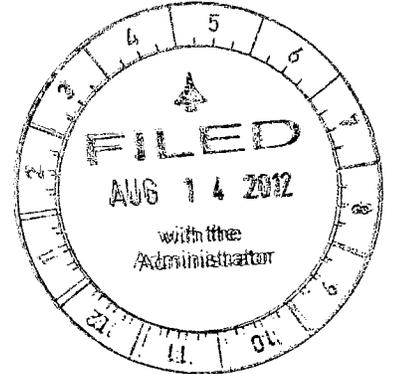


STATE OF OKLAHOMA
DEPARTMENT OF SECURITIES
FIRST NATIONAL CENTER
120 NORTH ROBINSON, SUITE 860
OKLAHOMA CITY, OKLAHOMA 73102



In the Matter of:

Geary Securities, Inc. *fka* Capital West Securities, Inc.;
Keith D. Geary; Norman Frager; and CEMP, LLC,

Respondents.

File No. 09-141

**DEPARTMENT'S (1) REPLY TO RESPONDENT FRAGER'S RESPONSE TO
MOTION FOR RECONSIDERATION ON MOTION FOR SUMMARY DECISION, AND
(2) RESPONSE TO NORMAN FRAGER'S CROSS MOTION FOR SUMMARY
DECISION**

The Oklahoma Department of Securities ("Department") filed a motion for reconsideration on its motion for summary decision on May 31, 2012 ("Motion for Reconsideration"). Respondent Norman Frager ("Frager") responded to the Department's Motion for Reconsideration on July 31, 2012 ("Response to Motion for Reconsideration"). In the same document, Frager also moved for summary decision against the Department ("Frager's MSD"). The Department submits the following reply to Frager's Response to Motion for Reconsideration and response to Frager's MSD.

BACKGROUND

In its Motion for Summary Decision against Frager, filed on November 1, 2011 ("Department's MSD"), the Department set forth the following as a material, undisputed fact: "At all times material here, the minimum net capital requirement for Geary Securities was \$250,000." Department's MSD ¶ 9. This fact was unqualifiedly admitted by Frager in his answer to the Enforcement Division Recommendation. Frager Answer

¶ 14. Yet, in his response to the Department's MSD, Frager stated that he disputed this fact. Resp. of Norman Frager to Mot. by Department for Summ. Decision at 7, ¶ 1. Frager explained that the net capital requirement under the firm's membership agreement with FINRA was "not necessarily the amount of net capital required to comply with [U.S. Securities and Exchange Commission ("SEC")] Rule 17a-11 promulgated under the Securities Exchange Act of 1934 ["SEA"], relating to the reporting of net capital deficiencies." *Id.* Frager further explained that it is the net capital requirement set forth in Rule 15c3-1, promulgated under the SEA ("SEA Rule 15c3-1" or "Net Capital Rule"), that determines when a broker-dealer has to provide notice of a net capital deficiency under SEA Rule 17a-11 and suspend business operations pursuant to FINRA Rule 4110.¹ *Id.* Frager did not submit **any** factual evidence to dispute that Geary Securities' minimum net capital requirement was \$250,000 under the Net Capital Rule, during the relevant time – including February 2010.

During the hearing on the Department's MSD held in April 2012, Frager's counsel represented that Geary Securities' minimum net capital requirement was only \$100,000 under the Net Capital Rule "on most days" in February 2010 because Geary Securities was not accepting payments directly from customers. See Ex. 1 at 37:15-20, 38:16-19. On May 16, 2012, the Hearing Officer entered an order denying the Department's MSD. Because Frager had submitted no factual evidence to support his counsel's oral representation, the Department filed its Motion for Reconsideration in which it submitted evidence that Geary Securities received customer checks made payable to itself on every business day in February 2010, except February 11th. See Motion for

¹ Contrary to ¶ 13 of Frager's affidavit filed with his Response to Motion for Reconsideration.

Reconsideration, Ex. A, Exs. 1-3. The Department further submitted evidence that these checks were not received by Geary Securities in error because Geary Securities' written policies and procedures allowed Geary Securities to accept checks made payable to Geary Securities. See Motion for Reconsideration, Ex. B, pp. II-5 and II-6.

Now, in Frager's Response to Motion for Reconsideration and Frager's MSD, he argues that Geary Securities did not "receive" customer funds for purposes of the Net Capital Rule because the customer checks that were made payable to Geary Securities, and delivered to Geary Securities, were deposited into an account of its clearing broker-dealer, Pershing LLC ("Pershing"), rather than deposited into its own account. Frager further argues that because these customer checks were "promptly transmitted" to Pershing, Geary Securities' minimum net capital requirement was \$100,000 under paragraph (a)(2)(ii) of the Net Capital Rule as a result of the exemption from Rule 15c3-3, promulgated under the SEA ("SEA Rule 15c3-3" or "Customer Protection Rule"), under paragraph (k)(2)(i) thereof.

As explained below, Frager has still not demonstrated that there is a genuine factual issue regarding Geary Securities' minimum net capital requirement under the Net Capital Rule in February 2010. Whether Geary Securities "received" customer funds in February 2010 for purposes of paragraph (a)(2)(i) of the Net Capital Rule is a legal issue involving application of the definitions within the rule rather than a factual dispute. Further, Frager has failed to set forth, and provide evidence of, the facts necessary to support a conclusion of law that Geary Securities was exempt from the Customer Protection Rule under paragraph (k)(2)(i) thereof and thus subject to a \$100,000 minimum net capital requirement. As a result, the Department's Motion for

Reconsideration should be granted, and a summary decision should be entered against Frager.

RESPONSE TO FRAGER'S STATEMENT OF UNDISPUTED FACTS

1. The Department does not dispute Frager's Fact No. 1.

2. The Department does not dispute Frager's Fact No. 2.

3. With regard to Frager's Fact No. 3, the Department does not dispute that Geary Securities deposited the checks that were made payable to itself into an account of Pershing by means of an electronic deposit system. The Department disputes Frager's statement that the deposits were made "promptly" and in compliance with paragraph (k)(2)(i) of the Customer Protection Rule. Frager has not submitted evidence demonstrating that Geary Securities deposited the customer funds by the later of noon of the next business day after receipt or noon of the next business day following settlement date, as required to be "promptly" under (k)(2)(i) of the Customer Protection Rule. See Ex. 2 (Definition of "Promptly Transmit"). Further, a fully disclosed introducing broker-dealer cannot use a (k)(2)(i) account, except for mutual fund transactions. See Ex. 3 at 5, Question #5, Answer. Finally, whether the deposits were in compliance with (k)(2)(i) of the Customer Protection Rule is a question of law rather than a question of fact.

4. The Department disputes Frager's Fact No. 4. The question of whether a customer check that was made payable to, and delivered to, Geary Securities, but then electronically deposited into a Pershing account, was "received" by Geary Securities for purposes of paragraph (a)(2)(i) of the Net Capital Rule is a question of law that requires application of the definitions included therein.

5. The Department disputes Frager's Fact No. 5. Frager's statement that Geary Securities was subject to a \$100,000 net capital requirement under paragraph (a)(2)(ii) of the Net Capital Rule and paragraph (k)(2)(i) of the Customer Protection Rule is a conclusion of law that is not supported by the facts set forth by Frager. Geary Securities did not effectuate its financial transactions between itself and its customers through one or more bank accounts designated as "Special Account for the Exclusive Benefit of Customers of Geary Securities" as required by (k)(2)(i) of the Customer Protection Rule. See Frager Aff., Ex. B to Frager's MSD, ¶ 9. Further, on its Annual Audited Report for the year 2009 and its Focus Report for February 2010, Geary Securities represented that it was exempt from the Customer Protection Rule under paragraph (k)(2)(ii) **NOT** (k)(2)(i). See Ex. 4 at 11 and Ex. 5 at 7.

6. The Department does not dispute Frager's Fact No. 6.

ARGUMENT AND AUTHORITY

I. WHETHER GEARY SECURITIES "RECEIVED" CUSTOMER FUNDS IN FEBRUARY 2010 FOR PURPOSES OF PARAGRAPH (a)(2)(i) OF THE NET CAPITAL RULE IS A LEGAL ISSUE AND NOT A FACTUAL DISPUTE.

The Department and Frager agree that, in February 2010, customer checks made payable to Geary Securities were delivered to Geary Securities who deposited the checks with Pershing through an electronic deposit system. The parties also agree that Geary Securities had no *written* policies in place to prevent customers from transmitting funds to the firm by checks made payable to itself or to address the actions the firm would take if its customers transmitted checks made payable to the firm inadvertently ("Required Policies").

The issue is whether, in light of the undisputed facts, Geary Securities “received” customer funds in February 2010 for purposes of paragraph (a)(2)(i) of the Net Capital Rule and the relevancy of the lack of Required Policies in the determination of whether Geary Securities was subject to the \$250,000 net capital requirement. This dispute is a question of law rather than fact. See *Swain v. C&N Evans Trucking Co., Inc.*, 484 S.E.2d 845, 848 (N.C. Ct. App. 1997) (An issue of law, not fact, is raised where a determination requires application of a definition set forth in a statute and the case law construing the statute.)

Fragar attempts to advance his position that Geary Securities was a \$100,000 broker-dealer in February 2010, by submitting the affidavit of his designated expert, Mr. Luque. Fragar relies primarily on paragraphs 41 and 42 of the affidavit. However, for the reasons set forth below, such statements should be disregarded by the Hearing Officer in his determination of this matter.

Mr. Luque’s statements in paragraphs 41 and 42 of his affidavit (to the extent paragraph 42 is even intelligible) are inadmissible and should be disregarded because they equate to legal conclusions that invade the province of the Hearing Officer. The court in *SEC v. U.S. Environmental, Inc.*, concluded, “[w]hile the expert can make factual conclusions that embrace an ultimate issue to be decided by the fact-finder, the expert cannot give testimony stating ultimate legal conclusions based upon those facts....” 2002 WL 31323832 at *4 (S.D.N.Y. 2002). The testimony of a securities industry expert “encompassing an ultimate legal conclusion based upon the facts of the case is not admissible, and may not be made so simply because it is presented in terms of industry practice.” *U.S. v. Bilzerian*, 926 F.2d 1285, 1295 (2d Cir. 1991).

Moreover, Section 2702 of the Oklahoma Evidence Code requires that the trier of fact ensure that all expert testimony is relevant and reliable.² Okla. Stat. tit. 12, § 2702 (2011). The U.S. Supreme Court, in *Kumho Tire Co., Ltd. v. Carmichael*, concluded that Rule 702 authorizes the trier of fact “to determine [the] reliability [of an expert’s testimony] in light of the particular facts and circumstances of the particular case.” 526 U.S. 137, 158 (1999). In other words, the expert’s testimony must have “a valid . . . connection to the pertinent inquiry as a precondition to admissibility.” *Id.* at 149 (citing *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993)).

The factual basis of Mr. Luque’s testimony is questionable at best because he disregards key language of the Net Capital Rule relating to checks made payable to a broker-dealer. Additionally, Mr. Luque seems unaware of the fact that Geary Securities allowed customers to make checks payable to itself and did, in fact, receive such checks from customers during the relevant period. Consequently, Mr. Luque’s testimony (1) does not correctly apply the provisions of paragraph (a)(2)(i) of the Net Capital Rule; (2) is not factually reliable; and (3) is not admissible.

In summary, the dispute over whether Geary Securities “received” customer funds in February 2010 for purposes of paragraph (a)(2)(i) of the Net Capital Rule is a legal issue and not a factual dispute. Paragraphs 41 and 42 of Mr. Luque’s affidavit are inadmissible because they equate to legal conclusions.

² Section 2702 is modeled after Rule 702 of the Federal Rules of Evidence; therefore, case law relating to Rule 702 is instructive when interpreting Section 2702 under Oklahoma law.

II. GEARY SECURITIES “RECEIVED” CUSTOMER FUNDS IN FEBRUARY 2010 FOR PURPOSES OF PARAGRAPH (a)(2)(i) OF THE NET CAPITAL RULE.

