

Clearing Deposits

Interpretive Guidance on Capital Treatment of Introducing Broker-Dealers' Clearing Deposits

Effective Dates: Immediately with respect to Interpretation I; January 5, 2009, with respect to Interpretation II

Executive Summary

This *Notice* provides FINRA member firms with interpretive guidance from the staff of the Securities and Exchange Commission's Division of Trading and Markets regarding clearing deposits:

- **Interpretation I**, applicable to all clearing agreements and effective immediately, clarifies the net capital treatment of introducing firms' clearing deposits with their clearing firm in the event the clearing agreement is terminated.
- **Interpretation II**, effective January 5, 2009, addresses termination penalty clauses in clearing agreements and affects only those member firms whose clearing agreements contain such a clause.

We strongly encourage all firms that are a party to a clearing agreement to review this *Notice* carefully for its impact and any action that may be necessary.

Questions regarding this *Notice* may be directed to:

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Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Operations
- Regulatory Reporting
- Senior Management

Key Topic(s)

- Clearing Agreements
- Clearing Deposits
- Net Capital Requirements

Referenced Rules & Notices

- SEA Rule 15c3-1

Background and Discussion

Many clearing and carrying agreements (clearing agreements) require the introducing firm to deposit money with the clearing firm (clearing deposit) to cover any obligations that may arise from the clearance of the introducing firm's accounts (*e.g.*, unsecured customer debit balances). Such clearing deposits are typically retained by the clearing firm for the duration of the clearing arrangement and are generally returned to the introducing firm, as long as the introducing firm does not have obligations to the clearing firm that it cannot otherwise satisfy, within a short period after the termination of the clearing arrangement. The interpretive guidance in this *Notice* deals with the time period in which an introducing firm may consider its clearing deposit as an allowable asset for net capital purposes once the clearing agreement has been terminated.

Some FINRA introducing firms have entered into clearing agreements that, in addition to requiring a clearing deposit, contain a provision or clause that would impose a monetary penalty upon the introducing firm (payable to the clearing firm) if the introducing firm voluntarily terminates the clearing arrangement prior to a period specified in the agreement (termination penalty clause). Typically, such clauses are effective at the time the agreement is entered into but cease after a specified period, after which a monetary penalty would not be imposed on the introducing firm if it were to voluntarily terminate its clearing arrangement with the clearing firm. A common reason that clearing firms impose such termination penalty clauses is to ensure that they retain the introducing firm clearing relationship for a period sufficient to recoup investments in technology, systems, and personnel, among other things, which accommodate the clearance of an introducing firm's accounts.

These termination penalty clauses have given rise to questions about the clearing firm's rights to the clearing deposit of an introducing firm that is subject to an early termination penalty if the introducing firm becomes the subject of a protective decree pursuant to the Securities Investor Protection Act of 1970. Questions have also arisen as to how the introducing firm should contemplate such clauses vis a vis its net capital computation.

These issues, and the guidance provided by the staff of the Securities and Exchange Commission (SEC), are discussed on the next page.

Interpretation I – Net Capital Treatment of a Clearing Deposit Upon Termination of the Agreement

The SEC interpretation of Securities Exchange Act (SEA) Rule 15c3-1 provides that a clearing deposit may be treated as an allowable asset, provided that the clearing agreement explicitly states that the deposit will be returned to the introducing firm within 30 calendar days after cancellation of the agreement. The SEC's interpretation further requires that a written Proprietary Accounts of Introducing Brokers (PAIB) agreement has been executed between the clearing and introducing firms. Moreover, the clearing agreement must state that the introducing firm's clearing deposit does not represent an ownership interest in the clearing broker-dealer in order for the clearing deposit to be deemed allowable for capital purposes.¹

