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Implementation of recordkeeping provisions of rule 15c3-3

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IMPLEMENTATION OF RECORDKEEPING PROVISIONS OF RULE 15c3-3

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On January 15, 1973, just five days from today, the Securities and Exchange Commission rule restricting brokers' use of customers' funds and securities becomes effective. The SEC release dated November 10, 1972 explains that the rule requires that customers' funds held by a broker and the cash which is realized through the lending, hypothecation, and other permissible uses of customers' securities are deployed in safe areas of the broker business involved in customer service. To the extent that the funds are not deployed in these limited areas, they must be deposited in a reserve bank account. It further requires a broker to promptly obtain possession or control of all fully paid securities and excess margin securities carried by that broker for the account of customers and requires him to act within designated time frames where possession or control has not been established. Under the rule, the release states, a broker will have to maintain more current records.

ADMINISTRATION AND IMPACT

The Commission also announced that it had made every effort to make the rule flexible enough to be compatible with the accounting, clearance, settlement, and depository systems presently operating or being developed in the securities industry. When the rule was proposed on September 14, 1972, after two previously published proposals were discarded, it announced that the rule may substantially affect certain brokers' financing requirements and will necessitate activity on the part of these members of the industry to raise additional capital. . . nevertheless, despite the necessity on the part of the industry to make adjustments to meet the impact of the proposed rule, the program for public investor protection is paramount. This was repeated in the announcement of the adoption rule. It was also stated that the rule would be carefully monitored by the Commission to determine whether there will be a need in the public interest and for the protection of investors to tighten or relax any of the restraints and time frames embodied in the rule.

The rule may have its greatest impact on the smaller brokers, many of whom have neither engaged in firm trading activities nor have lent or hypothecated customers' securities to obtain funds to finance segments of the business unrelated to customers' transactions. It appears that the requirement to maintain a special reserve bank account for the exclusive benefit of customers will affect the small brokers, who do not maintain customer margin accounts, much more than it will their larger counterparts. On the other hand, the burden of changing the way of doing business may be more expensive to smaller brokers than any loss of interest income obtained previously from the use of those funds.

COMPUTATION AND TIMING

The rule provides that the computation necessary to determine the amount required to be deposited in this special account shall be made weekly as of the close of business on the last day of the week. It requires that the deposit so determined shall be made no later than one hour after the opening of banking business on the second following business day. There is an exception to this if the brokers' aggregate indebtedness does not exceed 800% of net capital as computed under the rule applicable to him and he does not hold aggregate customer funds exceeding $1,000,000. In that event, a monthly computation is permissible but the deposit required would be 105% of the amount computed under the formula. It is not enough merely to comply with the deposit requirement. The broker shall make and maintain a record of each computation and preserve each such record in accordance with Rule 17a-4. A withdrawal from the reserve bank account will require the broker to make a record of the computation on the basis of which he makes such withdrawal. These requirements discourage transactions in the reserve bank account even though the broker would know that the amount which he is withdrawing would not impair his requirement; therefore, the reserve bank account should not be used as an account through which a broker is to conduct all customer business. As I stated earlier, it is much more likely that the larger broker who maintains margin accounts will have no reserve bank account requirements; therefore, his weekly computation, which would prove no deposit requirement, would not be nearly as critical as that of a broker who must determine the amount required to be deposited and then would be precluded from withdrawing amounts unless he makes a record of the requirement on the date of withdrawal.

The computation itself is not particularly difficult; however, the formula requires a determination of free credit balances and credit balances and also debit balances in customers' cash and margin accounts, excluding unsecured accounts and accounts of doubtful collection. Generally, the brokers' bookkeeping system would have customer accounts under a single ledger control. I understand it will be allowable in a weekly computation to use the net control amount after excluding unsecured debits and accounts doubtful of collection; however, these accounts must be shown broad in the monthly computation. The formula also requires entries of several items at market values. Hopefully, these will not be significant.

