

SECTION 1: CUSTOMER PROTECTION RULE

1a. RULE 15c-3-3 - CUSTOMER PROTECTION RULE OVERVIEW

The Customer Protection Rule was written in 1975 after a number of brokerage firm failures resulted in customer losses. The intent of the rule is to insure that brokerage firms always have sufficient funds on hand to meet customer claims in a liquidation. In addition, the rule places requirements on broker-dealers to promptly obtain possession or control of securities on settlement. These requirements insure that "back office" operations do not get out of control.

1b. SPECIAL RESERVE BANK ACCOUNT FOR THE BENEFIT OF CUSTOMERS

**Required For
Clearing Broker-
Dealers Only**

The Customer Protection Rule requires every broker-dealer that carries customer funds or securities (\$250,000 broker-dealers) to perform a weekly computation. In this computation, the firm compares the amount of monies that customers owe the firm (customer debits) to monies that the firm owes customers (customer credits). We have already looked at a brokerage firm's balance sheet when computing Net Capital. The major items included in the Reserve Computation are:

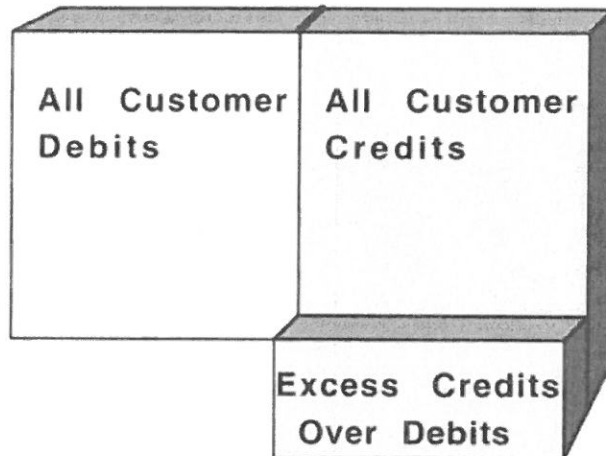
CUSTOMER RESERVE ACCOUNT COMPUTATION

CUSTOMER DEBITS (Owed By Customers)	CUSTOMER CREDITS (Owed To Customers)
Debit Balances In Customer Accounts	Credit Balances In Customer Accounts
Fails to Deliver For Customer Accounts	Fails to Receive For Customer Accounts
Stock Borrowed For Customer Accounts	Stock Loaned From Customer Accounts
	Bank Loans Using Customer Collateral

The intent of the rule is to insure that, at all times, the firm has enough money to pay existing customer claims. If the aggregate debits exceed credits, then, in a liquidation, the net result is that the customers owe the firm money. In this case, no funds have to be deposited to a reserve account.

On the other hand, if aggregate credits exceed debits, in a liquidation, the net result is a liability to customers. In this case, the Customer Protection Rule requires that the excess portion representing the net liability be deposited to a Special Reserve Bank Account.

IF ALL CREDITS EXCEED ALL DEBITS.....



THEN EXCESS MUST BE DEPOSITED TO THE SPECIAL RESERVE BANK ACCOUNT

Bank Notified That Account Is Solely For Customer Benefit - No Liens

When the broker-dealer opens the Special Reserve Account at the bank, it must obtain a letter from the bank stating that the bank understands that this is a "Special Reserve Account" and that no liens can be placed on the account by the bank. The funds are to be kept segregated and are solely payable to customers in the event of a liquidation. The bank cannot claim the account's assets to meet other liabilities of the broker-dealer!

**Weekly Computation
Deposit Only Cash or Governments**

The computation is performed weekly. Any required deposits to the account can only be made in cash or U.S. Government guaranteed securities - that is, Treasuries and Ginnie Maes - not Federal agency securities. If deposits are made of Government guaranteed securities, these are **not** subject to the haircut rules. Thus, 100% of the securities' value is included for deposit purposes. Note, however, that these securities will still be haircuted in the member's firm's net capital computation.