The pertinent language and relevant legal authority do not support Frager’s position that Geary Securities did not “receive” customer funds for purposes of paragraph (a)(2)(i) of the Net Capital Rule because the customer checks, made payable to Geary Securities and delivered to Geary Securities, were deposited into a Pershing account rather than deposited into an account of Geary Securities. Paragraph (a)(2)(i) of the Net Capital Rule states, in pertinent part:

A broker or dealer (other than one described in paragraphs (a)(2)(ii) or (a)(8) of this rule) shall maintain net capital of not less than \$250,000 if it carries customer or broker or dealer accounts and receives or holds funds or securities for those persons. A broker or dealer **shall be deemed to receive funds, or to carry customer or broker or dealer accounts and to receive funds from those persons if, in connection with its activities as a broker or dealer, it receives checks . . . made payable to itself** or persons other than the requisite registered broker or dealer carrying the account

(Emphasis added.) 17 C.F.R. § 240.15c3-1(a)(2)(i).

In interpreting the language of a statute, the U.S. Supreme Court has said that the first determination to be made is “whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case.” *Barnhart v. Sigmon Coal Co., Inc.*, 534 U.S. 438, 450 (2002). The Supreme Court has “stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there.” *Id.* at 461-62 (quoting *Connecticut Nat. Bank v. Germain*, 503 U.S. 249, 253-254 (1992)). If the words of a statute are unambiguous, the “judicial inquiry is complete.” *Id.* at 462 (quoting *Germain*, 503 U.S. at 253-254). These principals are useful in interpreting the Net Capital Rule.

In paragraph (a)(2)(i) of the Net Capital Rule, the phrase “if . . . it receives checks . . . made payable to itself,” is unambiguous. The plain meaning of the word “receive” is “to come into possession of.” Webster’s New Collegiate Dictionary 964 (1975). The term “receives” does not mean “deposits.” We must presume that the SEC would have used the term “deposits” if its intention was for a broker or dealer to be “deemed to receive funds” if it deposited checks made payable to itself into its own account.

Another principal of statutory construction is “that when ‘Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.’” *Sigmon Coal Co., Inc.*, 534 U.S. at 452 (quoting *Russello v. U.S.*, 464 U.S. 16, 23 (1983)). Paragraph (a)(2)(i) of the Net Capital Rule explicitly states, “A broker or dealer shall be deemed to *hold securities* . . . if it does not promptly forward or promptly deliver all of the securities of customers or other brokers or dealers received by the firm in connection with its activities as a broker or dealer” (emphasis added). 17 C.F.R. § 240.15c3-1(a)(2)(i). Accordingly, we must presume that the SEC did not intend for a broker or dealer to be “deemed to receive funds,” under paragraph (a)(2)(i), only if the broker or dealer did not promptly forward or promptly deliver the funds.

Multiple SEC interpretations of paragraph (a)(2) of the Net Capital Rule provide further support that Geary Securities “received” funds for purposes of paragraph (a)(2)(i) when checks made payable to Geary Securities were sent to Geary Securities, other than by error. See Ex. 6. SEA Rule Interpretation 15c3-1(a)(2)(iv)/02 and SEA Rule Interpretation 15c3-1(a)(2)(vi)/03 state:

Any introducing broker that receives customer funds (checks made payable to itself and or cash), except by error, will be subject to the minimum net capital requirements of a broker-dealer that carries customer accounts (See SEA Rule 15c3-1(a)(2)(i)).

SEA Rule Interpretation 15c3-1(a)(2)(iv)/01 states, in part:

The introducing firm should also maintain procedures to prevent their customers from **transmitting** funds (other than checks made out to appropriate third parties) to the firm (except by error). Procedures should address the actions the broker-dealer will take to advise its customers (in writing) should they **send** funds to the firm by error. (Emphasis added.)

SEC Release No. 34-31511, 1992 WL 356004, (Dec. 2, 1992), which discusses amendments to the Net Capital Rule that were adopted in 1992, provides insight into why a broker-dealer who accepts checks made payable to itself has a \$250,000 net capital requirement. See Ex. 7. The Release explains that the “net capital rule requires introducing brokers to promptly forward all customer funds and securities to the clearing broker-dealer.” *Id.* at *13. But, “[e]ven when this requirement is complied with . . . many customers make checks payable or endorse securities directly to the introducing firm.” *Id.* The Release provided examples of instances where introducing firms converted and/or misappropriated customer assets including, but not limited to, checks made payable to the firm. See *id.*

The Securities Investor Protection Corporation and the SEC were concerned about the “receipt of customer funds or securities by inadequately capitalized introducing firms[.]” *Id.* at *12. Ultimately, the SEC created two net capital requirements for introducing firms that depended on whether the firm received securities. *Id.* at *16.

SEC Release No. 34-31511 explains:

Under the approach adopted by the Commission, an introducing broker-dealer that receives customer ch[e]cks made payable to itself would be subject to a \$250,000 minimum net capital requirement. An introducing broker-dealer that receives securities as well as customer checks made payable to its clearing firm or other appropriate third party (e.g., escrow agent) that it promptly forwards to such third party would be subject to a minimum net capital requirement of \$50,000. An introducing broker-dealer that receives no securities and only receives customer checks made payable to appropriate third parties would [b]e subject to a \$5,000 minimum net capital requirement.

(Emphasis added.) *Id.* at *17. These continue to be the net capital requirements for introducing broker-dealers under the Net Capital Rule. See 17 C.F.R. § 240.15c3-1(a)(2).

In summary, the undisputed facts demonstrate that, in February 2010: customers made checks payable to Geary Securities who deposited the checks into an account of Pershing; such checks were not received in error because the written policies and procedures of Geary Securities allowed for the checks to be made payable to the firm; and the trade confirmation used by the firm did not inform the customer to whom to make their check payable. The language of paragraph (a)(2)(i) of the Net Capital Rule and the relevant legal authority demonstrate that Geary Securities “received” funds in February 2010 for purposes of paragraph (a)(2)(i) and was subject to a \$250,000 net capital requirement.

III. FRAGER HAS FAILED TO SET FORTH, OR PROVIDE EVIDENCE OF, FACTS NECESSARY TO SUPPORT A CONCLUSION OF LAW THAT GEARY SECURITIES WAS EXEMPT FROM THE CUSTOMER PROTECTION RULE UNDER PARAGRAPH (k)(2)(i) THEREOF AND, AS A RESULT, SUBJECT TO A \$100,000 NET CAPITAL REQUIREMENT.

Frager argues that Geary Securities' minimum net capital requirement was \$100,000 under paragraph (a)(2)(ii) of the Net Capital Rule, in February 2010, because it was exempt from the provisions of the Customer Protection Rule pursuant to paragraph (k)(2)(i) thereof. Frager bases his argument on the fact that Geary Securities "promptly deposited" the customer checks, made payable to itself, into an account of Pershing. Frager's argument is inconsistent.

To be exempt from the requirements of the Customer Protection Rule under paragraph (k)(2)(i) thereof, a broker-dealer must meet the following five criteria:

- 1) Carry no margin accounts;
- 2) Promptly transmit all customer funds and deliver all securities received in connection with his broker-dealer activities;
- 3) Not otherwise hold funds or securities for customers;
- 4) Not otherwise owe money or securities to customers; **and**
- 5) Effectuate all financial transactions between the broker-dealer and his customers through bank account(s) designated as "Special Account for the Exclusive Benefit of Customers of Geary Securities".

17 C.F.R. § 240.15c3-3(k)(2)(i). Frager has not submitted evidence, or even suggested, that Geary Securities met all five of these criteria that would qualify it for an exemption from the requirements of the Customer Protection Rule under paragraph (k)(2)(i) thereof. In fact, Frager states that although Geary Securities maintained "the special

account required by the Customer Protection Rule,” Geary Securities never deposited customer funds into it. Frager Aff. ¶ 9. Assuming *arguendo* that Geary Securities maintained the required account, by Frager’s own admission, Geary Securities did not effectuate all financial transactions with customers through the account.

Geary Securities did not effectuate its financial transactions with customers through a bank account required by (k)(2)(i) of the Customer Protection Rule because Geary Securities operated as an introducing broker-dealer who cleared its transactions through Pershing and relied on the exemption from the Customer Protection Rule provided in paragraph (k)(2)(ii) thereof.³ On its Annual Audited Report for the year 2009 and its Focus Report for February 2010, Geary Securities represented that it was exempt from the Customer Protection Rule based on paragraph (k)(2)(ii) **NOT** (k)(2)(i). See Ex. 4 and Ex. 5 at 7.

In summary, Frager has failed to state, and provide evidence of, the facts necessary to support a conclusion of law that Geary Securities was exempt from the Customer Protection Rule pursuant to paragraph (k)(2)(i) thereof and, as a result, subject to a \$100,000 net capital requirement, in February 2010.

CONCLUSION

The undisputed facts and legal authority demonstrate that Geary Securities was subject to a capital requirement of \$250,000 under the Net Capital Rule in February 2010. Geary Securities’ net capital fell below \$250,000 on fifteen (15) business days in February 2010, but Frager allowed the firm to continue its securities business in violation of the Net Capital Rule, FINRA Rule 4110, FINRA Rule 2010, and 660:11-5-17

³ An exemption from the Customer Protection Rule under paragraph (k)(2)(ii) thereof does not qualify a broker-dealer for a \$100,000 minimum net capital requirement. See 17 C.F.R. § 240.15c3-1(a)(2).

and 660:11-5-42(b)(1) of the Rules of the Oklahoma Securities Commission and the Administrator of the Department of Securities. Frager also caused Geary Securities to fail to timely file notices of the firm's net capital deficiencies as required by SEA Rule 17a-11(b)(1). The Department respectfully requests that Frager's MSD be denied, and the Department's MSD be granted.

Respectfully submitted,



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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the above and foregoing was emailed and mailed, with postage prepaid, this 14th day of August, 2012, to:

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STATE OF OKLAHOMA
DEPARTMENT OF SECURITIES
FIRST NATIONAL CENTER
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IN THE MATTER OF:)
Geary Securities, Inc. fka)
Capital West Securities, Inc.;) File No. 09-141
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And CEMP, LLC,)

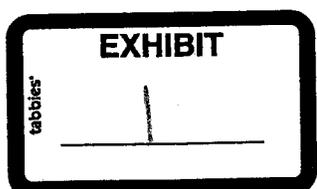
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TRANSCRIPT FROM DIGITAL RECORDING
OF TELEPHONIC HEARING
ON MOTION FOR SUMMARY DECISION
HAD ON APRIL 27TH, 2012

* * * * *

A P P E A R A N C E S

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22 REPORTED BY: KIT VICKERY, R.D.R.

23 Court Reporter

24

25

1 anticipated reiterating much of what's in those
2 responses. I would like to summarize Attorney Bonnell
3 with due respect has categorized any number of facts
4 as being undisputed, and we clearly disputed many of
5 those facts in our responses.

6 I think I would like to address two issues, one
7 with respect to the February 2010 net capital
8 violations, and again, as we had in our response,
9 there are net capital obligations that differ for
10 different purposes, and the membership agreement
11 contained a net capital requirement of \$250,000, which
12 is undisputed, but under the SEC rules that is not the
13 number that is used for determining when a firm has to
14 cease business.

15 And the FINOP, Mr. Frager, relied on the fact
16 that under the SEC rule there is a \$100,000 limit that
17 allows the firm to continue to do business if it is
18 not accepting payments directly from customers, and at
19 that time it was not doing so, that is a fact that we
20 disputed. We said that there's -- that's a fact that
21 we believe should be subject to hearing, and it is not
22 clear, and we did not agree to that fact, and the rule
23 itself I think was included with our response.

24 The rule that requires net capital computations
25 and ceasing business refers to 15 C3-11 I believe it

1 is, and that rule has -- 15 C3-1 excuse me -- and that
2 rule has a \$100,000 threshold instead of the 250 if
3 you're not accepting payments, that would be a fact
4 that would need to be determined at a hearing.

5 HEARING OFFICER KOHL: So if that -- if that
6 rule, in fact, says what you said, then Oklahoma would
7 not be permitted to impose a higher net capital
8 requirement, \$250,000 requirement.

9 MS. BRYANT: That's exactly right.

10 HEARING OFFICER KOHL: In that situation.

11 MS. BRYANT: That's correct.

12 HEARING OFFICER KOHL: Would the lowering of
13 the net capital requirement for the February 2010
14 period have made a difference as far as whether the
15 firm was -- was or was not in compliance?

16 MS. BRYANT: Yes. For most of those days
17 that were in -- you know, that the State is alleging
18 the firm was out of compliance, the firm was in
19 compliance with the \$100,000 threshold.