CONTROL OF SECURITIES

While the recordkeeping requirements of restrictions on cash may be considered merely bothersome, the requirements on control of securities cannot be taken lightly. The rule requires that a broker promptly obtain, and thereafter maintain, the physical possession or control of all fully paid securities and excess margin securities carried for the account of customers. It further requires that a broker shall not be deemed to be in violation of the rule if, solely as the result of normal business operations, temporary lags occur between the time when a security is required to be in the possession or control of the broker and the time that it is placed in his physical possession or under his control, provided that the broker takes timely steps in good faith to establish prompt physical possession or control. It continues that the burden of proof shall be on the broker to establish that the failure to obtain physical possession or control of securities for customers is temporary and solely the result of normal business operations, including same day receipt and redelivery (turn-around), and to establish that he has taken timely steps in good faith to place them in his physical possession or control.

Physical possession of securities comprehends the positions of box and safekeeping. Control of securities includes: In-transit positions between offices of the broker and dealer; transfer items within forty days after transmission to the transfer agent; paid securities in custody or control of a clearing organization of a national security exchange or association; paid securities held for the broker's customers by another broker in a special omnibus account; and securities held by banks and foreign depositories under specified terms.

The rule has specific requirements to reduce securities to possession and control. Not later than the next business day a broker, as of the close of the preceding business day, shall determine from his books or records the quantity of fully-paid securities and excess margin securities in his possession or control and the quantity of fully-paid securities and excess margin securities not in his possession or control. If any deficiencies exist in obtaining the physical possession or control of fully-paid or excess margin securities, certain steps should be taken. In the case of securities pledged as collateral or loaned, instructions for their return shall be issued not later than the business day following the day of determination. Such securities must be received within two business days following the date of issuance of the instructions in the case of collateral securities, and five days following the date of issuance of instructions in case of securities loaned. If securities failed to receive are more than thirty days old the broker must take steps to buy in such securities. Securities receivable by the broker as a dividend or stock split or similar distribution older than forty-five calendar days must be obtained immediately or bought in. Generally, the reasons that a small broker would be deficient in a control situation would be that a customer paid for securities when the broker has been delayed from obtaining possession because of the normal delays in a fail situation or if a stock dividend split or similar distribution takes place before the transaction is completed. Even if deficient under these circumstances, normally there would be little problem under present procedures except if a customer who sold his securities caused similar securities to become available for delivery. Such securities are required to be used to cover the deficiency under this new rule. Regardless of the problems of ascertaining and rectifying deficiencies under this new rule, the most burdensome task for small brokers no doubt will be the daily computations. Remember, not later than the next business day a broker, as of the close of the preceding business day, shall determine from his books or records the quantity of fully-paid securities and excess margin securities in his possession or control, and the quantity of fully-paid securities and excess margin securities not in his possession or control. I repeat, the most significant impact of the rule on the broker with the manual security position record will be this daily determination.

ACTIONS NECESSARY TO COMPLIANCE

What must be done by January 15 to satisfy the regulatory agencies?

At the Securities Industry Association seminar on December 6, 1972, Brian Coughlin, vice president of the Midwest Stock Exchange, speaking on behalf of the self-regulatory group, stated that they intend to consider violations of this Rule as serious as net capital violations. There are, however, many unanswered questions, and you have their promise to be helpful in the initial implementation of the rule. You should, therefore, make every effort to perform the recordkeeping, make the required deposits, and take action to bring securities under control within the time frames of the rule.

First let us examine some exceptions available.

Paragraph (k) of the Rule provides for several exceptions. These generally apply to the mutual fund salesman or the broker who operates on a fully disclosed basis, introducing accounts to a carrying broker; however, one exception may be of interest to brokers who do not carry margin accounts. It requires that the broker promptly transmit all customer funds and deliver all customer securities and does not hold funds or securities of customers and handles all financial transactions with customers through a bank account designated as "Special Account for the Exclusive Benefit of Customers of (name of broker)".

This exception deserves consideration by brokers who do only an accommodation customer business as well as those who do not carry margin accounts.

Assuming exemption is out, we must then prepare to comply with the various provisions of the Rule by January 15, 1973.

First, open a bank account called "Special Account for the Exclusive Benefit of Customers" and notify the bank(s) as required by paragraph (f), which requires the broker to obtain a written notification from the bank that it was informed that all cash and/or qualified securities deposited therein are being held for the exclusive benefit of customers of the broker in accordance with the regulations of the Commission, and are being kept separate from any other accounts maintained by the broker with the bank, and the broker shall have a written contract with the bank which provides that the cash and/or qualified securities shall at no time be used directly or indirectly as security for a loan to the broker by the bank and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

The next thing the broker should do, if he uses a correspondent broker who holds any paid-for securities, is to arrange for identification with the correspondent of paid-for securities and arrange notification as required by sub-paragraph c(2). If your correspondent doesn't hold paid-for securities on your behalf but performs transfer services for you, the notification might be placed on transfer instructions.

