

- Copies of customer confirmations and copies of notices of all other debits and credits for customer accounts.
- Identification data on beneficial owners of all accounts. This must include the beneficial owners' name and address.
- The application for employment and/or any questionnaire for employment for any associated person. This must be kept for up to three years after employment is terminated.
- Fingerprint records for everyone associated with the firm, including each of its partners, directors, officers, and employees. Like employment applications, these fingerprint records must be kept until three years after employment is terminated.

All records may be kept either as a hard copy or as an electronic file, as long as they are in an un-rewritable and un-erasable format. Additionally, a firm may use an outside service bureau, depository, or bank to maintain the records. If so, the outside entity must file a notice with the SEC indicating for whom it is holding the records along with a statement allowing any SEC designee permission to look at the records during business hours.

SEA Rules 17a-3 and 17a-4

## Managing Compliance With Financial Responsibilities

### NET CAPITAL REQUIREMENTS

The SEC requires member firms to carry a minimum amount of capital to meet its ongoing financial obligations. Since 1975, the SEC has imposed net capital requirements on member firms in order to measure a firm's financial viability and to protect customers and other creditors from insolvent firms. As we will see shortly, the minimum requirements differ depending on the type of firm. Firms must calculate their net capital daily to make sure that they can meet these minimum requirements.

#### CALCULATING A FIRM'S NET CAPITAL

Before examining the SEC's net capital requirements for the various types of broker-dealers, let's spend some time understanding the term itself. Net capital refers to the *liquid* value of a firm. A firm's liquid value is the amount of *liquid* assets remaining after its liabilities have been paid off. The following equation is used by the SEC to determine a firm's net capital:

$$\text{Net Capital} = \text{Net Worth} + \text{Subordinated Debt} - \text{Non-allowable Assets} - \text{Haircuts}$$

Clear as mud? Let's break it down.

## Net Worth

Net worth is the difference between assets and liabilities. On a balance sheet, assets must always equal liabilities plus owners' equity. Liabilities are the obligations of a firm to outsiders. Owners' equity is a firm's obligations to its owners. When a firm first opens for business, owners' equity is the amount of cash owners put into the business or the amount of securities a firm sells to the public. For a going concern, owners' equity is what is left over from a firm's assets after all liabilities have been paid. In other words, it is a residual. Owners' equity can be more or less than the owners' original investment. Another word for owners' equity is net worth.

$$\begin{aligned}\text{Assets} &= \text{Liabilities} + \text{Owners' Equity} \\ \text{Net Worth} &= \text{Owners' Equity} = \text{Assets} - \text{Liabilities}\end{aligned}$$

## Liquid Assets

Assets are a firm's resources. They include cash, securities, property, inventory, and office equipment. Liquid assets are assets that can quickly be converted into cash. The securities a firm owns are a liquid asset. So are the securities a brokerage holds on behalf of a customer, just as the cash acquired from a bank loan is a liquid asset.

## Subordinated Debt

Subordinated debt is comprised of debt that ranks below other debt in its claims on assets or earnings during a bankruptcy or liquidation. For example, many lending agreements prohibit a borrower from incurring an additional loan. Often this restriction will require only that additional borrowing be subordinated to the original loan. Subordinated debt means that creditors agree to wait until all claims of existing, or senior, debt are satisfied prior to receiving any distribution of assets.

Note the following equivalency:

$$\text{Net Worth} + \text{Subordinated Debt} = \text{Total Assets} - (\text{Total Liabilities} - \text{Subordinated Debt})$$

## Non-allowable Assets

Non-allowable assets are illiquid assets, assets that cannot be quickly sold at fair market value. It is hard to sell an office building in an afternoon. You might think that liquid assets would equal total assets minus non-allowable assets. Not quite yet. You also need to deduct haircuts, which we will get to in a minute. For now, we will introduce you to another term: tentative net capital.

$$\text{Tentative Net Capital} = \text{Net Worth} + \text{Subordinated Debt} - \text{Non-allowable Assets}$$

Tentative net capital reflects the total liquid assets of a firm before haircuts are withdrawn from security values.

## Haircuts

Haircuts are a discount that the SEC applies to the market value of securities held by a broker-dealer. Since the value of a security is constantly fluctuating, the SEC discounts its current market value to provide a cushion to account for a possible decrease in value at the time of a firm's liquidation.