Deposit 1 Hour After Banks Open On 2nd Business Day

If a deposit is required, the deposit must be made by 1 hour after banks open on the 2nd business day following the computation. Thus, most firms will compute on Friday. If a

deposit is required, it must be made by 10:00 AM the following Tuesday. If the weekly computation shows that there are excess funds in the account, the firm is free to remove them.

**Deduct Lesser Of
Required Amount
Or Amount On Deposit
When Computing "AI
For Ratio Purposes"**

Also remember from the Net Capital chapter that funds on deposit in the Special Reserve Bank Account are deducted from Aggregate Indebtedness "for Ratio Purposes" (when computing the AI/NC ratio). If there are funds on deposit in excess of the required amount, only the required amount can be deducted. Translated, this means that the deduction is the lesser of the required amount or the amount on deposit.

**"Solid" Firms Can
Compute Monthly**

**AI/NC < 8:1 and
<\$1,000,000 Customer
Credits; Deposit 105%**

If the firm is in solid financial shape, it can elect to compute monthly instead of weekly. To qualify, the firm cannot have credits in customer accounts in excess of \$1,000,000 and its AI/NC ratio cannot exceed 8:1. In this case, it can compute monthly. If monthly computation is elected, the firm must deposit 105% of any calculated amount.

If a firm computing monthly finds that its ratio of AI/NC exceeds 8:1, it must resume making weekly computations. It must do so until 4 successive weeks have passed with its ratio of AI/NC at or less than 8:1. At that point, it can resume monthly computations.

**Failure To Make
Deposit-Electronic
Notice**

If a broker-dealer fails to make a required deposit, it must give immediate electronic notice to FINRA and the SEC. Following the electronic notice, the firm must promptly confirm the electronic notice in writing.

The Customer Protection Rule provides the following exemptions from the requirement to maintain a Special Reserve Bank Account:

**K-1 Exemption:
Mutual Fund
Broker-Dealers**

K-1 - Exempts mutual fund broker-dealers from the requirement. These are firms who solely handle investment company shares. This is known as a "K-1" exemption. Those broker-dealers that accept subscriptions for investment company shares have a minimum Net Capital requirement of \$5,000; while those that accept wire orders have a \$25,000 Net Capital requirement.

**K-2-i Exemption:
No Margin Accounts;
All Customer Trades
Through Reserve A/C**

K-2-i - Exempts firms that carry customer accounts but who have no margin accounts; as long as the firm promptly transmits all customer funds and securities to a clearing firm; and handles all customer transactions through a "Special Bank Account for the Benefit of Customers." Thus, all customer monies are always segregated.

(A special note: Firms that operate under this exemption are not required to maintain \$250,000 of Net Capital as is the requirement for firms carrying customer accounts. Firms operating under the K-2-i exemption have a Net Capital requirement of \$100,000.)

**Omnibus
Arrangement
Requires \$100,000
Net Capital**

If the introducing broker-dealer does **not** "fully disclose" the names of the customers, then the account is opened on an "omnibus" basis. In an "omnibus account," the introducing firm maintains the records of customer activities and sends confirmations to the customers. Customer funds are transmitted to the introducing firm, who retransmits the funds to the clearing firm. Because of this, the introducing firm is "holding customer funds" and does not qualify for the lower "fully disclosed" net capital requirement. To maintain an omnibus account, a broker-dealer must have \$100,000 of net capital.

**K-2-ii Exemption
Fully Disclosed
Broker-Dealers**

K-2-ii - Exempts non-clearing fully disclosed broker-dealers from the requirement. The types of broker-dealers that can use this exemption are \$5,000 broker-dealers that neither receive nor hold customer funds; \$50,000 fully disclosed broker-dealers that receive but do not hold customer funds and securities; and \$100,000 broker-dealers that trade for their own account.

After all is said and done, generally speaking, the only broker-dealers that are required to maintain the Reserve are \$250,000 broker-dealers carrying customer accounts.

