the deductions reported on the most recently required filed Form X–17A–5 have not materially changed since the time such report was filed.

(ii) The term equity capital includes capital contributions by partners, par or stated value of capital stock, paid-in capital in excess of par, retained earnings or other capital accounts. The term equity capital does not include securities in the securities accounts of partners and balances in limited partners' capital accounts in excess of their stated capital contributions.

(iii) Paragraphs (e)(1) and (e)(2) of this section shall not preclude a broker or dealer from making required tax payments or preclude the payment to partners of reasonable compensation, and such payments shall not be included in the calculation of withdrawals, advances, or loans for purposes of paragraphs (e)(1) and (e)(2) of this section.

(iv) For the purpose of this paragraph (e) of this section, any transaction between a broker or dealer and a stockholder, partner, sole proprietor, employee or affiliate that results in a diminution of the broker or dealer's net capital shall be deemed to be an advance or loan of net capital.

* * * * *

February 28, 1991.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

Dissenting Statement of Commissioner Fleischman

I dissent from the adoption of paragraph (e)(3) of Rule 15c3–1. Its ends are salutary and susceptible of accomplishment by properly-crafted Commission rule, but its means are no more authorized by the Exchange Act than would be a one-sentence Rule 15c3–1 stating that every broker-dealer shall maintain such net capital as the Commission prescribes for it by order.

"In some areas particular regulatory requirements, whether created by statute or regulations, may impose costs that far exceed any public benefits derived therefrom." [1] Paragraph (e)(3) creates just such a requirement. Having provided responsible early-warning levels in paragraph (e)(1) and appropriate notification procedures in paragraph (e)(2), the Commission had to decide whether, and if so how, to deal with the circumstance described in the Release as "emergency" [2] and described by the Chairman as involving "a serious question * * * as to whether [a] broker-dealer is transferring excess net capital, or whether in fact it is transferring capital that is part of net capital, not indeed, 'excess'." [3]

The costs of the Commission's decision to adopt paragraph (e)(3) in its present form are the uncertainty cost and the statutory rupture introduced by an *ad hominem* "order" procedure in implementation of (1) a statutory subsection that, like several provisions of the Exchange Act (and in direct contrast to its sister subsections),[4] prohibits broker-dealer activities "in contravention of such rules and regulations as the Commission shall prescribe" [5] for all persons similarly situated, and (2) an empowering provision that authorizes "rules and regulations" [6] but (unlike the Public Utility Holding Company Act, Trust Indenture Act, and Investment Company and Investment Advisers Acts [7]) not adjudicatory-type "orders". Specification of "rules and regulations" as the general modality of Commission action under the Exchange Act dates back to the bills first introduced into the House and Senate in 1934.[8] Where an "order" procedure was desired, as in the disciplining of exchanges,[9] that procedure was specified in each bill along with provision for judicial review at the instance of "[a]ny person aggrieved by an order * * *." [10] The Senate Banking and Currency Committee Report, in prescribing that "considerable latitude [be] allowed for the exercise of administrative discretion," also specifically noted that: "Of course, well defined limits must be indicated within which the authority of such administrative authority [sic] may be exercised." [11] Section 15, which had been a one-paragraph "rules and regulations" section in the original Act, was divided into three subsections in 1936, with an "order" procedure added in subsection (b) but "rules and regulations" retained in subsection (c).[12] Subsection (c) itself was

[1] *Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services* (July 1984) (the "Bush Task Force Report").

[2] Accompanying Release at III.D., first, third and fourth paragraphs.

[3] Tape recording of SEC public meeting held February 20, 1991, at tape 1.

[4] Securities Exchange Act Section 15(a)(2) "by rule or order"; Section 15(b)(1)(A) "by order"; Sections 15(b) (4), (5) and (6) "by order"; Section 15(b)(9) "by rule or order"; Section 15(c)(4) "an order". Sections 15(b)(4) (D) and (E), the general broker-dealer disciplinary provisions, provide only for discipline of a broker or dealer that has violated the "rules or regulations", not the orders, under the statutes administered by the Commission.

[5] Securities Exchange Act Section 15(c)(3).

[6] Securities Exchange Act Section 23(a).

[7] Public Utility Holding Company Act Section 20(a); Trust Indenture Act Section 319(a); Investment Company Act Section 38(a); Investment Advisers Act Section 211(a).

[8] H.R. 9323, 73rd Cong., 2d Sess., Section 22(a), and also *inter alia* Section 14, "Over-the-Counter Markets"; S. 3420, 73rd Cong., 2d Sess., Section 4(b), and also *inter alia* Section 15.

[9] H.R. 9323, 73rd Cong., 2d Sess., Section 18; S. 3420, 73rd Cong., 2d Sess., Section 19.

