

Asset Management, Capital Markets, Financial Institutions Advisory & Financial Regulatory | February 2010

## FINRA Adopts Changes to Financial Responsibility Rules for Carrying or Clearing Members; Creates Additional Obligations for Members Exempt Under Rule 15c3-3(k)(2)(i)

### Overview

On December 7, 2009, the Securities and Exchange Commission (“SEC”) approved the adoption of several rules proposed by the Financial Industry Regulatory Authority (“FINRA”) relating to financial responsibilities required of FINRA members.<sup>1</sup> The new rules (“Rules”) are part of FINRA’s rule consolidation process<sup>2</sup>, and replace certain National Association of Securities Dealers, Inc. (“NASD”) and New York Stock Exchange (“NYSE”) Rules.<sup>3</sup> FINRA’s financial responsibility rules operate in addition to the SEC’s Uniform Net Capital Rule, Rule 15c3-1.

FINRA members should be aware that an important change to the current financial responsibility rules, as

adopted, is that these Rules require both member firms that clear and carry accounts and FINRA members that operate under the exemptive provisions of Rule 15c3-3(k)(2)(i) of the “Exchange Act”, in which the member clears customer transactions and effectuates all financial transactions between itself and its customers in one or more bank accounts each designated as a “Special Account for the Exclusive Benefit of Customers” (“Exempt Member”) to comply with various provisions under the new Rules. The application of certain heightened standards to Exempt Members will have the effect of applying certain (former) NYSE standards to former NASD-only members for the first time.

The new rules are discussed in the sections set out below. The new Rules will become effective on February 8, 2010.

<sup>1</sup> See Exchange Act Release No. 60933 (November 4, 2009), 74 FR 58334 (November 12, 2009) (Order Granting Approval to Proposed Rules Change, File No. SR-FINRA-2008-067) (Approval Order).

<sup>2</sup> On July 26, 2007, the SEC approved the Merger of the regulatory operations of the NYSE and the NASD. See “Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc.”, SEC Release 34-56145 (July 26, 2007), currently available at <http://sec.gov/rules/sro/nasd/2007/34-56145.pdf>. FINRA commenced operations on July 30, 2007. Information regarding the Merger is available at the FINRA Internet website: [www.finra.org](http://www.finra.org). For more information regarding the FINRA Rulebook consolidation process, See “Report from SIFMA’s 40th Annual Compliance and Legal Division Seminar: FINRA Officials Provide an Update on the NASD – NYSE Merger” (April 2008), currently available at: [http://www.shearman.com/cm\\_041408/](http://www.shearman.com/cm_041408/).

<sup>3</sup> The new Rules are numbered 4110 (Capital Compliance), 4120 (Regulatory Notification and Business Curtailment), 4130 (Regulation of Activities of Section 15C Members Experiencing Financial and/or Operational Difficulties), 4140 (Audit) and 4521 (Notifications, Questionnaires and Reports).

### Introduction and Executive Summary

The Rules require certain permanency of FINRA members’ capital, the review and approval of certain material financial transactions, and establish criteria intended to identify FINRA members nearing financial difficulty so that FINRA can monitor their financial and operational condition. In addition, FINRA has “tiered” many provisions so that they apply only to those members that clear or carry customer accounts, including Exempt Members.

The new Rules regulate:

- Net capital requirements;
- Business curtailments;

- Financial and/or operational difficulties; and,
- Audits.

### Executive Summary

The rules are briefly summarized as follows:

Rule	Brief Description	Applies to Self-Clearing Members and Exempt Members?	Applies to Other Members?
4110(a)	Enables FINRA to prescribe greater capital requirements than are otherwise required by Rule 15c3-1.	Yes	No
4110(b)	Requires suspension of business operations when the member is not in compliance with Rule 15c3-1.	Yes	Yes
4110(c)	Prohibition on withdrawing equity capital for a period of one year.	Yes	Yes
4120(a)	Requires regulatory notification when certain specified financial triggers are reached.	Yes	No
4120(b)	Prohibition on business expansion when certain financial triggers are reached.	Yes	No, but FINRA's ability to issue a notice curtailing business is not limited.
4120(c)	Requires a reduction in business to enable the member to meet its capital requirements.	Yes	No, but FINRA's ability to issue a notice curtailing business is not limited.
4140	Gives FINRA the authority to request an audit.	Yes	Yes
4521	Gives FINRA the authority to request certain information from members to carry out its surveillance and examination responsibilities.	Yes	No

## Certain major provisions of the Financial Responsibility Rules

### FINRA Rule 4110 (Capital Compliance)

Pursuant to FINRA Rule 4110, FINRA regulates a member's compliance with the SEC Net Capital Rule 15c3-1. Most of the provisions under FINRA Rule 4110 are, like most capital regulation, self-operative, requiring members to remain in compliance at all times. This new Rule, and its provisions, applies to Exempt Members, but does not apply to introducing firms or to certain firms with more limited business models (together, referred to as "non-clearing firms").