1c. SPECIAL RESERVE COMPUTATION

The actual Special Reserve Bank Account computation considers more items than those listed in the previous section. The full listing of items is:

Customer Debits	Customer Credits
Debit Balances in Customer Accounts	Credit Balances in Customer Accounts
Customer Fails to Deliver Not Older Than 30 Days	Customer Fails to Receive
Customer Stock Borrowed	Customer Stock Loaned

**Margin Required and
on Deposit with
Options Clearing
Corp. For Customer
Positions**

**Loans Obtained
Using Customer
Securities As
Collateral**

**Credit Balances in
Firm Accounts
Arising From
Short Sales to
Customers**

**Market Value of
Short Securities
Count Differences
Over 30 Days Old**

There are some other credit items in the formula that are not required on the examination. For the exam, the first 3 debit items and the 6 credit items must be memorized.

On the next page is presented the trial balance for Go-For-Broker's Inc. We will identify and discuss the items that are included in the Reserve Computation and perform the computation.

Also, for those of you that are accountants (as are most persons taking Series #27 exam) please note that in Rule 15c-3-3, the reserve formula is presented in a mirror image of what it should be - Credits are on the LEFT; and Debits are on the RIGHT (strange, but true). In the presentation of questions in the Series #27, this format may be used, so be careful!

Go - For - Brokers Inc.
 Trial Balance
 January 31, 20XX

		<u>Debit</u>	<u>Credit</u>
01	Cash in Bank	\$250,000	
02	Cash On Deposit In Special Reserve Bank Account	\$100,000	
03	Customer Control	\$550,000	
04	Fails to Deliver - Firm (January 24th, 20XX)	\$100,000	
05	Fails to Deliver - Customer (January 28th, 20XX)	\$325,000	
06	Note Receivable (Collateral of \$160,000 of marketable securities)	\$150,000	
07	Firm Trading Account	\$1,200,000	
08	Stock Borrowed - Customer	\$60,000	
09	Firm Investment (Warrants - Unregistered)	\$200,000	
10	Municipal Syndicate Receivable (Less Than 60 Days Old)	\$50,000	
11	Good Faith Deposit - Corporate (Closed for 30 Days)	\$25,000	
12	Commissions Receivable (Less than 30 days old)	\$5,000	
13	Prepaid Expenses	\$50,000	
14	Salaries	\$125,000	
15	Computer Service	\$50,000	
16	Phone Wires	\$25,000	
17	Furniture and Fixtures	\$10,000	
18	Real Estate	\$250,000	
19	Customer Control		\$500,000
20	Trading Account-Short Sales To Customers		\$325,000
21	Mortgage Payable		\$200,000
22	Fails to Receive - Firm - Unsold		\$250,000
23	Fails to Receive - Firm - Sold		\$100,000
24	Fails to Receive - Customer		\$150,000
25	Short Securities Count Differences (Over 30 Days)		\$200,000
26	Bank Loan - Firm Collateral		\$150,000
27	Bank Loan - Customer Collateral		\$50,000
28	Stock Loaned - Firm		\$100,000
29	Stock Loaned - Customer		\$50,000
30	Subordinated Loan - Unapproved		\$250,000
31	Commission Income		\$350,000
32	Trading/Underwriting Profits		\$200,000
33	Retained Earnings		\$250,000
34	Common Equity		\$400,000

The debit items that are included in the Reserve Formula (remember, there are 3 debits) are:

03	Customer Control	\$550,000
05	Fails to Deliver - Customer (January 28th, 20XX)	\$325,000
08	Stock Borrowed - Customer	\$60,000

01 Customer Control: These represent debit balances in all customer accounts (both cash and margin), meaning that these are cash amounts owed by customers to the firm. Any amounts that are doubtful of collection and unsecured amounts must be **excluded** from the computation. Assume that \$50,000 of debits are doubtful, listed below:

Security	Debit	Market Value
ABC Cmn	\$20,000	\$10,000
DEF Cmn	\$20,000	\$0
XYZ Cmn	\$10,000	\$8,000

There is only \$18,000 of collateral backing the \$50,000 of doubtful debits, therefore \$32,000 of the amount is **excluded** from the Reserve Formula. The balance that is included in the Formula is therefore \$518,000. Notice that no haircut is taken on the underlying collateral - as is the case in the Net Capital computation.