FINRA staff has received questions about the definition of "cancellation of the agreement." As an example, an introducing firm may give notice to the clearing firm that it will cancel its clearing agreement on X date (cancellation date), in which case it must receive its clearing deposit within 30 days after such date. Firms have stated that in some cases the process of transferring all of the introducing firm's customers to the new clearing firm may not be completed, or even begun, within the 30 days of the cancellation date. In such case, the clearing firm may retain the clearing deposit until the transfer of accounts to the new clearing firm has been completed. While the retention of the deposit by the clearing firm in such case may be deemed operationally reasonable, the current interpretation to SEA Rule 15c3-1 does not provide flexibility to accommodate the operational reality and requires the introducing firm to apply a net capital charge for the unreturned deposit on the 31st day after the cancellation date.

To assist member firms in fulfilling their obligations to each other upon the termination of a clearing arrangement under such circumstances, FINRA sought guidance from the SEC. As a result, effective immediately, the interpretation of SEA Rule 15c3-1, as described above, is amended to reflect that the 30-calendar day period shall commence five business days after the date of the initial transfer of customer accounts. The amount of any clearing deposit held under the terms of the clearing agreement that is not returned to the introducing firm within 30 calendar days after the five-business-day grace period shall be treated as a non-allowable asset in the computation of the introducing firm's net capital commencing on the 31st day.

Interpretation II – Clearing Agreements Containing an Early Termination Penalty Clause

Due to the potential lien on the introducing firm's clearing deposit if such firm becomes the subject of the issuance of a protective decree pursuant to the Securities Investor Protection Act of 1970 while the termination clause is still in effect, the introducing firm must treat any clearing deposits of cash and/or securities held by its clearing broker-dealer, up to the amount of the termination penalty, as non-allowable assets pursuant to SEA Rule 15c3-1, unless the clearing agreement contains the following language:

In the event that [the Introducing Broker-Dealer] is the subject of the issuance of a protective decree pursuant to the Securities Investor Protection Act of 1970 (15 USC 78aaa-III), [the Clearing Firm's] claim for payment of a termination fee under this Agreement shall be subordinate to claims of [the Introducing Broker's] customers that have been approved by the Trustee appointed by the Securities Investor Protection Corporation pursuant to the issuance of such protective decree.

The above quoted language is voluntary on behalf of the clearing firm. In this regard, in order for an introducing firm that is party to a clearing agreement containing a termination penalty clause to treat its clearing deposit as an allowable asset for net capital purposes, its clearing agreement must be amended to include the aforementioned language by January 2, 2009. The clearing firm may provide the additional language either in an amended clearing agreement, or an addendum to an existing clearing agreement.

Further, each clearing firm must provide by January 2, 2009 written documentation to its FINRA Coordinator 1) stating that its clearing agreements have been revised accordingly for all of its introducing firms, or 2) listing the names of the introducing broker-dealers whose clearing agreements were not revised. Absent the additional language specified above in its clearing agreement, an introducing firm whose clearing agreement contains a termination penalty clause must treat its clearing deposit, up to the amount of the early termination penalty, as a non-allowable asset starting January 5, 2009, until the early termination penalty is no longer applicable.

Notwithstanding the above, on the date that an introducing firm provides notice to the clearing firm of its voluntary termination of a clearing agreement that results in a termination penalty (*i.e.*, the termination clause has not expired), the introducing firm must apply a net capital charge for the lesser of the amount of the termination penalty or the amount of the clearing deposit. The introducing firm must also make a determination, under generally accepted accounting principles, whether it must accrue a liability to reflect the effect of the termination penalty clause. An introducing firm that accrues a liability for the full amount of the termination penalty may reduce the aforementioned net capital charge by the amount of such accrual. The amount of any such accrued liability must be included in aggregate indebtedness by introducing firms that use the Basic Method of computing their net capital requirement pursuant to SEA Rule 15c3-1.

Endnotes

- 1 This interpretation was published by the New York Stock Exchange as interpretation /021 of SEA Rule 15c3-1(c)(2)(iv)(E).