20 HEARING OFFICER KOHL: You alluded in
21 your -- your response that you had experts that were
22 going to testify to this, but as far as I know you
23 haven't named any of the experts, nor have you
24 provided any kind of -- of evidentiary material
25 concerning what their opinions would be.

(k)(2)(ii) EXEMPTIONS (continued)/014 Sale of Registered Investment Company Shares

An introducing BABD that sells registered investment company shares on a wire order basis may not use the exemption provided by (k)(2)(ii) as to its sales of shares of investment companies. The exemption for this activity is provided by (k)(2)(i) which requires that books and records be maintained and preserved as required by SEA Rules 17a-3 and 17a-4.

In effect, introducing activity is exempt under (k)(2)(ii) and sale of investment company shares is exempt under (k)(2)(i).

(SEC Letter to NASD, July 1, 1986) (No. 88-1, February 1988)

/015 Definition of "Promptly Transmit"

The term "promptly transmit" as used in SEA Rules 15c3-3 (k)(1) and (k)(2)(i) requires a broker-dealer to transmit customer funds and securities by noon of the next business day after receipt or by noon of the next business day following settlement date, whichever is later.

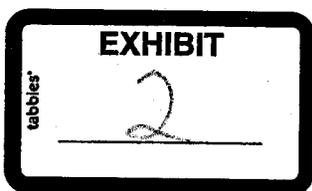
A broker-dealer operating pursuant to the (k)(2)(ii) exemptive provision must transmit customer funds and securities by noon of the next business day following receipt.

(SEC Staff to NYSE) (No. 95-3, May 1995)

/016 Self-Clearing of Commodities Transactions

A broker-dealer may self-clear customers' commodities transactions while operating pursuant to the (k)(2)(ii) exemptive provision of SEA Rule 15c3-3.

(SEC Staff to NYSE) (No. 95-3, May 1995)





Print

93-30 NASD Provides SEC-Approved Clarifications and Interpretations to Recent Net Capital Rule Amendments

SUGGESTED ROUTING
Senior Management Internal Audit Legal & Compliance Operations Systems

Executive Summary

On November 24, 1992, the Securities and Exchange Commission (SEC) adopted significant amendments to the Net Capital Rule, Rule 15c3-1. The changes to the minimum net capital requirements will take effect in three installments beginning July 1, 1993; other changes took effect on January 1. Additional amendments to the rule, published for comment in December, are still being considered. This Notice sets forth, in question and answer format, certain guidelines for compliance with the new requirements.

Background

As announced in *Notice to Members 92-72* (December 15, 1992), several amendments to the SEC's Net Capital Rule were effective January 1. One change concerning market makers is effective July 1, 1993. The net capital ceiling for a market maker will increase to \$1 million as of that date. The changes to the rule's minimum net capital requirements will take effect in three steps starting July 1, 1993.

The adopted amendments increase the required minimum net capital for firms that carry customer accounts to at least \$250,000 (\$100,000 for those firms that operate pursuant to the paragraph (k)(2)(i) exemption of Rule 15c33); create two classes of introducing firms each with a different minimum requirement (at least \$50,000 for firms that receive but do not hold customer securities for delivery to the clearing broker/dealer and \$5,000 for firms that do not receive customer funds or securities); increase the minimum to at least \$100,000 for dealers and underwriters that trade solely for their own accounts; increase the minimum to at least \$25,000 for firms that transact a business in mutual fund shares and certain other share accounts on other than a subscription-way basis; increase the minimum requirements for market makers to at least \$100,000; and maintain a \$5,000 minimum category for other broker/dealers that do not handle customer funds or securities.

Other adopted amendments establish one standardized method of calculating haircuts for all firms; adopt the alternative method for computing concentration charges for all firms; reduce the impact on aggregate indebtedness for two items (mutual funds payable offset by fails to deliver and corresponding stock loan/stock borrow); and permit the use of an offset when computing the open contractual commitment haircut on underwritings.

Since publication of *Notice to Members 92-72*, several NASD members have raised questions concerning the new requirements. The Association is publishing the answers to certain of these questions for the benefit of all members.

Questions concerning this Notice may be directed to Samuel Luque, Associate Director, Financial Responsibility at (202) 728-8472.

Minimum Net Capital Quick Reference Guide



Minimum Dollar Requirements

Phase-in Periods

Amended to	July 1, 1993	Jan. 1, 1994	July 1, 1994
------------	--------------	--------------	--------------

Mutual fund dealers subscription basis	5,000	3,300	4,100	5,000
Mutual fund dealers wire-order basis	25,000	10,000	17,500	25,000
*Introducing firms not receiving funds/securities	5,000	5,000	5,000	5,000
Introducing firms receiving securities	50,000	20,000	35,000	50,000
Firms carrying customer accounts under k(2)(i) exempt/15c3-3	100,000	50,000	75,000	100,000
Dealers and market makers	100,000	50,000	75,000	100,000
*Brokers' brokers	150,000	150,000	150,000	150,000
Firms carrying customer accounts basic (AI) method	250,000	100,000	175,000	250,000
Firms electing the alternative method	250,000	150,000	200,000	250,000
**Futures commission merchants	250,000	250,000	250,000	250,000
*Other brokers or dealers	5,000	5,000	5,000	5,000

Note: Whenever a broker/dealer engages in more than one of the above activities the highest requirement for any of those activities is the dollar requirement.

Ratio requirements and other requirements for futures commission merchants and market makers may dictate requirements higher than the minimum dollar requirement.

* Denotes no change.

** Futures Commission Merchant = National Futures Association minimum.

Item

SEC Net Capital Rule

Minimum Net Capital Requirements

I. Firms That Carry Accounts:

A. Firms that carry customer accounts or broker or dealer accounts and receive or hold funds or securities for those persons

i. Basic Method

Greater of \$250,000 or 6 2/3% of AI

ii. Alternative Method

Greater of \$250,000 or 2% of Rule 15c3-3 Reserve Formula debits

B. Firms that carry customer accounts, receive but do not hold customer funds or securities, and operate under the paragraph (k)(2)(i) exemption of Rule 15c3-3 Greater of \$100,000 or 6 2/3% of AI

II. Introducing Brokers:

A. Firms that introduce accounts on a fully disclosed basis to another broker or dealer and do not receive funds or securities Greater of \$5,000 or 6 2/3% of AI

B. Firms that introduce accounts on a fully disclosed basis to another broker or dealer and receive, but do not hold, customer or other broker/dealer securities and do not receive funds Greater of \$50,000 or 6 2/3% of AI

III. Dealers

Brokers or dealers that trade solely for their own accounts, endorse or write options, or effect more than ten transactions for their investment account in any one calendar year Greater of \$100,000 or 6 2/3% of AI

IV. Mutual Fund Brokers or Dealers

Brokers or dealers transacting a business in redeemable shares of registered investment companies and certain other share accounts

A. Wire orders Greater of \$25,000 or 6 2/3% of AI

B. Application method, and do not otherwise receive or hold funds or securities Greater of \$5,000 or 6 2/3% of AI

V. Market Makers

A broker or dealer engaged in activities as a market maker Greater of \$100,000 or 6 2/3% of AI or \$2,500 per security for securities with a market value greater than \$5 per share, and \$1,000 per security for securities with a market value of \$5 or less with a maximum requirement of \$1 million

VI. Other Broker or Dealers

A. Firms that deal only in Direct Participation Programs (DPPs) Greater of \$5,000 or 6 2/3% of AI

B. Firms that do not take customer orders, hold customer funds or securities, or execute customer trades, because of the nature of their activities (e.g., mergers and acquisitions) Greater of \$5,000 or 6 2/3% of AI

VII. Alternative Method

Any firm may elect this method, however, they will be subject to the \$250,000 minimum net capital requirement Greater of \$250,000 or 2% of Rule 15c3-3 Reserve Formula debits

VIII. Securities Haircuts

A. Equity securities 15% of the market value of the greater of the long or short position, plus 15% of the lesser to the extent it exceeds 25% of the greater position

B. Undue concentration The charge for undue concentration for equities is 15%, applied to the concentrated position immediately

IX. Aggregate Indebtedness

A. Mutual funds payable offset to fails to deliver 85% of the amounts payable related to fails to deliver of the same quantity and issue of registered investment company shares is excluded from AI

B. Stock loan and stock borrowed 85% of stock loan payables related to stock borrowed receivables of the same class and issue is excluded from AI

X. Contractual Charges

A. Open contractual commitment haircut for securities designated as Nasdaq National Market^{®} or listed on a national securities exchange 15% haircut

B. Open contractual commitment haircut for securities not designated as Nasdaq National Market or listed on a national securities exchange 30% haircut; however, for brokers or dealers with more than \$250,000 in net capital, the first \$150,000 of the haircut need not be deducted in the computation of net capital

XI. Secured Demand Note Collateral

Other securities including equities collateralizing secured demand notes 30% haircut

Questions and Answers Relating to the Amendments to the Uniform Net Capital Rule

Question #1: Should a fully disclosed introducing firm (current \$5,000 minimum requirement), that does *not* have a clearing agreement stating that the introduced customer accounts are the responsibility of the carrying firm, be considered self-clearing (with a \$25,000 current minimum requirement) immediately?

Answer: No. By June 30, 1993, introducing firms will be required to have properly executed clearing agreements stating that introduced customer accounts are the responsibility of the carrying firm. If a proper clearing agreement is not executed, an introducing firm can no longer be considered an introducing firm. Such a firm will have a minimum net capital requirement of \$250,000.

Question #2: If a customer disregards written instructions (i.e., the confirmation) to make the check payable to the clearing broker/dealer and submits a check to the introducing broker/dealer, made payable to the introducing firm, will the introducing broker/dealer's requirement increase from \$5,000 to \$250,000?

Answer: No. The SEC has recognized that on occasion customers will mistakenly make their checks payable to the introducing firm. However, the burden of demonstrating mistakes rests with the introducing firm. Firms must have procedures in place to demonstrate how such customer mistakes will be addressed. The confirmation should always indicate that checks are to be made payable to the clearing firm, escrow agent, or appropriate third party. Customers making such mistakes should be contacted directly, in writing, and instructed regarding the proper procedures.

Question #3: Into which net capital category does an introducing firm that receives and promptly transmits customer checks made out to third parties fall?

Answer: An introducing firm that receives and promptly transmits all customer and broker/dealer checks made payable to the appropriate third party will have a minimum requirement of \$5,000, provided that the firm does not receive customer securities.

Question #4: In *Notice to Members 92-72*, it was noted that the adopted amendments created two classes of introducing firms. However, some firms introduce accounts on a fully disclosed basis and separately transact business in mutual fund shares through a (k)(2)(i) "Special Bank Account." Since the firm is *receiving* funds from customers for its mutual fund business, is the firm's minimum net capital requirement \$250,000?

Answer: No. An introducing firm that processes customer monies related to its mutual fund business through a (k)(2)(i) account will be required to maintain net capital of not less than \$25,000, provided that other activities of the firm do not require a higher net capital.

Question #5: If an introducing broker/dealer receives checks payable to itself, deposits the checks in a (k)(2)(i) account, and then promptly forwards the funds to its clearing broker/dealer, would the introducing broker/dealer be subject to a minimum net capital requirement of \$100,000 or \$250,000?

Answer: The firm would be deemed to have received customer funds if it operates in this manner and, therefore, would be subject to the \$250,000 minimum net capital requirement. The SEC has informed us that a (k)(2)(i) account cannot be used by fully disclosed firms, except for mutual fund transactions.

Question #6: Can a \$5,000 firm accept customers' funds and forward such funds to its clearing firm? If so, under what circumstances?

Answer: Yes. If the checks are made payable to the clearing firm and promptly forwarded.

Question #7: What would be the minimum net capital requirement for an introducing firm that trades for its own account, makes no markets, and does not participate in firm commitment underwritings?

Answer: An introducing firm that effects more than 10 transactions in its investment account during a calendar year will be required to maintain \$100,000 in net capital. (Transactions in money market instruments are excluded from the 10-transaction limitation.) If 10 or fewer transactions are effected, the minimum net capital requirement would be either \$5,000 or \$50,000, as appropriate for introducing firms. (A transaction is either a purchase or sale.)

Question #8: Is an introducing broker/dealer, that has the ability to *write* checks or drafts on the clearing broker/dealer's behalf, subject to a higher net capital requirement than the \$5,000 required for an introducing broker/dealer?