Then compute the formula for determination of the reserve requirement as of the end of December and this weekend, so that problems can be resolved prior to the effective date.

Orient cashier's department on control locations, rules against creating or increasing deficits of securities required to be in possession or control, action to be taken in case of deficiencies, changes in routines to minimize problems, and recordkeeping requirements.

Finally, establish a system to identify securities required to be in possession or control and a means to identify those in possession and control on a daily basis as required by paragraph (d) of the Rule.

AN EXAMPLE

Let us examine how "Complying Broker" will use his manual securities position record as a basis for his possession and control system. (See Exhibits 1 through 4, beginning on page 128.)

Under this system, additional information regarding the transaction must be furnished to the "long and short" clerk so these requirements and locations can be identified. The method of doing this may vary from firm to firm.

The general approach is to comprehend, in the information recorded in the securities position record, customers' "long" paid for securities positions and to distinguish possession or control locations on the "short" side. These positions would be added and total recorded above the position totals on the record. Where these totals are not in agreement, they would be transferred to the daily Possession and Control Report which would be prepared at least in duplicate. The cashier would explain what action is to be taken on deficits and take steps to prevent any increase and, if required, take action to eliminate deficiencies. I would anticipate that unusual elements such as transfer positions over forty days could be handled either on the securities position record or added directly to the Possession and Control Report.

It appears that the safekeeping location may have lost its usefulness under this new rule. However, each firm's decision on whether to retain it or not should be made on an individual basis. First of all, we all recognize that the new rule's emphasis is on possession. It doesn't make any difference whether the security is here or there; and as a matter of fact, control is just as good. However, it seems preferable to have a position where dormant paid-for securities are held. These would be held separate from the other securities. The cashier department would process active box securities and generally not handle these safekeeping securities which would represent paid or excess margin securities which had completed the transaction process. It would appear that such a position would be used in conjunction with a system in which instructions are issued to a cashier's section as recommended by the joint self-regulatory agencies. These recommendations are included in the SEC staff interpretation dated January 2, 1973 (Release No. 9922) which states the time that instructions must be issued to acquire possession or control, or the time at which such instructions may be released. These recommendations should result in availability of instructions to the cashiering section: (1) In the case of purchases of securities by customers: on or before the business day following settlement date or the business day following actual date of receipt of payment, whichever is later; (2) in the case of sales of securities by customers: not earlier than the close of business on the third business day before settlement date, which is deemed to allow adequate time for processing securities for pending deliveries.

I would like to point out that the same general concept could be used without designating paid long customers' securities. If this is done, you would consider all customer long positions paid on the securities position record and items unpaid after settlement would be added to the possession and control report by the cashier.

CONCLUSION

In conclusion, I must stress the importance of timely preparation of the records required by this new rule. It may be several months before definitions are clarified, but determination of the possession and control requirements must be made on the day following each business day. ●

EXHIBIT 1

COMPLYING BROKER–POSSESSION AND CONTROL REPORT

DATE	SECURITY	REQUIRED TO BE IN CONTROL	IN POSSESSION OR CONTROL	EXCESS (DEFICIT)	EXPLAIN DEFICITS
1/1	United Williams	1,100	1,800	700	
1/2	United Williams	1,100	1,200	100	
1/3	Cons. Moss	900	500	(400)	Current F/R
	Mandate Corp.	1,100	1,150	(50)	To remove 100 from B/L
	United Williams	1,100	1,700	600	
1/4	Cons. Moss	600	500	(100)	Current F/R 400
	Mandate Corp.	1,100	1,150	(50)	Remove 100 Cust. Loan
	United Williams	1,100	1,200	100	
1/5	Cons. Moss	600	300	(300)	(Current F/R 400 (Del'd 200 in error
	Mandate Corp.	700	600	(100)	(Remove 100 Cust. (Loan (Remove 200 Firm (Loan
	United Williams	1,500	1,200	(300)	Remove 300 from B/L
1/8	Cons. Moss	600	700	100	
	Mandate Corp.	700	600	(100)	Same
	United Williams	1,500	1,200	(300)	Same
1/9	Mandate	700	600	(100)	Same
	United Williams	1,500	1,200	(300)	Same
1/10					

EXHIBIT 2

COMPLYING BROKER–SECURITY POSITION RECORD

Transactions in Consolidated Moss

On January 1, "Complying Broker" showed customer Apple with 500 shares of Consolidated Moss Corp. in safekeeping. Of course, these were paid-for securities. This created the situation that there were 500 shares to be controlled, which are designated by a "C" on the security position record. The total long position was 500 shares. 500 shares were in its possession (possession and control positions designated by "C" on this and following Exhibits) and a total of 500 shares.