#### Authority to Increase Capital Requirements

FINRA Rule 4110(a), which is similar to NYSE Rule 325(d), enables FINRA to prescribe greater net capital requirements for carrying and clearing members and Exempt Members, or require any such member to restore or increase its net capital or net worth, when deemed necessary for the protection of investors or in the public interest.<sup>4</sup>

This provision does not apply to other non-clearing firms.

#### Suspension of Business Operations

Under FINRA Rule 4110(b)(1), all members are required to suspend all business operations during any period of time in which they are not in compliance with Rule 15c3-1. If any member is not in such compliance, FINRA may issue a notice directing a member to suspend all or a portion of its business.

#### Withdrawal of Equity Capital

Under FINRA Rule 4110(c)(1), all members are prohibited from withdrawing equity capital for a period of one year, unless otherwise permitted by FINRA. Members are not prohibited, subject to the requirements of Rule 4110(c)(2), from withdrawing profits earned.

<sup>4</sup> See FINRA Rule 4110(a).

FINRA Rule 4110(c)(2) also prohibits any carrying or clearing member and Exempt Members without FINRA's approval, from withdrawing capital, paying a dividend or effecting a similar distribution that would reduce the member's equity, or making any unsecured advance or loan to a stockholder, partner, sole proprietor, employee or affiliate, if such withdrawals, in the aggregate, in any rolling 35-calendar-day period, on a net basis, would exceed 10% of the member's excess net capital.<sup>5</sup> This provision is effectively a ratcheting-up of the current Rule 15c3-1(e), which requires notice two business days prior to any withdrawal if the withdrawal on a net basis exceeds, taken together, in any 30-calendar-day period, 30 percent of the broker or dealer's excess net capital. This provision does not apply to other non-clearing firms.

#### Sale-and-Leasebacks, Factoring, Financing, Loans and Similar Arrangements

Under FINRA Rule 4110(d), no carrying or clearing member or Exempt Members may consummate a sale-and-leaseback arrangement in respect of any of its assets, or a sale, factoring or financing arrangement with respect to any unsecured accounts receivable, where any such arrangement would increase the member's tentative net capital by 10 percent or more, without the prior written authorization of FINRA.<sup>6</sup> This provision does not apply to other non-clearing firms.

Subordinated Loans, Notes Collateralized by Securities and Capital Borrowings; requirements on borrowing of affiliates that will be used to finance certain member firms.

FINRA Rule 4110(e)(1) requires that all subordinated loans or notes collateralized by securities must meet the standards that FINRA may set forth to ensure the continued financial stability and operational capability of

a member.<sup>7</sup> This provision applies to all FINRA members.

Rule 4110(e)(2) requires that each member structured as a partnership whose general partner enters into any secured or unsecured borrowing, the proceeds of which will be contributed to the capital of the member, must, in order for the proceeds to qualify as capital acceptable for inclusion in computation of the member's net capital, submit to FINRA for approval a signed copy of the loan agreement. The loan agreement must have at least a twelve-month duration, and provide no recourse to the assets of the member. This provision applies to all FINRA members that are partnerships.

#### FINRA Rule 4120 (Regulatory Notification and Business Curtailment)

##### Regulatory Notification

FINRA Rule 4120(a) requires clearing or carrying members and Exempt Members to notify FINRA within 24 hours when its net capital falls below any of the following percentages:<sup>8</sup>

- the member's net capital is less than 150 percent of its minimum dollar net capital requirement or such greater percentage thereof as may from time to time be designated by FINRA;
- the member is subject to the aggregate indebtedness requirement of Rule 15c3-1, and its aggregate indebtedness is more than 1,000 percent of its net capital;
- the member elects to use the alternative method of computing net capital pursuant to Rule 15c3-1(a)(1)(ii), and its net capital is less than the level specified in Rule 17a-11(c)(2);

<sup>7</sup> This provision is based on Appendix D of Rule 15c3-1. FINRA is generally responsible review and approval of subordinated loan documentation used by member firms.