Answer: No. If the bank account is in the name of the clearing firm, and there is a written contract between the carrying broker/dealer and the introducing firm specifying that the introducing firm is acting as agent for the carrying broker/dealer, the introducing firm's minimum net capital requirement will be \$5,000.

Question #9: What is an introducing broker/dealer's net capital requirement, if it receives checks from a mutual fund made payable to the firm with a reference to the customer's name and account number? (The checks are the customer's dividends and capital gains, which the customer wants deposited in its brokerage account and the customer has requested that the mutual fund send the checks to the broker/dealer.)

Answer: A firm that receives checks from a mutual fund made payable to itself, resulting from dividends or capital gains in a customer's account, will have a net capital requirement of \$250,000. The fact that the customer requested this transaction would not alter this requirement.

Question #10: Does the required clearing agreement for introducing firms (i.e., the agreement must state that customers are the customers of the clearing firm for purposes of the Securities Investors Protection Act, that account statements must be sent directly to customers, etc.) apply to a \$5,000 introducing firm as well as to a \$50,000 introducing firm?

Answer: Yes. All fully disclosed introducing firms will be required to execute clearing agreements that contain the appropriate language as outlined in *Notice to Members 9272* (see page 517). The language required by the Rule to be included in all clearing agreements is intended to establish the concept that the customers must look to the clearing firm for the payment of monies and delivery of securities.

Question #11: If a firm (i) conducts a general securities business on a fully disclosed basis, receives no customer securities, and all customer checks are made payable, and promptly forwarded, to the clearing firm, and (ii) deposits customer checks made payable to itself for mutual fund transactions (only) into a (k)(2)(i) "Special Bank Account" and promptly transmits the firm's own check to the mutual fund issuer, what would be the broker/dealer's net capital requirement?

Answer: Based on its mutual fund wire-order business, the firm's net capital requirement would be \$25,000, and the firm would claim the (k)(2)(i) exemption from the Customer Protection Rule.

Question #12: If a sole mutual fund dealer (current \$2,500 minimum requirement) receives checks made payable to the fund, what will its new capital requirement be?

Answer: A firm that operates pursuant to 15c3-1(a)(2)(v), acting only on a subscription-order basis with respect to the purchase and sale of open-end mutual fund shares and insurance company separate accounts, and receives checks made payable to the appropriate third party, will have a minimum net capital requirement of \$5,000.

Question #13: What is the net capital requirement for a firm that acts as the underwriter for a mutual fund?

Answer: A broker/dealer that engages solely in mutual fund transactions will be required to maintain a minimum net capital of \$5,000, provided that all trades are done on a subscription basis directly with the fund. The requirement for a firm that conducts a similar business but on a wire-order basis will be \$25,000.

Question #14: What is the minimum net capital requirement for a firm that holds mutual fund securities in street name on behalf of customers?

Answer: The requirement is \$250,000, the same as for any firm that holds securities on behalf of its customers, regardless of whether the securities are mutual fund shares, equities, or debentures.

Question #15: Does the \$1,000 per security requirement for market makers go into effect on July 1, 1993, the same time that the \$1 million ceiling goes into effect?

Answer: No. The requirement to maintain net capital of not less than \$1,000 per security with a market value of \$5 or less for those securities in which they make a market became effective on January 1, 1993. The current \$100,000 ceiling requirement will be increased to \$1 million effective July 1, 1993.

Question #16: Does a broker/dealer calculating net capital under the alternative standard require SEC approval if it wishes to change to the aggregate indebtedness standard?

Answer: Yes. Also, any firm that wishes to compute net capital under the alternative standard after January 1, 1993, must file the appropriate notification with its Designated Examining Authority. If the firm wishes to change from the alternative standard, it must obtain prior approval from the SEC before the change can be made.

Question #17: What is the contractual charge for initial public offerings and secondary offerings listed on the Nasdaq National Market or an exchange?

Answer: For all securities being underwritten in an initial public offering, the percentage deduction applied as the open contractual commitment charge is 30 percent, even if the issue immediately begins trading in the secondary market on the Nasdaq National Market or an exchange. If the underwriting is a secondary offering of an issue already trading on the Nasdaq National Market or an exchange, the percentage is 15 percent.

Question #18: What is the open contractual commitment charge for a firm commitment underwriting of a new convertible debt security that is immediately convertible into an existing Nasdaq National Market security for the same issuer?

Answer: The open contractual commitment charge for a convertible debt security is calculated by multiplying the dollar amount of the commitment by the appropriate percentage as determined by Rule 15c3-1 (c)(2)(vi)(G). If the security has a market value at par or higher, the percentage deduction is determined by Rule 15c3-1(c)(2)(vi)(J). If the security has a market value less than par, the percentage deduction is determined by Rule 15c3-1(c)(2)(vi)(F).

Question #19: What is the new net capital requirement for a direct participation program firm that does not have a (k)(2)(i) account and does not "receive" customer funds?

Answer: A firm, which limits its activities to selling direct participation programs or other similar securities and uses an escrow account pursuant to SEC Rule 15c2-4, will be in the \$5,000 minimum net capital category and will not be required to have a (k)(2)(i) account.

Question #20: Is a sole government securities firm going to be subject to any changes in liquid capital requirements?

Answer: No. At this time, the adopted amendments to the Net Capital Rule will not change the liquid capital requirements for a sole government securities firm.

Question #21: Should an NASD-designated member firm increase its fidelity bond in six-month intervals as the minimum net capital requirements increase, or may the firm wait until it is time to renew the bond?

Answer: Article III, Section 32, requires a member firm to review annually the adequacy of its fidelity bond coverage. This review is required annually at the anniversary date of the issuance of the bond.

Question #22: Will a new member be subject to the new minimum requirements immediately, or will it be subject to the temporary phase-in minimums allowed existing members?

Answer: A new member would be required to comply with the minimum net capital requirements in effect at the time the firm becomes a member of the NASD, including the temporary phase-in minimums.

Question #23: May a firm that conducts a business in private debt and equity offerings, *where there is no clearing relationship*, but the firm promptly forwards all checks made out to the issuer, operate with a \$5,000 minimum net capital requirement?

Answer: Yes. The \$5,000 minimum net capital requirement is appropriate for this type of firm. However, if the offering involves any contingencies, the firm must comply with the provisions of SEC Rule 15c2-4. This firm may also operate as an introducing broker.

Question #24: May a firm elect to accelerate the effectiveness of its minimum net capital requirement and report this final minimum requirement amount as its current requirement amount on the July 1, 1993, FOCUS Report?

Answer: No. A firm must follow the SEC's temporary phase-in minimums for reporting its net capital requirement.

Question #25: If a firm falls in more than one category for determining minimum net capital requirements, which requirement would apply (e.g., a market maker that is also an introducing broker/dealer)?

Answer: A firm that engages in more than one type of business will be required to maintain a minimum net capital equal to the highest requirement for any business conducted. In the example given, the requirement would be the highest minimum associated with the firm's market-making activities. Additionally, firms should be aware of the ratio requirements if computing net capital under the aggregate indebtedness method or the alternative method.

Question #26: What does "statutory underwriter" mean?

Answer: A statutory underwriter is any broker/dealer that is contractually committed to an issuer for the purchase of its securities.

Question #27: What is the minimum net capital requirement for an introducing firm participating in a firm-commitment underwriting, but not as an underwriter?

Answer: An introducing firm may participate in a firm-commitment offering as a selling group member only, not committed to the issuer, and operate under the \$50,000 minimum net capital requirement.

Question #28: Did the haircuts for equity securities change on January 1, 1993?

Answer: Yes. All firms, whether they compute net capital under the basic method or the alternative method, now compute equity haircuts the same, that is, 15 percent of the market value of the greater of the long or short position and, if the lesser position exceeds 25 percent of the greater position, an additional 15 percent is taken on the excess amount. This treatment applies to all securities in paragraph (c)(2)(vi)(J) "All Other Securities." For those equity securities that are included in paragraph (c)(2)(vi)(K)(ii) the haircut remains 40 percent.

Question #29: Did the method for determining undue concentration deductions change on January 1, 1993?

Answer: Yes. All firms, whether they compute net capital under the basic method or the alternative method must compute undue concentration deductions pursuant to paragraph (c)(2)(vi)(M). For equities and debt securities, the deduction must be applied immediately, except for securities underwritten (for which the deduction is not applied until after 11 business days).

Question #30: Is there any relief given to the aggregate indebtedness charge of 6 2/3 percent for firms that conduct a mutual fund business?

Answer: Yes. If a broker/dealer has a payable to a mutual fund that is related to a fail-to-deliver receivable of the same quantity, 85 percent of that liability would be excluded from aggregate indebtedness. Additionally, similar aggregate indebtedness relief will be afforded stock loan payables that are offset by stock borrowed receivables of the same quantity and issue.

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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**ANNUAL AUDITED REPORT
FORM X-17A-5
PART III**

SEC FILE NUMBER
8- 48259

FACING PAGE

**Information Required of Brokers and Dealers Pursuant to Section 17 of the
Securities Exchange Act of 1934 and Rule 17a-5 Thereunder**

REPORT FOR THE PERIOD BEGINNING: 01-01-2009 AND ENDING 12-31-2009
MM/DD/YY MM/DD/YY

A. REGISTRANT IDENTIFICATION

NAME OF BROKER-DEALER: Geary Securities, Inc.

OFFICIAL USE ONLY
FIRM I.D. NO.

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

211 N. Robinson, Suite 200

(No. and Street)

Oklahoma City

Oklahoma

73102

(City)

(State)

(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

Denise Hintze

405-235-5714

(Area Code - Telephone Number)

B. ACCOUNTANT IDENTIFICATION

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this Report*

Grant Thornton LLP

(Name - if individual, state last, first, middle name)

211 N. Robinson, Suite 1200, Oklahoma City, OK 73102

(Address)

(City)

(State)

(Zip Code)

CHECK ONE:

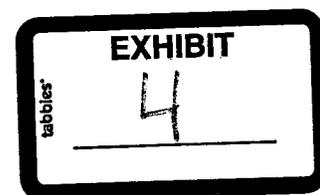
- Certified Public Accountant
 Public Accountant
 Accountant not resident in United States or any of its possessions.

FOR OFFICIAL USE ONLY

*Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on as the basis for the exemption. See Section 240.17a-5(e)(2)

SEC 1410 (06-02)

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.



OATH OR AFFIRMATION

I, Keith D. Geary, swear (or affirm) that, to the best of my knowledge and belief the accompanying financial statement and supporting schedules pertaining to the firm of Geary Securities, Inc. (The "Company"), as of December 31,, 20 09, are true and correct. I further swear (or affirm) that neither the company nor any partner, proprietor, principal officer or director has any proprietary interest in any account classified solely as that of a customer, except as follows:

[Signature]
Signature

President and Chief Executive Officer
Title

March 9, 2010

[Signature]
Notary Public



This report ** contains (check all applicable boxes):

- (a) Facing Page.
- (b) Statement of Financial Condition.
- (c) Statement of Income (Loss).
- (d) Statement of ~~CASH FLOW~~ Cash Flow
- (e) Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietors' Capital.
- (f) Statement of Changes in Liabilities Subordinated to Claims of Creditors.
- (g) Computation of Net Capital.
- (h) Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3.
- (i) Information Relating to the Possession or Control Requirements Under Rule 15c3-3.
- (j) A Reconciliation, including appropriate explanation of the Computation of Net Capital Under Rule 15c3-1 and the Computation for Determination of the Reserve Requirements Under Exhibit A of Rule 15c3-3.
- (k) A Reconciliation between the audited and unaudited Statements of Financial Condition with respect to methods of consolidation.
- (l) An Oath or Affirmation.
- (m) A copy of the SIPC Supplemental Report.
- (n) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit.

**For conditions of confidential treatment of certain portions of this filing, see section 240.17a-5(e)(3).

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Report of Independent Registered Public Accounting Firm

Board of Directors
Geary Securities, Inc.