**Arbitrary 1%
Reduction Of
Customer Debits**

In calculating the Reserve, the rule requires that "good" debit balances be reduced by an arbitrary 1%. Thus, 99% of \$518,000 is included in the formula = \$512,820.

**3% Reduction Of
Customer Debits
For Firms Using
Alternate Method**

(Also, please note that this adjustment is increased to 3% for firms that elect to use the Alternate Method of Computing Net Capital (Greater of 2% of debits in the Reserve Formula or \$250,000) instead of the regular method. We use the regular method throughout the text, so the 3% reduction does not apply. However, it must be known for the exam)

In computing debits, balances of principals of the firm and their household members must be excluded.

**Concentration
Haircut For
Securities
Collateralizing
Customer Debits**

The rule also requires that if the securities that collateralize customer debit balances are concentrated in any one non-exempt security, the debit balance used in the Formula must be "haircutted." (In our problem, assume that there is no concentration.) The concentration test for securities collateralizing customer debits works as follows:

If Any Non-Exempt Security Position > 15% Of All Securities Collateralizing Customer Debits, Excess Is Deducted From Customer Debits

If any one **non-exempt** securities position exceeds 15% of the total of **all** securities collateralizing customer debit balances, this is a "concentration amount." Customer debit balances in the Formula must be reduced to reflect this, increasing the amount that must be put into the Special Reserve.

Assume that the securities collateralizing customer debit balances consist of:

Treasury Bonds	\$ 6,100,000
ABC Cmn	\$ 2,900,000
DEF Pref	<u>\$ 1,000,000</u>
Total	\$10,000,000

The concentration threshold is 15% of \$10,000,000 total securities = \$1,500,000.

There is **no** concentration in Treasury Bonds since these are exempt securities (and hence, are safe). The ABC common stock position is concentrated by \$1,400,000. The DEF position falls under the threshold.

Thus, in this example, customer debit balances as used in the Reserve Formula must be reduced, increasing the amount of funds that must be "in reserve." The actual amount to be deducted is not the \$1,400,000 amount. These are dollars representing collateral. To translate this into dollars representing debit, take $\$1,400,000/140\% = \$1,000,000$ reduction of customer debit balances in the Reserve Formula. Please note that on the exam, not only is the dollar amount of securities above the 15% threshold is tested, but also the actual dollar reduction of customer debits.

If Any Single Customer Debit > 25% Of Tentative Net Capital, Excess Is Deducted From Customer Debits

Another concentration rule applies to customer debit balances (only in margin accounts). If a single customer has a debit balance in excess of 25% of the firm's Tentative Net Capital, the excess amount must be deducted from debit balances in the Reserve computation, increasing the amount that must be placed on reserve.

05 Customer Fails To Deliver Not Older Than 30

Days: Customer Fails to Deliver represent a security receivable from a customer (this was covered in the previous section). The full amount of the contract value is included in the formula. There is no requirement to mark the position to market or to take haircuts.

08 Customer Stock Borrowed: Stock is borrowed for customer accounts to effect short sales for those customers. The customers owe those securities to the brokerage firm. The full amount is included as a debit item in the Formula.