[10] H.R. 9323, 73rd Cong., 2d Sess., Section 24; S. 3420, 73rd Cong., 2d Sess., Section 24.

[11] Sen. Rep. 792, 73rd Cong., 2d Sess., at 5.

[12] Pub. L. 74–621, 49 Stat. 1375, Section 3 (May 27, 1936).

divided in three by the Maloney Act in 1938, with all three paragraphs retaining "rules and regulations" [13] although the new section 15A (with which the Maloney Act is identified used "order" as the prevalent modality for Commission action. [14] The final amendments relevant here were made in 1975, when (1) specific provision to "establish minimum financial responsibility requirements for all brokers and dealers" was added to the final sentence ("Such rules and regulations shall require * * *.") of section 15(c), [15] and (2) section 23(a) was amended, *inter alia*, to state that the general rulemaking authority encompassed "prescrib[ing] greater, lesser or different requirements for different *classes*" of persons, transactions, etc., [16] and the Conference Report, in the direct context of Commission rulemaking authority concerning minimum broker-dealer capital requirements, specifically referred to that amendment using those very words. [17] Most significantly, the House considered (in 1973–74) and passed (in 1975) an amendment to section 15(c)(3) that would have given the Commission authority "to order any broker or dealer or class thereof to restrict any of its activities" upon certain findings [18]; in its official Comments to the House Subcommittee on Commerce and Finance in 1973, the Commission stated, with respect to the proposed "order" authority: "[W]e believe that this is a desirable power to have, because it would allow the Commission great flexibility to restrict individual firms on a case-by-case basis * * *." [19], but the amendment was nevertheless omitted from the Act as agreed to in conference.

The benefits of the Commission's decision to create an "order" process by adopting paragraph (e)(3) in its present form are difficult to comprehend, in view of the Chairman's own testimony before the House Subcommittee on Telecommunications and Finance in April of last year:

"[T]he issuance of a temporary cease-and-desist order would be appropriate where emergency action is necessary to ensure that a registered broker-dealer maintains sufficient net capital. For example, the financial failure of Drexel Burnham Lambert Group, Inc., although it did not result in investor losses, illustrates the type of situation in which temporary cease-and-desist authority would facilitate the Commission's ability to take prompt action for the purpose of protecting investor assets. Given the highly technical nature of the issues involved in such cases, it may be difficult or impossible to obtain emergency judicial relief in time to be effective. The Commission, as the financial regulator that monitors the operations of broker-dealers and has the most expertise in measuring the adequacy of their capital, should be empowered to take emergency action in appropriate circumstances." [20]

With the omission of a portion of the third sentence above quoted, the words of that testimony were adopted almost *in haec verba* both by the House Energy and Commerce Committee [21] and by the Senate Banking, Housing, and Urban Affairs Committee [22] in their respective reports on the bill that resulted from the Chairman's testimony. "Emergency" authority, for this very purpose, was specifically asked and given.

The Committee avidly took authorization from the House and Senate Committees (indeed, it quite apparently presented the very language of the Committee Reports) and now substitutes a spurious process for the one deliberately bestowed by the Congress and signed into law by the President. For that questionable process the Committee first asserts its plenary authority under *Chevron* [23] to construe its fundamental statutes, and then, lest some chink be left unplastered, structures the process so as to reserve to itself the capacity to thwart appellate review by rendering the initial order moot after twenty days (with or without Commission decision at hearing) only to be able to renew the proceeding at will thereafter on a "detrimental" standard. Peculiarly, the Commission turned to this alien process and adopted this provision without a single reference in the Release to the section 19(b)(1) filing (made in May of last year) [24] of the New York Stock Exchange, the self-regulatory organization that is the designated examining authority under Rule 17d-1 for most of the principal broker-dealers, proposing a notification provision, or to the rule [25] of that Exchange that was actually applied last year, under the broad scope of the membership Constitution of the Exchange, to prohibit outflow of funds.

By its adoption of the "order" procedure of paragraph (e)(3) the Commission confirms, today, that ever more regulatory authority is its goal and ever more administrative discretion is its chosen tool; that in that pursuit it will elasticize any scrap of helpful legislative wording while overriding every consistency in inhibitory statutory structure; and that it is willing to put forward the virtual minimum of due process mechanics as camouflage for the maximum of discretionary regulatory intrusion.

I recur, finally, to the Bush Task Force Report:

"Lacking any new Congressional direction [which, as shown above, is not the Commission's circumstance], the agencies * * * must fashion an appropriate action from agency 'policy.' However, where agency actions are guided by self-defined policy rather than express provisions of law, serious burdens can be created for private [regulated] parties where they are unable to predict agency actions * * *." [26]

Applicability of rules is predictable; proceeding by "order" is *ad hoc* and uncertain, particularly on a standard as vague as "may be detrimental * * * or may unduly jeopardize * * * which may cause * * * or [may] expose * * *." The Commission's action today is self-defined agency policy at its most egregious, with increase in the Commission's authority and discretion as its unspoken justification.