We have audited the accompanying statements of financial condition of Geary Securities, Inc. (formerly Capital West Securities, Inc.), an Oklahoma Corporation, as of December 31, 2009 and 2008, and the related statements of operations, stockholder's equity and cash flows for the years then ended that you are filing pursuant to Rule 17a-5 under the Securities Exchange Act of 1934. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America as established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Geary Securities, Inc. as of December 31, 2009 and 2008, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note B to the financial statements, the Company has suffered recurring losses from operations and had regulatory net capital deficiencies subsequent to December 31, 2009. These factors, among others, as discussed in Note B, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note B. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in the supplementary information is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by Rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Grant Thornton LLP

Oklahoma City, Oklahoma
March 9, 2010

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

STATEMENTS OF FINANCIAL CONDITION

December 31,

ASSETS	<u>2009</u>	<u>2008</u>
CASH AND CASH EQUIVALENTS	\$ 168,601	\$555,758
RECEIVABLES FROM CLEARING ORGANIZATIONS	521,262	467,417
SECURITIES OWNED - AT MARKET, pledged to clearing organization	367,488	3,812,872
RECEIVABLE FROM PARENT	830,944	-
ACCRUED INTEREST RECEIVABLE	1,167	43,598
INCOME TAXES RECEIVABLE	-	19,068
PROPERTY AND EQUIPMENT, net	231,682	319,399
GOODWILL, net	-	90,203
OTHER ASSETS	<u>66,325</u>	<u>151,852</u>
	<u>\$2,187,469</u>	<u>\$5,460,167</u>
LIABILITIES AND STOCKHOLDER'S EQUITY		
LIABILITIES		
Accrued liabilities and payables	\$ 611,409	\$ 425,907
Payable to clearing organizations	<u>-</u>	<u>2,706,820</u>
Total liabilities	611,409	3,132,727
COMMITMENTS AND CONTINGENCIES (notes B and G)		
STOCKHOLDER'S EQUITY		
Common stock - \$.01 par value; authorized, issued and outstanding, 3,000,000 shares	30,000	30,000
Additional paid-in capital	853,571	853,571
Retained earnings	<u>692,489</u>	<u>1,443,869</u>
	<u>1,576,060</u>	<u>2,327,440</u>
	<u>\$2,187,469</u>	<u>\$5,460,167</u>

The accompanying notes are an integral part of these statements.

Gearly Securities, Inc.
(a wholly owned subsidiary of The Gearly Companies, Inc.)

STATEMENTS OF OPERATIONS

Year ended December 31,

	2009	2008
REVENUES		
Commissions	\$5,695,776	\$10,601,922
Trading profits, net	1,748,901	718,921
Management and underwriting fees	673,779	1,253,291
Interest and dividends	154,107	177,229
Other	<u>(2,936)</u>	<u>474,522</u>
Total revenues	8,269,627	13,225,885
EXPENSES		
Employee compensation and benefits	5,318,266	5,709,558
Clearing, execution and account charges	103,346	280,638
Communications	246,737	248,406
Occupancy and equipment	291,275	148,372
Depreciation and amortization	123,797	76,276
Professional fees	594,488	626,693
Management fee	-	3,532,433
Advertising	441,557	422,576
Research	269,184	204,629
Interest expense	151,014	224,310
Goodwill impairment	90,203	-
Other operating	<u>940,960</u>	<u>873,432</u>
Total expenses	8,570,827	12,347,323
NET (LOSS) EARNINGS	\$ <u>(301,200)</u>	\$ <u>878,562</u>

The accompanying notes are an integral part of these statements.

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

STATEMENT OF STOCKHOLDER'S EQUITY

Years ended December 31, 2009 and 2008

	<u>Common stock</u>	<u>Additional paid-in capital</u>	<u>Retained earnings</u>	<u>Total</u>
Balance at January 1, 2008	\$ 30,000	\$853,571	\$1,062,786	\$1,946,357
Net earnings	-	-	878,562	878,562
Distribution to Parent	<u>-</u>	<u>-</u>	<u>(497,479)</u>	<u>(497,479)</u>
Balance at December 31, 2008	30,000	853,571	1,443,869	2,327,440
Net loss	-	-	(301,200)	(301,200)
Distribution to Parent	<u>-</u>	<u>-</u>	<u>(450,180)</u>	<u>(450,180)</u>
Balance at December 31, 2009	<u>\$ 30,000</u>	<u>\$853,571</u>	<u>\$692,489</u>	<u>\$1,576,060</u>

The accompanying notes are an integral part of this statement.

Gearly Securities, Inc.
(a wholly owned subsidiary of The Gearly Companies, Inc.)

STATEMENTS OF CASH FLOWS

Year ended December 31,

	2009	2008
OPERATING ACTIVITIES		
Net (loss) earnings	\$ (301,200)	\$ 878,562
Adjustments to reconcile net (loss) earnings to net cash provided by (used in) operating activities		
Depreciation and amortization	123,797	76,276
Goodwill impairment	90,203	-
Changes in operating assets and liabilities		
Receivables from clearing organizations	(53,845)	150,682
Securities owned	3,445,384	(3,246,554)
Accrued interest receivable	42,431	(41,722)
Income taxes receivable	19,068	29,793
Other asset	85,527	(76,966)
Accrued liabilities and payables	185,502	(579,381)
Payable to clearing organizations	<u>(2,706,820)</u>	<u>2,640,502</u>
Net cash provided by (used in) operating activities	930,047	(168,808)
INVESTING ACTIVITIES		
Purchase of property and equipment	(36,080)	(362,644)
Change in receivable from Parent	<u>(830,944)</u>	<u>-</u>
	(867,024)	(362,644)
FINANCING ACTIVITIES		
Distribution to Parent	<u>(450,180)</u>	<u>(497,479)</u>
NET DECREASE IN CASH AND CASH EQUIVALENTS	(387,157)	(1,028,931)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	<u>555,758</u>	<u>1,584,689</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 168,601</u>	<u>\$ 555,758</u>
SUPPLEMENTAL CASH FLOW INFORMATION		
Cash paid for interest	<u>\$ 151,014</u>	<u>\$ 224,310</u>

The accompanying notes are an integral part of these statements.

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

NOTES TO FINANCIAL STATEMENTS

December 31, 2009 and 2008

NOTE A - SUMMARY OF ACCOUNTING AND REPORTING POLICIES

Geary Securities, Inc. (the "Company") is registered as a broker-dealer under the Securities Exchange Act of 1934 (the "Act"). Effective December 1, 2009, Capital West Securities, Inc. changed its operating name to Geary Securities, Inc. The Company is wholly owned by The Geary Companies, Inc. (the "Parent").

The Company operates as an introducing broker-dealer on a fully disclosed basis and offers its clients (individual and institutional investors) a variety of products and services. The Company also offers investment banking and municipal finance services. The Company's operations are primarily in Oklahoma and Texas.

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and reflect industry practices. The following represents the more significant of those policies and practices.

1. Basis of Presentation

In preparing its financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Cash and Cash Equivalents

The Company considers all liquid investments with original maturities when acquired of three months or less to be cash equivalents. The Company maintains its cash in accounts which may, at times, exceed federally insured limits. The Company has not experienced any losses in cash and cash equivalents and believes it is not exposed to any significant risks. At December 31, 2009, the Company had bank balances of approximately \$207,000 at one financial institution. At December 31, 2008 the Company had bank balances of approximately \$474,000 and \$311,000 at two financial institutions.

3. Receivables From and Payable to Clearing Organizations

The Company clears certain of its proprietary and customer transactions through another broker-dealer on a fully disclosed basis resulting in receivables from and payables to the clearing organization. At December 31, 2009, receivables from clearing organizations also include deposits with the clearing broker. At December 31, 2009, there was no payable to the clearing organization. At December 31, 2008, receivables from clearing organizations included deposits with clearing brokers and amounts withheld by former clearing broker (see note G). At December 31, 2008, the payable to clearing organization relates to the aforementioned transactions and is collateralized by securities owned by the Company. Such payable can be subject to interest changes pursuant to the clearing agreement.

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2009 and 2008

NOTE A - SUMMARY OF ACCOUNTING AND REPORTING POLICIES - CONTINUED

4. Securities Transactions

Securities transactions and related commission revenue and expense are recorded on the trade date as if they had settled. Management and underwriting fees are recorded at the time the services are completed and the income is reasonably determinable.

5. Securities Owned

Securities owned primarily consist of tax-exempt and corporate securities carried at fair value (see note F). At December 31, 2009, securities owned consisted of corporate equities with a fair value of \$7 and tax exempt obligations with a fair value of \$367,481. At December 31, 2008 securities owned consisted of corporate equities with a fair value of \$22,440 and tax exempt obligations with a fair value of \$3,790,432.

6. Property and Equipment

Major classes of property and equipment consist of the following at December 31:

	2009	2008
Office equipment and furniture	\$ 290,118	\$ 275,526
Software	7,370	7,370
Leasehold improvements	<u>195,228</u>	<u>173,740</u>
	492,716	456,636
Less accumulated depreciation and amortization	<u>(261,034)</u>	<u>(137,237)</u>
	<u>\$ 231,682</u>	<u>\$ 319,399</u>

Depreciation of property and equipment is calculated under an accelerated method using estimated useful lives of three to seven years. Leasehold improvements are amortized over the term of the lease.

The Company reviews the carrying value of long-lived assets used in operations when changes in events or circumstances indicate the asset might have become impaired. The review is based on comparing the carrying amount of the assets to the undiscounted estimated cash flows over the remaining useful lives. If this review indicates that an asset has been impaired, the Company records a charge to operations to reduce the asset's carrying value to fair value, which is based on estimated discounted cash flows.

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2009 and 2008

NOTE A - SUMMARY OF ACCOUNTING AND REPORTING POLICIES - CONTINUED

7. Goodwill

Goodwill is not amortized, but is reviewed annually for impairment and tested between annual evaluations if an event occurs or circumstances change that would more likely than not reduce the fair value of the Company below its carrying amount. No impairment of goodwill was required for the year ended December 31, 2008. Due to net losses incurred in 2009, goodwill was fully impaired and an impairment loss of \$90,203 was recognized.

8. Income Taxes

The Company and the Parent previously made a qualifying subchapter S election. Accordingly, income taxes on net earnings are not payable by the Company and are not reflected in the accompanying financial statements.

9. Advertising Cost

The Company expenses the cost of advertising as incurred. Advertising expense for the years ended December 31, 2009 and 2008 was approximately \$442,000 and \$423,000, respectively.

10. Rule 15c3-3

The Company is exempt from Rule 15c3-3 under the provisions of subsection (k)(2)(ii). Under this exemption, the *Computation for Determining Reserves Requirements and Information Relating to the Possession or Control Requirements* are not required.

NOTE B - MANAGEMENT'S PLANS CONCERNING FINANCIAL CONDITION, NET CAPITAL REQUIREMENTS AND REGULATORY MATTERS

The Company sustained a net loss for 2009 and also sustained net losses in January and February of 2010. These losses were significant enough to cause the Company to fall below its regulatory net capital requirement for one day in January 2010 and several days in February 2010. On February 5, 2010 and February 26, 2010, \$75,000 and \$750,000, respectively, was paid to the Company as a reduction of the receivable due from Parent, a nonallowable asset for determining regulatory net capital. As a result of these payments, the Company restored its compliance with the regulatory net capital requirement.

As required, notifications of net capital below minimum amount required were made to FINRA, the Company's regulatory organization, the SEC and the Company's clearing organization pursuant to SEC Rule 17a-11(b). As a result, FINRA has commenced an investigation into the circumstances surrounding the notifications. The Company is cooperating fully with the FINRA investigation and will

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2009 and 2008

NOTE B – MANAGEMENT’S PLANS CONCERNING FINANCIAL CONDITION, NET
CAPITAL REQUIREMENTS AND REGULATORY MATTERS - CONTINUED

provide FINRA with all requested information and documentation. Under FINRA Sanction Guidelines, sanctions for net capital violations can include monetary sanctions (fines) and suspension of all activities and functions for a period of time. As the investigation has just begun, the Company is unable to comment as to the status of the investigation or the possibility of any sanctions.

Additionally, on March 8, 2010, the Oklahoma Department of Securities issued an Order Initiating Investigation (OII) indicating they commenced a public investigation of the Company and its President and Chief Executive Officer to determine if they violated any provisions of the Oklahoma securities laws or rules. No specific activities were identified in the OII, however management believes the investigation is directed towards a limited number of investment transactions with a limited number of institutional clients. As the investigation has just begun, the Company is unable to comment as to the status of the investigation, the ultimate outcome or the possibility of any enforcement actions.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern; however, its continued losses and the uncertainty of the ultimate outcome of the above noted investigations raise doubt about its ability to continue as a going concern. The financial statements do not include any adjustments related to the recoverability of recorded assets or to the amounts of liabilities or any other adjustments that might be necessary should the Company be unable to continue as a going concern. The Company's ability to continue as a going concern is dependent on market conditions and its ability to improve profitability and maintain adequate regulatory net capital.