Once you have a total amount of all haircuts taken, deduct that from the tentative net capital amount. The result will be the firm's net capital.

Let's see that formula again.

$$\begin{aligned}\text{Net Capital} &= \text{Net Worth} + \text{Subordinated Debt} - \text{Non-allowable Assets} - \text{Haircuts} \\ &= \text{Assets} - \text{Liabilities} + \text{Subordinated Debt} - \text{Non-allowable Assets} - \text{Haircuts} \\ &= [\text{Assets} - \text{Non-allowable Assets} - \text{Haircuts}] - [\text{Liabilities} - \text{Subordinated Debt}] \\ &= \text{Tentative Net Capital} - \text{Haircuts}\end{aligned}$$

Haircut amounts vary depending on the type of security – riskier securities tend to have higher haircuts. Here is a list of the most common haircuts:

- Equity securities, commonly traded = 15% of their current market value.
- Equity securities, limited trading market = 40% of their current market value.
- Equity securities, Aged Fail to Deliver = 15% of its current market value. An aged fail to deliver means that the security has not been delivered within four days after the settlement date.
- Nonmarketable securities = 100% of their current market value. A nonmarketable security is one in which there are no buyers other than your firm.
- Undue concentration = 15% of the excess concentration amount. A firm is allowed to have only up to 10% of its tentative net capital invested in one security. Any amount over the 10% allowed must be deducted by 15% when calculating net capital.

Once you have a total amount of all haircuts taken, deduct that from the tentative net capital amount. The result will be the firm's net capital.

☒ **Example:** XYZ Brokerage, Inc. carries the accounts of many customers and has custody over their assets. The following is selected balance sheet information from XYZ Brokerage.

ASSETS		LIABILITIES	
Cash	\$100,000	Accounts payable	\$25,000
Exchange membership fee	\$40,000	Customer credit balances	\$175,000
Customer debit balances	\$280,000	Stock loaned	\$45,000
Aged Fails to Deliver – marked to the market	\$10,000	Bank loans	\$130,000
Securities Inventory – marked to the market	\$200,000	Subordinated loans	\$250,000
Prepaid expenses	\$70,000		
<b>Total Assets</b>	<b>\$700,000</b>	<b>Total Liabilities</b>	<b>\$625,000</b>

Step 1: Calculate net worth by subtracting total liabilities from total assets.

$$\$700,000 - \$625,000 = \$75,000$$

Step 2: Add the amount of subordinated loans to our net worth resulting in our total available capital.

$$\$75,000 + \$250,000 = \$325,000$$

Step 3: Subtract all the non-allowable assets. This will include prepaid expenses (\$70,000) and the exchange membership fee (\$40,000) for a total of \$110,000. Subtract this amount from our total available capital above to reach our tentative net capital.

$$\$325,000 - \$110,000 = \$215,000$$

Step 4: Subtract any haircuts. Note that haircuts are based upon market prices and must be marked to the market daily. As the example states above, the market value of the aged fails to deliver is \$10,000 and the securities inventory is \$200,000.

The aged fail to delivers haircut would be 15% of \$10,000, which is \$1,500.

Assuming the securities are all marketable equity securities and there is no undue concentration, we take 15% of \$200,000, which will give us a total of \$30,000.

Subtract the total amount of the haircuts (\$1,500 + \$30,000 = \$31,500) from the tentative net capital above for the total net capital amount.

$$\$215,000 - \$31,500 = \$183,500$$

The total net capital amount is \$183,500.

### NET CAPITAL REQUIREMENTS FOR DIFFERENT TYPES OF FIRMS

Member firms are required to keep certain net capital requirements.

If a firm discovers that its net capital is less than 120% of its required minimum, it must notify FINRA and the principal and regional offices of the SEC within 24 hours of the discovery. This notifies the regulatory authority that the firm is getting close to hitting its minimum requirement so that they keep an eye on that firm.

If the firm discovers its net capital is below the minimum amount required, it must notify the same offices as above on the same day. The notification must include the amounts of the required minimum net capital and the current net capital.

While the SEC requires notification according to the rules above, FINRA keeps even a closer eye on firms' net capital. FINRA requires a firm to notify it within 24 hours of discovering its net capital has fallen under 150% of its minimum requirement. The firm must notify FINRA again if it reaches the 120% mark.

A firm must suspend all business operations if it falls under its required net capital minimums.

SEA Rule 15c3-1 and FINRA Rule 4120