<sup>8</sup> This provision is based on current NYSE Rule 325(b). The determination of whether the financial triggers were reached is based on the member's financial position as reported in its most recently filed FOCUS Report.

<sup>5</sup> This provision is based on NYSE Rule 312(h) and Rule 15c3-1(e).

<sup>6</sup> See FINRA Rule 4110(d)(1)(A).

- the member is approved to use the alternative method of computing net capital pursuant to Rule 15c3-1e, and
  - its tentative net capital as defined in Rule 15c3-1(c)(15) is less than 50 percent of the early warning notification amount required by Rule 15c3-1(a)(7)(ii), or
  - its net capital is less than \$1.25 billion;
- the member is registered as a Futures Commission Merchant pursuant to the Commodity Exchange Act, and its net capital is less than 120% of the minimum risk-based capital requirements of Commodity Exchange Act Rule 1.17; or
- the member's deduction of capital withdrawals, which it anticipates making, whether voluntarily or as a result of a commitment, including maturities of subordinated liabilities entered into pursuant to Appendix D of Rule 15c3-1, during the next six months, would result in any one of the conditions described in paragraph (a)(1)(A) through (E) of this Rule.

This new provision rule also applies to Exempt Members, but does not apply to other non-clearing firms.

#### Curtailment of Business Expansion

FINRA Rule 4120(b) requires carrying or clearing members and Exempt Members to refrain from expanding its business during any period in which any of the conditions described in FINRA Rule 4120(a)(1) continue to exist for the specified time period.<sup>9</sup> This new provision also applies to Exempt Members, but does not apply to other non-clearing firms.

Under Rule 4120(b)(2), FINRA is permitted, for any financial or operational reason, to restrict any member's ability to expand its business by the issuance of a notice as specified. In all such cases, the member would have the

right to request an expedited hearing. This provision applies to all FINRA members.

#### Reduction of Business

FINRA Rule 4120(c)(1) requires carrying and clearing members to reduce their business to a point enabling its available capital to exceed the standards set forth in FINRA Rule 4120(a)(1) (described and listed above) when any of those defined conditions continue to exist for more than fifteen consecutive business days, provided the conditions have been known to FINRA or the member for at least five consecutive business days.<sup>10</sup> This new provision does not apply to other non-clearing firms.

FINRA Rule 4120(c)(2) also provides that FINRA may issue a notice directing any such member to reduce its business, in which case the member would have the right to an expedited hearing. This provision applies to all FINRA members.

#### FINRA Rule 4140 (Audit)

FINRA Rule 4140 gives FINRA the authority to request an audit or an agreed-upon procedures review under certain circumstances.<sup>11</sup> This new rule imposes a late fee of \$100 for each day that a requested report is not timely filed, up to a maximum of ten business days. This provision applies to all FINRA members.

#### FINRA Rule 4521 (Notifications, Questionnaires and Reports)

Under Rule 4521, FINRA has the authority to request certain information from members to carry out its surveillance and examination responsibilities. Each carrying or clearing member must submit to FINRA

<sup>9</sup> This provision is based on NASD Rule 3130(c) and NYSE Rule 326(a).

<sup>10</sup> This provision is based on NASD Rule 3130(d) and NYSE Rule 326(b).

<sup>11</sup> Specifically, the rule states that "FINRA may at any time, due to concerns regarding the accuracy or integrity of a member's financial statements, books and records or prior audited financial statements, direct any member to cause an audit to be made by an independent public accountant of its accounts, or cause an examination to be made in accordance with attestation, review or consultation standards prescribed by the AICPA."

financial and operational information regarding the member or any of its correspondents, as FINRA deems essential for the protection of investors and the public interest. This new rule does not apply to other non-clearing firms.

## Conclusion

The new Rules represent important changes to the financial responsibility requirements for FINRA members, including Exempt Members. Notably, these new rules will require certain procedures that until now have been familiar only to NYSE members to be followed by all FINRA members meeting the specified criteria. All members should be mindful of these Rules and the impact on their businesses.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling LLP contact person or any of the following:

Charles S. Gittleman  
New York  
+1.212.848.7317  
cgittleman@shearman.com

Russell D. Sacks  
New York  
+1.212.848.7585  
rsacks@shearman.com