In order to improve profitability, management is taking actions to reduce corporate and operational expenses. Management also believes that additional capital support may be available from its Parent if another of the Parent’s subsidiaries is able to close one or more securitization transactions in the near future. Although there can be no absolute assurance, management believes the Company will be able to maintain its regulatory net capital requirements through December 31, 2010.

NOTE C - NET CAPITAL REQUIREMENT

The Company is subject to the Uniform Net Capital Rule (“Rule 15c3-1”) under the Securities Exchange Act of 1934, which requires the maintenance of minimum net capital and that the ratio of aggregate indebtedness to net capital, both as defined, shall not exceed 15 to 1. Rule 15c3-1 also limits the amount of capital withdrawals that can be made within any 30-day period without notification to the Securities and Exchange Commission.

At December 31, 2009, the Company had an aggregate indebtedness to net capital ratio of 1.43 to 1, with net capital of \$429,020 which was \$179,020 in excess of its required net capital of \$250,000.

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2009 and 2008

NOTE C - NET CAPITAL REQUIREMENT - CONTINUED

At December 31, 2008, the Company had an aggregate indebtedness to net capital ratio of .66 to 1, with net capital of \$1,109,832 which was \$859,832 in excess of its required net capital of \$250,000.

NOTE D - EMPLOYEE BENEFITS

The Company has a 401(k) plan covering substantially all employees. The plan permits employer discretionary contributions. During 2009, there were no discretionary contributions made. During 2008, discretionary contributions totaled approximately \$51,000.

NOTE E - RELATED PARTY TRANSACTIONS

In 2008, the Company had a management agreement with the Parent for the Parent to provide, among other things, office space and certain management services and support. The Company agreed to pay the Parent, as base compensation for the services, a monthly management fee of up to \$500,000. The agreement also provided for a reduction in the fee if regulatory net capital requirements would not be met. In 2009, the management agreement was cancelled on a retroactive basis to January 1, 2009. As a result of this termination, the Parent agreed to return funds previously received under the terms of the agreement resulting in a cash payment from the Parent of \$750,000 in September 2009 and a receivable from Parent. As of December 31, 2009, the receivable from Parent was approximately \$831,000. Because the management agreement was not renewed during 2009, the Company was directly responsible for the cost of the services previously provided by the Parent.

During 2009, the Company made distributions to the Parent in the amount of \$450,180.

During 2008, the Parent made distributions to the Parent in the amount of \$497,479.

As a part of the Parent's debt agreement with a bank, the Company can not declare or make any cash, share or other dividends or distributions on any class of its shares other than for federal and state tax obligations of the Parent arising from their status as an S Corporation. Additionally, there are certain restrictions on loans to and payments of bonuses to certain key officers, directors or employees as defined in the debt agreement.

NOTE F - FAIR VALUE OF FINANCIAL INSTRUMENTS

For cash and cash equivalents and receivables from and payable to clearing organizations, the carrying amount is a reasonable estimate of fair value due to their short-term nature. Securities owned are carried at fair value.

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2009 and 2008

NOTE F - FAIR VALUE OF FINANCIAL INSTRUMENTS – CONTINUED

Generally accepted accounting principals defines fair value, establishes a framework for measuring fair value and requires certain disclosures about fair value measurements.

Such principles establish a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- | | |
|---------|---|
| Level 1 | Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets. |
| Level 2 | Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset and liability, either directly or indirectly, for substantially the full term of the financial instrument. |
| Level 3 | Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities. |

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company's financial assets carried at fair value.

Securities Owned

U.S. Treasury securities and exchange-listed common stock are reported at fair value utilizing Level 1 inputs. Other owned securities are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value information from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, trading spreads, cash flows, developed yield curves, trading levels, trade and market data, credit information and the bond's terms and conditions, among other things.

The following table summarizes financial assets measured at fair value on a recurring basis as of December 31, 2008 and 2009, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2009 and 2008

NOTE F - FAIR VALUE OF FINANCIAL INSTRUMENTS - CONTINUED

	<u>Level 1</u> <u>inputs</u>	<u>Level 2</u> <u>inputs</u>	<u>Level 3</u> <u>inputs</u>	<u>Total</u> <u>fair</u> <u>value</u>
2009				
Securities owned	\$ 7	\$ 367,481	\$ -	\$ 367,488
2008				
Securities owned	\$ 22,440	\$3,790,432	\$ -	\$3,812,872

NOTE G - COMMITMENTS AND CONTINGENCIES

The Company leases certain office space and data information equipment under operating leases. Total rent expense in 2009 and 2008 was approximately \$244,300 and \$37,400, respectively.

Lease terms, excluding month-to-month arrangements, extend through 2011 and provide for payments as follows:

Year ending December 31	
2010	\$226,055
2011	<u>22,265</u>
	<u>\$248,320</u>

The Company is subject to market and credit risk in connection with security transactions. The Company is therefore exposed to risk of loss on these transactions in the event of the customers' or brokers' inability to meet the terms of their contracts, in which case the Company may have to purchase or sell securities at prevailing market prices which may not be sufficient to liquidate the contractual obligation. The Company controls this risk by monitoring the market value of securities on a daily basis.

Under the terms of the Company's agreement with its clearing organization, in the event that the Company's customers fail to pay for purchases or to supply securities sold, the Company would be obligated to indemnify the clearing organization for any resulting losses. The Company monitors its customer activity by reviewing information it receives from its clearing organization on a daily basis, monitoring the credit worthiness of the customers and requiring customers to deposit additional collateral or reduce positions when necessary.

In the normal course of business, the Company enters into when-issued and underwriting commitments. There were no such commitments at December 31, 2009.

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2009 and 2008

NOTE G - COMMITMENTS AND CONTINGENCIES - CONTINUED

A customer of the Company initiated an arbitration claim against the Company in 2005. The customer alleged that he suffered losses in his account and sought the recovery of actual damages and punitive damages in excess of \$2,900,000. The Company vigorously defended the claim through an arbitration hearing in 2006. The NASD Arbitration Panel issued a nominal award of \$9,900 to the customer and the Company immediately paid such award. Thereafter, in 2007, the customer unsuccessfully attempted to pursue a motion to vacate or modify the Panel's award through an action filed in the District Court of Oklahoma County. The court dismissed the customer's action to vacate or modify the award and the customer has since filed an appeal. Management's view, after consultation with outside counsel, is that any form of recovery by the customer will not have a material adverse effect on the Company's financial position or results of operations.

In 2008, the Company initiated a member-to-member arbitration case through FINRA's arbitration process against the former clearing organization. The arbitration claim arose from the clearing relationship that existed between the Company and the former clearing organization that originated in 2007. The Company elected to exercise its right to terminate the clearing agreement with the former clearing organization based on believed material events of default in the former clearing organizations performance of its obligations under the clearing agreement including, but not limited to, issues associated with the former clearing organization's troubled back-office technological conversion in March 2008. The Company was seeking to obtain a declaratory judgment (that the former clearing organization defaulted in its obligations) and money damages as a result of the former clearing organization withholding payment of funds owed to the Company. The former clearing organization denied default and asserted a counterclaim against the Company, seeking to recover contractual termination fees of approximately \$440,000. The former clearing organization withheld funds of approximately \$315,000 to satisfy any arbitration award that may be entered against the Company. During 2009, the Company and the former clearing organization have settled the dispute resulting in a loss to the Company of approximately \$142,000 which was recognized during 2009 and reported as other operating expenses.

A former employee broker has filed complaints against the Company for disability discrimination and retaliation, age discrimination and wrongful termination. While this suit is in the early stages, management's view, after consultation with outside counsel, is that this action will not have a material adverse effect on the Company's financial position or results of operations.

In the normal course of business, there are other legal actions and proceedings pending against the Company. In management's opinion, after consultations with outside counsel, the ultimate liability, if any, resulting from these actions will not have a material adverse effect on the Company's financial position or results of operations.

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2009 and 2008

NOTE H – SUBSEQUENT EVENTS

Subsequent to December 31, 2009, \$830,944 was paid to the Company as a reduction of the receivable due from the Parent.

The Company has evaluated events and transactions that occurred subsequent to December 31, 2009 through March 9, 2010, the date these financial statements were available to be issued, for potential recognition or disclosure in these financial statements.

SUPPLEMENTARY INFORMATION

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

COMPUTATION OF NET CAPITAL FOR BROKERS AND DEALERS PURSUANT TO
RULE 15c3-1 UNDER THE SECURITIES EXCHANGE ACT OF 1934

December 31, 2009

NET CAPITAL		
Total stockholder's equity from statement of financial condition		\$ 1,576,060
Deductions and/or charges		
Nonallowable assets		
Property and equipment	\$(231,682)	
Receivable from Parent	(830,944)	
Other assets	<u>(66,325)</u>	<u>(1,128,951)</u>
Net capital before haircuts on securities positions		447,109
Haircuts on securities positions		
Trading and investment securities		<u>(18,089)</u>
NET CAPITAL		<u>\$ 429,020</u>
AGGREGATE INDEBTEDNESS		
Total liabilities from statement of financial condition		<u>\$ 611,409</u>
TOTAL AGGREGATE INDEBTEDNESS		<u>\$ 611,409</u>
NET CAPITAL REQUIREMENT		
Minimum capital required to be maintained (the greater of \$250,000 or 1/15 of aggregate indebtedness)		<u>\$ 250,000</u>
Excess net capital		<u>\$ 179,020</u>
Excess net capital at 1000% (1)		<u>\$ 179,020</u>
Ratio of aggregate indebtedness to net capital		1.43 to 1

(1) Computed using minimum capital required to be maintained (the greater of \$250,000 or 1/10 of aggregate indebtedness).

Geary Securities, Inc.
(a wholly owned subsidiary of The Geary Companies, Inc.)

COMPUTATION OF NET CAPITAL FOR BROKERS AND DEALERS PURSUANT TO
RULE 15c3-1 UNDER THE SECURITIES EXCHANGE ACT OF 1934

December 31, 2009

The Company filed, on February 17, 2010 an amended Financial and Operational Combined Uniform Single (FOCUS) report that contained the reconciliation and explanation of material differences between the amended report and the original report.

Adjustments to record additional rent expense and goodwill impairment resulted in a decrease to total stockholder's equity with a corresponding decrease to receivable from Parent and goodwill when compared to the unaudited part II of Form X-17A-5 as of December 31, 2009, as amended. These adjustments had no effect on net capital or total aggregate indebtedness.



Board of Directors
Geary Securities, Inc.

Audit • Tax • Advisory
Grant Thornton LLP
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www.GrantThornton.com

In planning and performing our audit of the financial statements of Geary Securities, Inc., formerly Capital West Securities, Inc. (the Company), as of and for the year ended December 31, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding securities. This study included test of such practices and procedures the we considered relevant to the objectives stated in Rule 17a-5(g) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and for determining compliance with the exemptive provisions of Rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial function relating to customer securities, we did not review the practices and procedures followed by the Company in any of the following:

1. Making quarterly securities examinations, counts, verifications, and comparisons and recordation of difference required by Rule 17a-13.
2. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the SEC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (US GAAP). Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control or the practices and procedures referred to above, errors or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate. .

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the Company's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined above.

We understand that practices and procedures that accomplish the objective referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures as described in the second paragraph of this report were adequate at December 31, 2009, to meet the SEC's objectives.

This report is intended solely for the information and use of the Board of Directors, management, the SEC, Financial Industry Regulatory Authority and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Grant Thornton LLP

Oklahoma City, Oklahoma
March 9, 2010

FORM
X-17A-5

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
FOCUS REPORT
(FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT)
PART IIA 12

(Please read instructions before preparing Form)

This report is being filed pursuant to (Check Applicable Block(s)):

- 1) Rule 17a-5(a) 16
- 2) Rule 17a-5(b) 17
- 3) Rule 17a-11 18
- 4) Special request by designated examining authority 19
- 5) Other 26

NAME OF BROKER-DEALER

GEARY SECURITIES, INC. 13

ADDRESS OF PRINCIPAL PLACE OF BUSINESS (Do not use P.O. Box No.)