To summarize, the 3 debit items included are:

Debit Balances in Customer Accounts	\$ 512,820
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Customer Fails to Deliver Not Older Than 30 Days	\$ 325,000
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Customer Stock Borrowed	\$ 60,000
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Total Debits	\$ 897,820
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The 6 credit items from our trial balance are:

19	Customer Control	\$500,000
20	Trading Account-Short Sales To Customers	\$325,000
24	Fails to Receive - Customer	\$150,000
25	Short Securities Count Differences (Over 30 Days)	\$200,000
27	Bank Loan - Customer Collateral	\$50,000
29	Stock Loaned - Customer	\$50,000

19 Customer Control: All credit balances in customer accounts must be included in the formula. These amounts represent funds owed to customers by the broker-dealer. In addition, the formula requires that any bank overdrafts by the broker-dealer be included as a credit item - increasing the amount that must be put into the Reserve. There are no other adjustments to Customer Credit balances, so, in our example, the entire amount of \$500,000 is included in the Formula.

20 Trading Account - Short Sales To Customers: Any credit balances in the firm's proprietary accounts which are attributable to short sales to customers must be included in the Reserve. Technically, the firm owes these securities positions to the customer. There are no

adjustments to this item, so the entire amount of \$325,000 is included in the formula

24 Customer Fails To Receive: These represent securities bought (and paid for) by customers that have not been physically received by the firm. Thus, these positions are owed to the customers. There is no adjustment to this amount unless the Fail to Receive is 30 days or more old. Then, the contract value must be increased to the current market price, if values have risen. This increases the balance in the Reserve. In our example, assume that all balances are less than 30 days old. The balance included in the formula is \$150,000.

25 Short Securities Difference Reserve - Over 30 Days: Any short securities differences that are 30 calendar days old or greater, must be included in the Formula. This forces the firm to place funds in the Reserve to pay for the buy-in of these securities. The Customer Protection Rule requires that short securities difference be bought in immediately after 45 days after discovery - this is covered later. The entire balance of \$200,000 is included in the Formula.

27 Bank Loan - Customer Collateral: Any loans obtained by a broker-dealer using customer margin securities as collateral are included in the Formula as a credit. If the broker-dealer does not pay off these loans, the bank can keep the customer's securities as collateral.

From the bank's standpoint, these securities are in "street" name - the bank does not even know that they belong to customers. To insure that enough funds are available to meet customer claims for these securities in a liquidation, the full amount (\$50,000) of this item is included as a credit in the Reserve.

29 Stock Loaned - Customer: When a broker-dealer loans out a customer's securities to another firm or to another customer, it must ultimately replace that security. To insure that the firm can do so in a liquidation, the full amount (\$50,000) of this item is included as a credit in the Reserve.

The 6 credit items in our Reserve Computation for Go-For-Brokers is summarized below:

Customer Credits

Credit Balances in Customer Accounts	\$ 500,000
Customer Fails to Receive	\$ 150,000
Customer Stock Loaned	\$ 50,000
Loans Obtained Using Customer Securities As Collateral	\$ 50,000
Credit Balances in Firm Accounts Arising From Short Sales to Customers	\$ 325,000
Market Value of Short Securities Count Differences Over 30 Days	\$ 200,000
Total	<u>\$ 1,275,000</u>

The complete Reserve Formula for Go-For-Brokers is:

<u>Customer Debits</u>		<u>Customer Credits</u>	
Debit Balances in Cust. A/C's	\$ 512,820	Credit Balances Cust. A/C's	\$ 500,000
Cust. F/D	\$ 325,000	Cust. F/R	\$ 150,000
Cust. S/B	\$ 60,000	Customer S/L	\$ 50,000
		Customer Collat. Loans	\$ 50,000
		Short Sales to Customers	\$ 325,000
		Short Secur. Diff.	\$ 200,000
Total	<u>\$ 897,820</u>	Total	<u>\$ 1,275,000</u>

The EXCESS of Credits over Debits equals \$377,180. Thus, \$377,180 is required to be on deposit in the Special Reserve Bank Account, if the firm is computing weekly. If the firm is computing monthly, 105% of this amount must be on deposit in the Special Reserve Bank Account.

