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Recent Legislation: Protection of Investors' Free Credit Balances

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Recent Legislation

PROTECTION OF INVESTORS' FREE CREDIT BALANCES

Rule 15c3-2,[1] adopted under the Securities Exchange Act of 1934,[2] conditions the use of free credit balances by broker-dealers. In the normal course of business, a broker-dealer retains custody of both securities and cash belonging to his customers. The broker-dealer may retain *securities* to facilitate transfers as collateral for margin transactions,[3] or simply as a safekeeping service to the customer. Custody of customers' *cash* generally arises from one of three situations: (1) a customer may give cash to a broker-dealer with the understanding that instructions for the purchase of securities will follow; (2) a customer's securities may be sold and the proceeds held by the broker-dealer pending further investment or other disposition by the customer; or (3) a customer's cash may be retained when a broker-dealer does not immediately transmit interest and dividends he receives on his customer's securities held in a "street"[4] name.[5] In all of the foregoing situations, the customer has an immediate, unrestricted right to withdraw these cash holdings. It is this right which characterizes a *free credit balance.*[6] In contrast, a customer's cash may also be held as collateral for a margin transaction;[7] however, cash so held does not create a free credit balance since it is subject to the claim of the broker-dealer.[8]

Although there are numerous restrictions on the use of a customer's securities by a broker-dealer,[9] there are few restrictions on the use of a customer's free credit balance. These balances may be, and often are, used for the general operating needs of the broker-dealer's business, for financing its trading and investment accounts, or for loans to other cus-

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1. 29 Fed. Reg. 7240 (1964) (effective Aug. 3, 1964).

2. 48 Stat. 881 (1934), as amended, 15 U.S.C. §§ 78a-78jj (1958), as amended, Pub. L. No. 88-467, 88th Cong., 2d Sess. (Aug. 20, 1964).

3. In a margin transaction, the relationship between broker-dealer and customer is the reverse of that which exists when a customer creates a free credit balance. The broker-dealer lends the customer money to finance the purchase of securities. This creates a debit balance in the customer account in the amount of the loan.

4. For convenience in handling, stock certificates are often registered in the name of the broker, or in the name of one other than the owner. Such certificates are said to be registered in a "street" name. NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., TRAINING GUIDE 9 (1963)

5. Securities and Exchange Commission, *Report of Special Study of Securities Markets*, H.R. DOC. NO. 95, 88th Cong., 1st Sess. pt. 1, 393-94 (1963) [hereinafter referred to as *Special Study*].

6. *Id.* at 393.

7 See note 3 *supra.*

8. *Special Study*, at 393.

9. *E.g.*, 48 Stat. 888 (1934), as amended, 15 U.S.C. § 78h (1958)

tomers to finance margin transactions.[10] However, a few jurisdictions restricted the use of these funds prior to the adoption of Rule 15c3-2. For example, Iowa requires that customers' free credit balances be segregated from firm accounts.[11] Similarly, Ohio requires that customers' free credit balances be segregated if the net capital of a broker-dealer falls below $10,000, or if his total indebtedness exceeds fifteen times his net worth.[12]

Further restrictions were imposed upon the use of free credit balances with the adoption of Rule 15c3-2. This Rule provides that brokers and dealers may not use funds arising out of a free credit balance carried for the account of a customer unless such customer is notified every three months: (1) of the amount due him, (2) that this amount is not segregated and may be used in the broker's or dealer's business operations, and (3) that this amount is payable on demand.[13] These provisions alleviate a long standing inconsistency of permitting the use of free credit balances while restricting the use of customers' securities. In both instances, the question of propriety is the same; an agent is using his principal's property for his own purposes. Furthermore, free credit balances are just as subject to loss in the event of insolvency as are securities.

The Commission called attention to this inconsistency as early as 1941 when it requested Congress to give it the power to require segrega-

10. See note 3 *supra*.

11. IOWA CODE ANN. § 502.13 (1949).

12. Regulation DS-5, The Division of Securities of Ohio. Although the various securities exchanges and the National Association of Securities Dealers could restrict the use of customers' free credit balances by their members, none of these organizations has done so. *Special Study*, at 400.

13. The full text of the Rule provides as follows:

> No broker or dealer shall use any funds arising out of any free credit balance carried for the account of any customer in connection with the operation of the business of such broker or dealer unless such broker or dealer has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent, together with or as a part of the customer's statement of account, whenever sent but not less frequently than once every three months, a written statement informing such customer of the amount due to the customer by such broker or dealer on the date of such statement, and containing a written notice that (a) such funds are not segregated and may be used in the operation of the business of such broker or dealer, and (b) such funds are payable on the demand of the customer; *Provided, however*, That this rule shall not apply to a broker or dealer which is also a banking institution supervised and examined by State or Federal authority having supervision over banks. For the purpose of this rule the term "customer" shall mean every person other than a broker or dealer. 29 Fed. Reg. 7240 (1964).