211 NORTH ROBINSON STREET SUITE 200 20
(No. and Street)

OKLAHOMA CITY 21 OK 22 73102-7101 23
(City) (State) (Zip Code)

SEC. FILE NO.

8-48259 14

FIRM ID NO.

38182 15

FOR PERIOD BEGINNING (MM/DD/YY)

02/01/10 24

AND ENDING (MM/DD/YY)

02/26/10 25

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT (Area code) - Telephone No.

Norman Frager 30

(800) 297-8734 31

NAME(S) OF SUBSIDIARIES OR AFFILIATES CONSOLIDATED IN THIS REPORT

OFFICIAL USE

32

33

34

35

36

37

38

39

DOES RESPONDENT CARRY ITS OWN CUSTOMER ACCOUNTS ? YES 40 NO 41

CHECK HERE IF RESPONDENT IS FILING AN AUDITED REPORT 42

EXECUTION:

The registrant/broker or dealer submitting this Form and its attachments and the person(s) by whom it is executed represent hereby that all information contained therein is true, correct and complete. It is understood that all required items, statements, and schedules are considered integral parts of this Form and that the submission of any amendment represents that all unamended items, statements and schedules remain true, correct and complete as previously submitted.

Dated the _____ day of _____ 20 _____

Manual Signatures of:

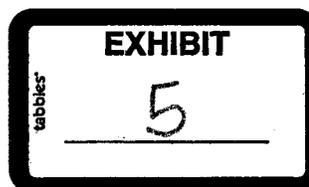
1) _____
Principal Executive Officer or Managing Partner

2) _____
Principal Financial Officer or Partner

3) _____
Principal Operations Officer or Partner

ATTENTION - Intentional misstatements or omissions of facts constitute Federal Criminal Violations. (See 18 U.S.C. 1001 and 15 U.S.C. 78:f (a))

FINRA



FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIA

BROKER OR DEALER
GEARY SECURITIES, INC.

as of 02/26/10

STATEMENT OF FINANCIAL CONDITION FOR NONCARRYING,
NONCLEARING AND CERTAIN OTHER BROKERS OR DEALERS
LIABILITIES AND OWNERSHIP EQUITY

<u>Liabilities</u>	A.I. <u>Liabilities</u>	Non-A.I. <u>Liabilities</u>	<u>Total</u>
13. Bank loans payable	\$ 1045	\$ 1255	\$ 1470
14. Payable to brokers or dealers:			
A. Clearance account	103,725 1114	1315	103,725 1560
B. Other	1115	1305	1540
15. Payable to non-customers	1155	1355	1610
16. Securities sold not yet purchased, at market value		1360	1620
17. Accounts payable, accrued liabilities, expenses and other	327,470 1205	1385	327,470 1685
18. Notes and mortgages payable:			
A. Unsecured	1210		1690
B. Secured	1211	1390	1700
19. Liabilities subordinated to claims of general creditors:			
A. Cash borrowings:		1400	1710
1. from outsiders \$ 970			
2. Includes equity subordination (15c3-1(d)) of	960		
B. Securities borrowings, at market value from outsiders \$ 990		1410	1720
C. Pursuant to secured demand note collateral agreements		1420	1730
1. from outsiders \$ 1000			
2. includes equity subordination (15c3-1(d)) of	1010		
D. Exchange memberships contributed for use of company, at market value		1430	1740
E. Accounts and other borrowings not qualified for net capital purposes	1220	1440	1750
20. TOTAL LIABILITIES	\$ 431,195 1230	\$ 1450	\$ 431,195 1760
 <u>Ownership Equity</u>			
21. Sole proprietorship			\$ 1770
22. Partnership (limited partners)	\$ 1020		1780
23. Corporation:			
A. Preferred stock			1791
B. Common stock		30,000	1792
C. Additional paid-in capital		853,571	1793
D. Retained earnings		148,796	1794
E. Total		1,032,367	1795
F. Less capital stock in treasury		(1796)	1800
24. TOTAL OWNERSHIP EQUITY			\$ 1,032,367 1800
25. TOTAL LIABILITIES AND OWNERSHIP EQUITY			\$ 1,463,562 1810

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIA

BROKER OR DEALER GEARY SECURITIES, INC.	as of	02/26/10
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COMPUTATION OF NET CAPITAL

1. Total ownership equity from Statement of Financial Condition	\$	1,032,367	3480
2. Deduct ownership equity not allowable for Net Capital	(3490
3. Total ownership equity qualified for Net Capital		1,032,367	3500
4. Add:			
A. Liabilities subordinated to claims of general creditors allowable in computation of net capital			3520
B. Other (deductions) or allowable credits (List)			3525
5. Total capital and allowable subordinated liabilities	\$	1,032,367	3530
6. Deductions and/or charges:			
A. Total non-allowable assets from			
Statement of Financial Condition (Notes B and C)	\$	269,610	3540
B. Secured demand note deficiency			3590
C. Commodity futures contracts and spot commodities- proprietary capital charges			3600
D. Other deductions and/or charges			3610
	(269,610	3620
7. Other additions and/or allowable credits (List)			3630
8. Net Capital before haircuts on securities positions	\$	762,757	3640
9. Haircuts on securities (computed, where applicable, pursuant to 15c3-1(f)) :			
A. Contractual securities commitments	\$		3660
B. Subordinated securities borrowings			3670
C. Trading and investment securities:			
1. Exempted securities		17,290	3735
2. Debt securities			3733
3. Options			3730
4. Other securities		9	3734
D. Undue concentration			3650
E. Other (List)			3736
	(17,299	3740
10. Net Capital	\$	745,458	3750

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIA

BROKER OR DEALER GEARY SECURITIES, INC.	as of	02/26/10
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COMPUTATION OF BASIC NET CAPITAL REQUIREMENT

Part A

11. Minimum net capital required (6-2/3% of line 19)	\$	28,746	3756
12. Minimum dollar net capital requirement of reporting broker or dealer and minimum net capital requirement of subsidiaries computed in accordance with Note (A)	\$	250,000	3758
13. Net capital requirement (greater of line 11 or 12)	\$	250,000	3760
14. Excess net capital (line 10 less 13)	\$	495,458	3770
15. Net capital less greater of 10% of line 19 or 120% of line 12	\$	445,458	3780

COMPUTATION OF AGGREGATE INDEBTEDNESS

16. Total A.I. liabilities from Statement of Financial Condition	\$	431,195	3790
17. Add:			
A. Drafts for immediate credit	\$	3800	
B. Market value of securities borrowed for which no equivalent value is paid or credited	\$	3810	
C. Other unrecorded amounts (List)	\$	3820	3830
19. Total aggregate indebtedness	\$	431,195	3840
20. Percentage of aggregate indebtedness to net capital (line 19 divided by line 10)	%	57.84	3850
21. Percentage of debt to debt-equity total computed in accordance with Rule 15c-3-1(d)	%	0.00	3860

COMPUTATION OF ALTERNATE NET CAPITAL REQUIREMENT

Part B

22. 2% of combined aggregate debit items as shown in Formula for Reserve Requirements pursuant to Rule 15c3-3 prepared as of the date of net capital computation including both brokers or dealers and consolidated subsidiaries' debits	\$	3870	3870
23. Minimum dollar net capital requirement of reporting broker or dealer and minimum net capital requirement of subsidiaries computed in accordance with Note (A)	\$	3880	3880
24. Net capital requirement (greater of line 22 or 23)	\$	3760	3760
25. Excess net capital (line 10 less 24)	\$	3910	3910
26. Net capital in excess of the greater of:			
5% of combined aggregate debit items or 120% of minimum net capital requirement	\$	3920	3920

NOTES:

(A) The minimum net capital requirement should be computed by adding the minimum dollar net capital requirement of the reporting broker dealer and, for each subsidiary to be consolidated, the greater of:

1. Minimum dollar net capital requirement, or
2. 6-2/3% of aggregate indebtedness or 4% of aggregate debits if alternative method is used.

(B) Do not deduct the value of securities borrowed under subordination agreements or secured demand notes covered by subordination agreements not in satisfactory form and the market values of the memberships in exchanges contributed for use of company (contra to item 1740) and partners' securities which were included in non-allowable assets.

(C) For reports filed pursuant to paragraph (d) of Rule 17a-5, respondent should provide a list of material non-allowable assets.

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIA

BROKER OR DEALER GEARY SECURITIES, INC.
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For the period (MMDDYY) from 02/01/10 3932 to 02/26/10 3933
Number of months included in this statement 1 3931

REVENUE

STATEMENT OF INCOME (LOSS)

1. Commissions:			
a. Commissions on transactions in exchange listed equity securities executed on an exchange	\$	154	3935
b. Commissions on listed option transactions		2,371	3938
c. All other securities commissions		148,903	3939
d. Total securities commissions		151,428	3940
2. Gains or losses on firm securities trading accounts			
a. From market making in options on a national securities exchange			3945
b. From all other trading		24,564	3949
c. Total gain (loss)		24,564	3950
3. Gains or losses on firm securities investment accounts			3952
4. Profits (losses) from underwriting and selling groups		96,258	3955
5. Revenue from sale of investment company shares		9,830	3970
6. Commodities revenue			3990
7. Fees for account supervision, investment advisory and administrative services			3975
8. Other revenue			3995
9. Total revenue		\$ 282,080	4030

EXPENSES

10. Salaries and other employment costs for general partners and voting stockholder officers			4120
11. Other employee compensation and benefits		345,601	4115
12. Commissions paid to other brokers-dealers		12,225	4140
13. Interest expense		3,661	4075
a. Includes interest on accounts subject to subordination agreements		4070	
14. Regulatory fees and expenses		1,905	4195
15. Other expenses		228,950	4100
16. Total expenses		\$ 592,342	4200

NET INCOME

17. Net Income (loss) before Federal income taxes and items below (Item 9 less Item 16)		\$ (310,262)	4210
18. Provision for Federal income taxes (for parent only)			4220
19. Equity in earnings (losses) of unconsolidated subsidiaries not included above			4222
a. After Federal income taxes of		4238	
20. Extraordinary gains (losses)			4224
a. After Federal income taxes of		4239	
21. Cumulative effect of changes in accounting principles			4225
22. Net income (loss) after Federal income taxes and extraordinary items		\$ (310,262)	4230

MONTHLY INCOME

23. Income (current month only) before provision for Federal Income taxes and extraordinary items		(310,262)	4211
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FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIA

BROKER OR DEALER GEARY SECURITIES, INC.
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For the period (MMDDYY)-from 02/01/10 to 02/26/10

STATEMENT OF CHANGES IN OWNERSHIP EQUITY
(SOLE PROPRIETORSHIP, PARTNERSHIP OR CORPORATION)

1. Balance, beginning of period	\$	1,342,629	4240
A. Net income (loss)		(310,262)	4250
B. Additions (includes non-conforming capital of	\$	4262	4260
C. Deductions (includes non-conforming capital of	\$	4272	4270
2. Balance, end of period (from item 1800)	\$	1,032,367	4290

STATEMENT OF CHANGES IN LIABILITIES SUBORDINATED
TO CLAIMS OF GENERAL CREDITORS

3. Balance, beginning of period	\$		4300
A. Increases			4310
B. Decreases			4320
4. Balance, end of period (from item 3520)	\$		4330

OMIT PENNIES

**FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIA**

BROKER OR DEALER GEARY SECURITIES, INC.	as of <u>02/26/10</u>
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Exemptive Provision Under Rule 15c3-3

25. If an exemption from Rule 15c3-3 is claimed, identify below the section upon which such exemption is based :

- A. (k) (1) - Limited business (mutual funds and/or variable annuities only) \$ 4550
- B. (k) (2) (i) - "Special Account for the Exclusive Benefit of customers" maintained 4560
- C. (k) (2) (ii) - All customer transactions cleared through another broker-dealer on a fully disclosed basis.
 Name(s) of Clearing Firm(s) - Please separate multiple names with a semi-colon
Pershing LLC 4335 X 4570
- D. (k) (3) - Exempted by order of the Commission 4580

**Ownership Equity and Subordinated Liabilities maturing or proposed to be
withdrawn within the next six months and accruals, (as defined below),
which have not been deducted in the computation of Net Capital.**