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[13] Pub. L. 75-719, 52 Stat. 1070, Section 2 (June 25, 1938).

[14] Pub. L. 75-719, 52 Stat. 1070, Section 1 (June 25, 1938).

[15] Pub. L. 94-29, 89 Stat. 97, Section 11(3) (June 4, 1975).

[16] Pub. L. 94-29, 89 Stat. 97, Section 18 (June 4, 1975) (emphasis added).

[17] H.R. Rep. 94-229, 94th Cong., 1st Sess., at 104.

[18] Section 15(c)(3)(B), as proposed to be added to the Securities Exchange Act by H.R. 5050, Section 304, 93rd Cong., reintroduced and passed by the House as H.R. 4111, Section 204, 94th Cong., 1st Sess. (emphasis added).

[19] Hearings before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, 93rd Cong., 1st Sess., on H.R. 5050 and H.R. 340, at 470 (Comments of the Securities and Exchange Commission on H.R. 5050 (titles II, III, and V)) (June 12, 1973).

[20] Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 4497, The "Penny Stock Reform Act of 1990", before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, United States House of Representatives (April 25, 1990).

[21] H.R. Rep. 101-616, 101st Cong., 2d Sess., at 26.

[22] Sen. Rep. 101-337, 101st Cong., 2d Sess., at 20

[23] *Chevron, U.S.A., Inc.* v. *Natural Resources Defense Council*, 467 U.S. 837 (1984).

[24] File No. SR-NYSE-90-26, Securities and Exchange Act Release No. 28083, 46 SEC Docket 573 (June 1, 1990).

[25] New York Stock Exchange Rule 325(d). My views on the proper S.E.C.-S.R.O. relationship are set forth in Fleischman, "The 'Unique Partnership' between the S.E.C. and the Self-Regulatory Organizations" (July 29, 1988).

[26] Bush Task Force Report at 30.

NASD

Notice To Members

National Association of Securities Dealers, Inc. April 1991

Number 91-21

Suggested Routing:*

- ✓ Senior Management
- _ Corporate Finance
- _ Government Securities
- _ Institutional
- _ Internal Audit
- ✓ Legal & Compliance
- _ Municipal
- _ Mutual Fund
- ✓ Operations
- _ Options
- _ Registration
- _ Research
- _ Syndicate
- _ Systems
- ✓ Trading
- _ Training

*These are suggested departments only. Others may be appropriate for your firm.

Subject: Amendments to Schedule H Eliminating the Price and Volume Reporting Thresholds, And Expanding the Definition of Non-Nasdaq Security

EXECUTIVE SUMMARY

On March 1, 1991, the SEC approved an NASD proposal to amend Schedule H to the NASD By-Laws to eliminate the current reporting thresholds of $10,000 or 50,000 shares so that the reporting requirements of Schedule H will apply to all principal transactions in a non-Nasdaq security. The rule change also requires the reporting pursuant to Schedule H of price and volume information for certain transactions in non-NMS Nasdaq and listed securities by expanding the definition of non-Nasdaq security to include (a) over-the-counter (OTC) transactions in non-NMS Nasdaq securities by firms not registered as Nasdaq market makers in such securities; and (b) regional exchange securities traded in the OTC market and not otherwise reported to an exchange or under other NASD Schedules. The amendments to Schedule H are effective June 1, 1991.

The text of the amendments follows this notice.

BACKGROUND AND DISCUSSION

Schedule H requires reporting of price and volume information for principal transactions in all "non-Nasdaq" securities if certain conditions are met. Subsection 1(a) of Schedule H defines "non-Nasdaq security" to mean "any equity security that is neither included in the National Association of Securities Dealers Automated Quotations System nor traded on any national securities exchange."

Since the adoption of Schedule H, it has become apparent that substantial trading is being effected in the over-the-counter (OTC) market in certain Nasdaq and regional exchange-listed securities that are not encompassed in the regulatory reporting requirements for non-Nasdaq over-the-counter securities as defined under Schedule H. These trades in Nasdaq and listed stocks being effected in the OTC market are also not required to be reported pursuant to Schedules D or G to the NASD By-Laws for Nasdaq securities or listed securities, respectively.

As amended, Section 1 of Schedule H expands the definition of "non-Nasdaq security" to apply to all OTC principal transactions in securities listed on a regional exchange that are not reported to this exchange and that are not reported

pursuant to Schedule G because the security does not meet primary exchange listing requirements. Schedule G requires only reporting of OTC transactions in securities listed on the New York Stock Exchange (NYSE) or the American Stock Exchange (Amex), or securities listed on regional exchanges that meet the original NYSE or Amex listing requirements.