The Rule was adopted under the provisions of § 23(a), 48 Stat. 901 (1934), as amended, 15 U.S.C. § 78w (1958), and § 15(c)(3), 52 Stat. 1075 (1938), 15 U.S.C. § 78*o* (1958), as amended, Pub. L. No. 88-467, 88th Cong., 2d Sess. (Aug. 20, 1964), of the Securities Exchange Act of 1934. Section 23(a) authorizes the Commission to make such rules and regulations as are necessary for the execution of its function under the act. More particularly, § 15(c)(3) empowers the Commission in the public interest, or for the protection of investors, to prescribe rules and regulations to provide safeguards with respect to the financial responsibility of brokers and dealers.

tion of customers' free credit balances.[14] However, the securities industry opposed the request arguing that alteration of the Bankruptcy Act would be sufficient to protect customers' free credit balances in the event of the broker's insolvency.[15] The Commission pointed out that

> even if the Bankruptcy Act [was] changed to make it clear that free credit balances which are segregated may be reclaimed, there will be no protection unless the broker in fact makes the appropriate segregation. . But no changes in the Bankruptcy Act could compel the broker to segregate.[16]

Although the merit of the Commission's argument seems obvious, the request was never adopted; the absence of restrictions continued. However, on September 5, 1961, section 19(d) of the Securities Exchange Act was enacted. This section authorized and directed the Commission "to make a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations " and to "report to Congress the results of the study and investigation, together with its recommendations, including such recommendations for legislation as it deems advisable."[17] The response to this Congressional mandate culminated in the *Report of Special Study of Securities Markets*.[18] While this study suggested that there was, at that time, no need to require segregation of customers' free credit balances, several recommendations were nevertheless made for their protection. Many of these recommendations were finally incorporated in the Rule.[19]

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14. Securities and Exchange Commission, *Report on Proposals for Amendments to Securities Act of 1933 and The Securities Exchange Act of 1934*, 77th Cong., 1st Sess. 29-32 (Comm. Print 1941)

15. *Id.* at 31.

16. *Ibid.*

17 75 Stat. 465 (1961), as amended, 15 U.S.C. § 78s (Supp. V 1963)

18. *Special Study.*

19. For example, the *Special Study* recommended that

> the net capital rules of the Commission and the self-regulatory agencies should be amended to require broker-dealers to maintain a reserve of, say, 15 percent of the aggregate amount of free credit balances in the form of cash or short-term U.S. Government securities; or in the alternative, if a lesser reserve is maintained, to charge the difference to net capital. In addition, broker-dealers holding free credit balances should be required to give customers at least quarterly notice of the amounts of such balances. Such notice should include information to the effect that their free credit balances may be withdrawn at any time; that while held by the firm they are not segregated and may be lent to other customers or otherwise used in the business of the firm; that interest is not paid on such balances (or the circumstances in which interest is paid), and that financial statements of the broker-dealer firm are available for inspection. *Special Study*, at 415.

With the exception of the suggested change in net capital rules, Rule 15c3-2, as originally proposed, substantially adopted these recommendations. 29 Fed. Reg. 3477 (1964). But as finally adopted, Rule 15c3-2 did not incorporate the provision that customers be given notice as to whether interest will or will not be paid on free credit balances. 29 Fed. Reg. 7239 (1964). As pointed out by those who submitted comments on the original proposal,

The effect of Rule 15c3-2 is to strike a balance between the desire to protect investors and the policy of minimizing the number of problems for the securities industry. By demanding that customers be informed of the status of their accounts, a measure of protection is provided for many unsophisticated investors who are unaware that their free credit balances are subject to possible loss in the event of insolvency. However, the rule does not prohibit the *use* of free credit balances, which account for an important addition to the income of many firms in the securities industry.[20] In addition, the question of propriety has been mitigated by the Rule; by requiring that the customer be put on notice, Rule 15c3-2 has made it mandatory that at least tacit approval be received from the customer before funds are used by the broker.

Perhaps the greatest significance of the Rule is that it was adopted in response to the *Special Study* which is the most thorough examination of the securities markets since the early 1930's.[21] It points up many shortcomings and makes no less than 175 recommendations for suggested corrections.[22] While the Commission has stated that it does not embrace all these recommendations,[23] the *Special Study* will unquestionably have profound impact in both the area of securities legislation and securities regulation in ensuing years. Indeed, Rule 15c3-2 may well prove to be only the beginning of a series of changes calculated to further the protection of private citizens from possible abuse by members of the securities industry.

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the Commission felt that this information was not directly pertinent to the purpose of the Rule, *i.e.*, to put customers on notice that free credit balances left with the broker-dealer may be used in the business. Further, it was believed that emphasis on this fact might induce customers to choose their brokers on the basis of this factor, rather than on the basis of the kind of service to be rendered, the reliability and integrity of the firm, and other factors which should be considered by a customer in choosing a broker. SEC Securities Exchange Act Release No. 7325, May 27, 1964, CCH FED. SEC. L. REP. ¶ 77,000 (1961-64 Transfer Binder).

20. *Special Study*, at 401.

21. See SEC 29TH ANN. REP. 1 (1963).

22. *Id.* at 3.

23. In a letter of transmittal from the Chairman of the Securites and Exchange Commission, William L. Cary, to the President of the Senate and the Speaker of the House of Representatives, it was stated: "We do not embrace every recommendation as our own, but we do accept them as a sound point of departure for proposals to the Congress, for rule making by the Commission and by the self-regulatory agencies, and for discussions with the industry." *Special Study*, at v.

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