On January 2, customer Bread purchased 400 shares. The selling broker failed to deliver those shares. He still has 500 shares to be controlled. Total long, 900 shares. Five hundred shares in possession; total short, 900 shares.

EXHIBIT 2 Continued

YEAR 1973 STOCK: CONSOLIDATED MOSS CORP.

			1/1	1/2	1/3	1/4	1/5	1/8	1/9	1/10
Fail to Deliver						200	—	300	200	—
Cust Apple	Open					300		—		
" "	Paid	C	500			200				
Cust Bread	Open			400	—					
" "	Paid	C			400					
To be Controlled			500	500	900	600	600	600	600	600
Total			500	900	900	1100	900	900	800	600
Cust Gourmet						200				—
Fail to Receive				400				—		
Transfer		C								
Safekeeping		C	500			200				600
Box		C				300	100	500	400	—
In Possession or Control			500	500	500	500	300	700	600	600
Total			500	900	900	1100	900	900	800	600

On January 3, customer Bread paid for the 400 shares of Consolidated Moss Corp. This increased the requirement to be controlled to 900 shares; total long, 900 shares. In possession or control, only 500 shares that were in safekeeping; 400 shares failed to receive, totaling 900 shares. This deficiency should be reported on the control status sheet and given to the cashier. The cashier, in turn, is obligated to consider the positions and ascertain the action he is required to take, if any. In this case, he should have in his file a fail to receive ticket for 400 shares. As long as that fail is not more than thirty calendar days old he has no required action at this time.

On January 4, customer Gourmet sells; no delivery was made, so they failed to deliver 200 shares. Also, a movement was made from safekeeping to box of 300 shares which represented shares owned by Apple which was sold for settlement January 8. Apple's position is adjusted for the sale.

At the close of business January 4, we showed 600 to be controlled and 500 in control. On January 5, we delivered 200 shares from the box to cover the fail to deliver.

EXHIBIT 2 Continued

This movement should not have been made. The cashier, knowing that customer Apple had sold 300 shares for settlement January 8, made the movement from safekeeping to box on January 4 which gave him usable securities; however, it is important for him to give priority to the deficiency that was caused by customer Bread paying for the 400 shares. Regardless of other circumstances, you should understand that the rule is interpreted to prohibit any delivery or removal of securities that would create or increase a deficiency. At the end of that day, the deficiency of 300 shares would be reported on the status sheet.

On January 8, the sale of 300 shares by customer Apple is recorded. We also received 400 shares from the street and placed them in the box. At that point we have an excess in control of 100 shares. This, also, would be reported on the status sheet. The interpretation by the joint self-regulatory agencies covering reporting of the excess is: "A member organization shall not be required to print or include in a separate record or listing the status of those securities which have neither an excess nor a deficit, but shall have available such books and records as may be necessary to provide an audit trail." The securities position record will provide the audit trail and include the historical data relating to items to be controlled, and those in possession or control. Excesses or deficiencies will be shown on the possession and control report with reasons for deficiency action taken, etc.

On January 9, we deliver 100 shares versus a fail to deliver which evens our control requirements and, on January 10, we receive securities from the short customer and deliver it to the street resulting in this security position becoming dormant; therefore, securities on hand should be moved to the inactive box or safekeeping.

EXHIBIT 3

COMPLYING BROKER–SECURITY POSITION RECORD

Transactions in United Williams

On January 1, "Complying Broker" had the following positions in United Williams Co. 200 due Midwest and Customers long 2,700 shares, 1,100 of which were paid or excess margin. He held in possession as control positions 1,800 shares, and had 1,100 shares in non-control positions.

On January 2, 300 were delivered to Midwest from the box and 400 shares were sent from safekeeping to the bank for collateral. These moves reduced control positions by 600 shares.