As amended, Section 1 also expands the definition of "non-Nasdaq security" to apply to OTC trades in non-NMS Nasdaq securities if effected by a member or person who acts as or holds himself out to be a market maker in the "pink sheets" or other quotation medium or in any other manner, and if such person is not registered as a Nasdaq market maker in such securities. Transaction reports on these securities are currently not reported under the daily reporting requirements of Section 5(a) of Schedule D to the NASD By-Laws.

The inclusion of these trades under the reporting requirements of Schedule H will allow the NASD to monitor trading and detect abuses regarding OTC transactions in such securities.

As amended, Section 2 to Schedule H eliminates the thresholds for calculating what is required to be reported. Currently, Schedule H requires members to aggregate daily purchases and sales of Nasdaq securities and to report certain price and volume information to the NASD if the aggregated numbers exceed thresholds of $10,000 or 50,000 shares. This is often a cumbersome process for members to follow for each security in order to determine whether trading in the stock has broken the threshold for the day. Also, the NASD cannot gather complete trading information for regulatory purposes if low levels of trading activity are not being reported. Removal of these thresholds will simplify calculations and reporting procedures for members doing a business in non-Nasdaq stocks and will also provide the NASD with a more complete record of non-Nasdaq trading activity for regulatory purposes.

The amendments to Schedule H are effective June 1, 1991. Questions regarding this notice may be directed to Jess Haberman of the NASD Market Surveillance Department at (301) 590-6483.

TEXT OF RULE CHANGE

The following is the full text of amendments to Section 1 and 2, Schedule H to the NASD's By-Laws.

(**Note:** New language is underlined; deleted language is in brackets.)

Schedule H
Section 1 — Definitions

For purposes of Schedule H, unless the context requires otherwise:

(a) "Non-Nasdaq security" means any equity security that is neither included in the National Association of Securities Dealers Automated Quotations System ("Nasdaq") nor traded on any national securities exchange. For purposes of Sections 2 and 3 of this Schedule, the term "non-Nasdaq security" shall also mean any Nasdaq security, if transactions in that security are effected by market makers that are not registered Nasdaq market makers pursuant to Schedule D of the NASD By-Laws, and any security listed on an exchange, if transactions are not required to be reported pursuant to Schedule G of the NASD By-Laws.

* * * * *

Section 2 — Price and Volume Reporting

(a) [On any day that principal transactions in the non-Nasdaq security exceed an aggregate daily volume of sales or purchases of either a minimum of 50,000 shares or a minimum of $10,000,] Each member shall report through the Non-Nasdaq Reporting System the following information on all principal transactions in non-Nasdaq securities:

(i) the highest price at which it sold and the lowest price at which it purchased each [any] non-Nasdaq security;

(ii) the total volume of purchases and sales executed by it in each [any] non-Nasdaq security; and

(iii) whether the trades establishing the highest price at which the member sold and the lowest price at which the member purchased the security represented an execution with a customer or with another broker-dealer.

The price to be reported for principal sales and purchases from customers shall be inclusive of mark-up or mark-down.

[The following examples illustrate the minimum reporting levels established by paragraph (a) above.

1. Dealer A executes aggregate purchase of 70,000 shares of AAA stock and executes aggregate sales of 20,000 shares of AAA stock.

Because the minimum reporting requirement is exceeded by the purchases, Dealer A is required to report aggregate purchases of 70,000 shares, aggregate sales of 20,000 shares of AAA stock, and the highest price at which it sold and lowest price at which it purchased AAA stock, even though the volume of sales did not reach the minimum requirement.

2. Dealer B executes aggregate purchases of 60,000 shares of BBB stock and does not execute any sales of BBB stock. Dealer B is required to report purchases of 60,000 shares, zero volume of sales, and the lowest price at which it purchased BBB stock.

3. Dealer C executes aggregate purchases of 40,000 shares for a total of $8,000 in CCC stock and executes aggregate sales of 49,000 shares for a total of $9,900 in CCC stock. CCC stock is not subject to reporting by Dealer C, as neither the volume nor price of aggregate purchases or sales of CCC stock exceed the minimum requirements for reporting.

4. Dealer D executes aggregate purchases of 45,000 shares in DDD stock for a total of $11,000 and executes aggregate sales of 35,000 shares in DDD stock for a total of $9,000. Dealer D is required to report aggregate purchases of 45,000 shares and sales of 35,000 shares of DDD stock, as well as the lowest purchase price and highest sale price of DDD stock, because the aggregate purchase price exceeds the minimum requirements.]