From the Go-For-Brokers trial balance on page 6, we find that the Special Reserve Bank Account shows:

02	Cash On Deposit In Special Reserve Bank Account	\$100,000
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This firm only has \$100,000 on deposit in the Reserve. Assuming that the firm computes weekly, an additional \$277,180 must be deposited to meet the requirement. As covered previously, only cash or government guaranteed securities can be deposited; and the deposit must be made by 1 hour after banks open on the second business day after the computation is made.

1d. OTHER REQUIREMENTS OF THE CUSTOMER PROTECTION RULE

Daily Requirement To Reduce Fully Paid And Excess Margin Securities To Control Or Possession The Customer Protection Rule requires that firms maintain full control over customer securities positions. The rule states that every firm has a daily requirement to "reduce all fully paid customer securities and all excess margin securities to possession or control."

"Possession or control" means that the firm physically has the security or the firm knows the whereabouts of the security. The firm must maintain in its possession or control:

Fully Paid Securities All fully paid customer securities - These must be segregated and placed in safekeeping

Excess Margin Securities All "excess margin securities" - Must be reduced to possession or control. Excess margin securities are those in excess of the maximum amount allowed to be rehypothecated to a bank. The rehypothecation limit on customer securities pledged to a bank is 140% of customer debit balances. Excess margin securities are those in excess of 140% of customer debit balances.

Those In Excess of 140% of Customer Debits

For example: A customer buys 1000 shares of ABC at \$20 on margin. The debit is \$10,000. The firm can rehypothecate 140% of \$10,000 debit = \$14,000 of ABC stock (700 shares) to a bank. This stock goes out of the firm's possession or control. The balance of ABC stock (\$6,000 or 300 shares) are excess margin securities that must be kept in safekeeping by the firm.

For Computation, Free Credits Are Netted Against Debits

In determining the amount of excess margin securities that must be reduced to possession or control, any customer free credit balances are netted against customer debit balances. However, credits arising from short sales (including short against the box) are **not** netted against debits.

"In Possession Or Control"

A security is considered to be "in possession or control" if the certificates are in:

the custody of the firm or a clearing corporation.

an omnibus account at a clearing broker-dealer in compliance with Regulation T.

the custody of a bank which has provided written acknowledgment that the securities are not subject to any liens or claims.

the custody of a foreign depository or bank that has been designated a satisfactory control location.

transfer for not more than 40 days. (If more than 40 days have elapsed, the issuer or transfer agent can give a written statement verifying that the securities are still in transfer.)

transit between offices of the broker-dealer (for no more than 5 business days).

**Daily Computation
Except For Inactive
Margin Accounts**

**Inactive Accounts
Computed Weekly**

Each day, the broker-dealer must compute from its books and records, as of the preceding day's close, the quantity of fully paid and excess margin securities in its possession or control; and the quantity not in its possession or control. In making this computation, inactive margin accounts may be computed weekly, instead of daily.

If it is found that securities which should be under possession or control **are not**; then on the next business day, the firm must:

issue instructions to broker-dealers holding such securities subject to a lien to return those securities. Securities which are subject to a lien for a loan of money must be physically returned within 2 business days of the instructions. Securities which were loaned to another broker-dealer must be physically returned within 5 business days of the issuance of instructions.

promptly buy in any securities failed to receive for more than 30 calendar days; alternately, borrowing of the securities to relieve the fail is also permitted.

take prompt steps to obtain possession of securities to be received from stock splits or dividends older than 45 calendar days (e.g., buy-in or borrow position).

Instead of buying-in the securities, the broker-dealer can borrow those securities from another firm to obtain possession or control.

Required Buy-In

But, borrowing is **not** allowed for the following situations that **require** buy-in:

**Buy In Short Securities
Differences After 45
Days**

Any short securities differences (firm is missing securities that it has recorded on its books) must be bought in after 45 days of discovery.

**Buy In Customer Fails
To Deliver After
10 Business Days**

Any sell order for a customer, where the customer fails to deliver within 10 business days after settlement, must be immediately closed thereafter.