On January 3, 200 shares were received from Fritter who had been short. 300 shares were received from correspondent. These shares were placed in box. Gourmet sold 500 shares short. Control positions increased by 500 shares.

On January 4, instructions were sent to correspondent to offset the paid position of 500 shares with the short sale position. The control positions total 1,200 shares, 100 in excess of requirements.

On January 5, Midwest is instructed to move 200 shares from loan free to the regular free position. Margin clerk advises to "seg" 400 for Donut. This creates a deficiency of 300 shares.

EXHIBIT 3 Continued

YEAR 1973 STOCK: UNITED WILLIAMS CO.

			1/1	1/2	1/3	1/4	1/5	1/8	1/9	1/10
Midwest			200					300		
Correspondent	(NY Trades)				500					
Cust Cake	(Open)									
" "	Paid	C	400							
Cust Donut	Margin		900				500			
" "	Excess	C	400				800			
Cust Eclair	Margin		700					400		
" "	Excess	C	300							
To be Controlled			1100	1100	1100	1100	1500	1500	1500	1500
Total			2900	2700	3200	2700	2700	2700	2400	2400
Cust Fritter			200							
Cust Gourmet					500					
Bank Loan Cust			500	900					600	300
CNS Loan			100							
CNS Loan	Free	C	200							
Midwest	Open									
	Free	C		100			300			
Correspondent	Paid	C	500							
"	Open		300							
Safekeeping		C	400							
Box		C	300		500					800
Transfer		C	400							
In Possession or Control			1800	1200	1700	1200	1200	1200	1200	1500
Total			2900	2700	3200	2700	2700	2700	2400	2400

On January 8, Eclair sells 300. Note that the 300 shares at Midwest were not used for the delivery because of the existing deficiency.

On January 9, 300 which were removed from bank loan collateral were delivered to Midwest to complete the open trade. This transaction is not allowable under the turn-around interpretation. You can deliver to an uncontrolled location securities received from another uncontrolled location (as a result of a settlement of a transaction) on the same day as long as you don't create or increase a deficiency, but this does *not* include securities received as the result of recall from bank or stock loan.

On January 10, 300 additional shares are withdrawn from bank loan and placed in the box to balance the control positions.

EXHIBIT 4

COMPLYING BROKER–SECURITY POSITION RECORD

Transactions in Mandate Corp.

On January 1, "Complying Broker," has customers long a total of 1,500 shares of Mandate Corp. Customer Apple bought but has not paid for 100 shares. Customers Bread and Cake have paid positions of 200 and 300 shares, respectively. Customer Donut, a margin account, has a total of 900 shares, 500 of which have been designated as "excess margin securities." 1,000 shares are required to be in control, and 1,000 shares are controlled.

On January 3, the following transactions took place; Customer Apple paid for 100 shares, 100 shares were sent to transfer for Apple. Customer Fritter brought in 150 shares. 100 shares were delivered to Midwest. This resulted in an excess of 50 shares.

On January 5, Customers Apple, Bread, and Cake sold 100, 200, and 300 shares, respectively. Firm trading sold 500 shares. Margin clerk issued "seg" instructions of 200 shares for Donut. 300 shares were delivered to Midwest. 150 shares were received from Transfer. The net result was a deficiency of 100 shares.

On January 10, Firm Trading bought 250 shares; 200 shares from firm bank loan and 100 shares from customer bank loan were delivered to Midwest. Control positions are in balance again.

YEAR 1973 STOCK: MANDATE CORP.

			1/1	1/3	1/5	1/10
Firm Trading			250			
Midwest					450	
Cust Apple	Open		100			
" "	Paid	C		100		
Cust Bread	Open					
" "	Paid	C	200			
Cust Cake	Open					
" "	Paid	C	300			
Cust Donut	Margin		400		200	
" "	Excess	C	500		700	
To be Controlled			1000	1100	700	700
Total			1750	1750	1350	900
Cust. Fritter			150			
Transfer		C	50	150		
Bank Loan Cust			300			200
Bank Loan Firm			200			
Firm Trading					250	
Midwest	Open		100			
Midwest	Free	C	150	250		100
Safekeeping		C	600			600
Box		C	200	150		
In Possession or Control			1000	1150	600	700
Total			1750	1750	1350	900