Type of Proposed Withdrawal or Accrual (See below for code to enter)	Name of Lender or Contributor	Insider or Outsider ? (In or Out)	Amount to be with- drawn (cash amount and/or Net Capital Value of Securities)	(MMDDYY) Withdrawal or Maturity Date	Expect to Renew (Yes or No)
<u>4600</u>	<u>4601</u>	<u>4602</u>	<u>4603</u>	<u>4604</u>	<u>4605</u>
<u>4610</u>	<u>4611</u>	<u>4612</u>	<u>4613</u>	<u>4614</u>	<u>4615</u>
<u>4620</u>	<u>4621</u>	<u>4622</u>	<u>4623</u>	<u>4624</u>	<u>4625</u>
<u>4630</u>	<u>4631</u>	<u>4632</u>	<u>4633</u>	<u>4634</u>	<u>4635</u>
<u>4640</u>	<u>4641</u>	<u>4642</u>	<u>4643</u>	<u>4644</u>	<u>4645</u>
<u>4650</u>	<u>4651</u>	<u>4652</u>	<u>4653</u>	<u>4654</u>	<u>4655</u>
<u>4660</u>	<u>4661</u>	<u>4662</u>	<u>4663</u>	<u>4664</u>	<u>4665</u>
<u>4670</u>	<u>4671</u>	<u>4672</u>	<u>4673</u>	<u>4674</u>	<u>4675</u>
<u>4680</u>	<u>4681</u>	<u>4682</u>	<u>4683</u>	<u>4684</u>	<u>4685</u>
<u>4690</u>	<u>4691</u>	<u>4692</u>	<u>4693</u>	<u>4694</u>	<u>4695</u>
TOTAL			\$ <u>4699</u>		

OMIT PENNIES

Instructions: Detail listing must include the total of items maturing during the six month period following the report date, regardless of whether or not the capital contribution is expected to be renewed. The schedule must also include proposed capital withdrawals scheduled within the six month period following the report date including the proposed redemption of stock and payments of liabilities secured by fixed assets (which are considered allowable assets in the capital computation pursuant to Rule 15c3-1(c) (2) (iv)), which could be required by the lender on demand or in less than six months.

WITHDRAWAL CODE:	DESCRIPTION
1.	Equity Capital
2.	Subordinated Liabilities
3.	Accruals
4.	15c3-1(c) (2) (iv) Liabilities

(a)(2) MINIMUM REQUIREMENTS(i) BROKERS OR DEALERS THAT CARRY CUSTOMER ACCOUNTS

A broker or dealer (other than one described in paragraphs (a)(2)(ii) or (a)(8) of this section) shall maintain net capital of not less than \$250,000 if it carries customer or broker or dealer accounts and receives or holds funds or securities for those persons. A broker or dealer shall be deemed to receive funds, or to carry customer or broker or dealer accounts and to receive funds from those persons if, in connection with its activities as a broker or dealer, it receives checks, drafts, or other evidences of indebtedness made payable to itself or persons other than the requisite registered broker or dealer carrying the account of a customer, escrow agent, issuer, underwriter, sponsor, or other distributor of securities. A broker or dealer shall be deemed to hold securities for, or to carry customer or broker or dealer accounts, and hold securities of, those persons if it does not promptly forward or promptly deliver all of the securities of customers or of other brokers or dealers received by the firm in connection with its activities as a broker or dealer. A broker or dealer, without complying with this paragraph (a)(2)(i), may receive securities only if its activities conform with the provisions of paragraphs (a)(2)(iv) or (v) of this section, and may receive funds only in connection with the activities described in paragraph (a)(2)(v) of this section.

/01 Introducing Brokers

Introducing brokers who do not meet the requirements outlined in interpretation 15c3-1(a)(2)(iv)/01 shall be subject to the requirements of brokers that carry customer accounts.

(SEC Staff to NYSE) (No. 93-6, November 1993)

/02 Non-Carrying Brokers

A broker who clears and carries only accounts of "non-customers" is subject to the minimum net capital requirement under SEA Rule 15c3-1(a)(2)(i).

(SEC Staff to NYSE)

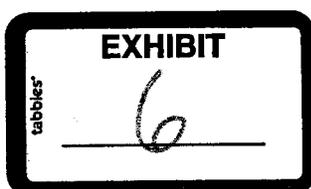
/03 Prime Broker Capital Requirements

A broker-dealer that acts as a prime broker must maintain net capital of not less than \$1,500,000.

A broker-dealer acting as an executing broker in a prime broker relationship who self clears or a broker-dealer clearing prime broker transactions on behalf of an introducing executing broker must have minimum net capital of at least \$1,000,000.

A broker-dealer must notify its DEA that it intends to act as a prime broker.

(SEC Letter to SIA, January 24, 1994) (No. 94-5, May 1994)



SEA Rule 15c3-1(a)(2)(i)/03

(a)(2) MINIMUM REQUIREMENTS (continued)

(iv) BROKERS OR DEALERS THAT INTRODUCE CUSTOMER ACCOUNTS AND RECEIVE SECURITIES

A broker or dealer shall maintain net capital of not less than \$50,000 if it introduces transactions and accounts of customers or other brokers or dealers to another registered broker or dealer that carries such accounts on a fully disclosed basis, and if the broker or dealer receives but does not hold customer or other broker or dealer securities. A broker or dealer operating under this paragraph (a)(2)(iv) of this section may participate in a firm commitment underwriting without being subject to the provisions of paragraph (a)(2)(iii) of this section, but may not enter into a commitment for the purchase of shares related to that underwriting.

/01 Requirements for Broker-Dealers Who Introduce Accounts on a Fully Disclosed Basis

Firms who introduce their accounts on a fully disclosed basis and wish to maintain their minimum Net Capital requirement pursuant to this paragraph (a)(2)(iv), must meet the following requirements:

1. The introducing firm must maintain a written clearing agreement (signed by the clearing broker-dealer) which states that for purposes of SIPA and SEA Rules 15c3-3, and 15c3-1, the customers are customers of the clearing firm and not the introducing firm;
2. The clearing firm must issue all account statements directly to customers;
3. Account statements must disclose the fact that all customer funds and/or securities are located at the clearing broker-dealer; and
4. Account statements must provide a contact person or department at the clearing firm who can address customer inquiries regarding their account(s).

If the introducing firm fails to meet any of the above requirements, it would be required to comply with the greater minimum net capital requirements of a broker-dealer that carries customer accounts.

The introducing firm should also maintain procedures to prevent their customers from transmitting funds (other than checks made out to appropriate third parties) to the firm (except by error). Procedures should address the actions the broker-dealer will take to advise its customers (in writing) should they send funds to the firm by error.

(SEC Release No. 34-31511) (No. 93-6, November 1993)

SEA Rule 15c3-1(a)(2)(iv)/01

(a)(2)(iv) MINIMUM REQUIREMENTS; BROKERS OR DEALERS THAT INTRODUCE CUSTOMER ACCOUNTS AND RECEIVE SECURITIES (continued)

/02 Introducing Brokers - Receiving Funds

Any introducing broker that receives customer funds (checks made payable to itself and or cash), except by error, will be subject to the minimum net capital requirements of a broker-dealer that carries customer accounts (See SEA Rule 15c3-1(a)(2)(i).)

(SEC Release No. 34-31511, December 2, 1992) (No. 93-6, November 1993)

/03 Commission Recapture/Commission Rebate Program of Introducing Brokers

Any introducing broker who rebates a portion of its commission back to its customers either as a cash payment or to a creditor of the customer is required to maintain a minimum net capital requirement of at least \$250,000. It is also considered a carrying firm for purposes of SEA Rule 15c3-3 unless it elects the following method for the handling of the customers' rebates:

The introducing broker deposits money into a separate 15c3-3 bank account similar to those accounts established under a SEA Rule 15c3-3(k)(2)(i) exemption and the balance in the bank account at all times must equal or exceed the payables to customers. The firm issues checks from this bank account to pay the customer or the creditor of the customer.

(SEC Staff to NYSE) (No. 02-3, February 2002)

(a)(2)(vi) MINIMUM REQUIREMENTS; OTHER BROKERS OR DEALERS (continued)/021 Requirement to use a Qualified Escrow Agent

A broker-dealer operating pursuant to the \$5,000 minimum net capital requirement of SEA Rule 15c3-1(a)(2)(vi) must comply with the provisions of SEA Rule 15c2-4(b)(2) when participating in a contingent best efforts underwriting or offering. This provision of the rule requires that customer funds in a contingent offering must be deposited in an escrow account with a qualified escrow agent, that has agreed in writing to hold such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto, when the appropriate event or contingency has occurred. A qualified escrow agent must be a bank that is unaffiliated with either the issuer; general partner of the issuer; or the broker-dealer. A bank is defined in Section 3(a)(6) of the Securities Exchange Act and does not include a Savings and Loan Association or Credit Union. Failure to comply with the escrow requirements of SEA Rule 15c2-4(b)(2) subjects a \$5,000 broker-dealer to a \$250,000 minimum net capital requirement and nullifies its SEA Rule 15c3-3 exemption.

(SEC Staff of DMR to NASD Notice to Members 84-7)

/03 Introducing Brokers - Receiving Funds

Any introducing broker that receives customer funds (checks made payable to itself and or cash), except by error, will be subject to the minimum net capital requirements of a broker-dealer that carries customer accounts (SEA Rule 15c3-1(a)(2)(i)).

(SEC Release No. 34-31511, December 2, 1992) (No. 93-6, November 1993)

/031 Error Transactions of Floor Brokers – (Rescinded, No. 02-7, August 2002)/032 Error Transactions of Floor Brokers

When a broker-dealer, which is primarily in the business of acting as a floor broker, makes an error in executing a transaction, which is done as a floor broker for another broker, no haircut need be taken on the resulting error position provided the security position is immediately liquidated upon discovery, but no later than the closing of the business day after the day the error occurred.

A broker-dealer is considered to be primarily in the business of acting as a floor broker when 75% of its gross revenue is derived from floor brokerage commissions.

This interpretation is applicable for a floor broker which either owns its seat or leases its seat.

(SEC Staff to NYSE) (No. 02-7, August 2002)

SEA Rule 15c3-1(a)(2)(vi)/032

Release No. 31511 (S.E.C. Release No.), Release No. 34-31511, 52 S.E.C. Docket 2694, 1992 WL 356004
17 CFR Part 240

S.E.C. Release No.
Securities Exchange Act of 1934

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

NET CAPITAL RULE

File No. S7-28-89

RIN: 3235-AD79

November 24, 1992

*1 AGENCY: Securities and Exchange Commission

ACTION: Final Rule Amendments

SUMMARY: The Securities and Exchange Commission is amending its net capital rule under the Securities Exchange Act. The amendments will raise the absolute minimum net capital required of certain registered broker-dealers. Broker-dealers that hold customer funds or securities will be required to maintain at least \$250,000 in net capital. Those firms that clear customer transactions but do not hold customer funds or securities beyond the settlement of the transaction will be subject to a \$100,000 minimum net capital requirement. Broker-dealers that introduce customer accounts to other broker-dealers will be required to maintain \$50,000 or \$5,000 in minimum net capital, depending on whether or not they receive securities. Broker-dealers that make markets in certain securities will be required to maintain greater net capital in proportion to the number of securities in which they make markets. The maximum on this additional market maker minimum net capital requirement will be raised from \$100,000 to \$1,000,000. The minimum net capital requirement for certain mutual fund broker-dealers will be increased to \$25,000. The increases to the minimum capital levels will be implemented over a period of eighteen months. Additionally, the two methods of computing deductions for equity securities positions (or "haircuts") will be standardized. Finally, certain changes will be made to the computation of aggregate indebtedness.

EFFECTIVE DATE: For the amendments relating to equity securities haircuts (paragraph (c)(2)(vi)(J)), charges to aggregate indebtedness (paragraph (c)(1)), and the capital requirements for market makers (paragraph (a)(4), except as to that provision raising the ultimate market maker capital requirement to \$1,000,000, which shall become effective on June 30, 1993), the effective date shall be January 1, 1993. For the amendments relating to minimum net capital requirements contained in paragraph (a), see the temporary phase-in schedule set forth in Appendix E to Rule 15c3-1.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, (202) 272-2904, Michael P. Jamroz, (202) 272-2372 or Roger G. Coffin, (202) 272-7375, Division of Market Regulation, 450 Fifth Street, N.W., Washington, D.C. 20549.

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SUPPLEMENTARY INFORMATION:

I. Introduction

A. The Commission's Proposal.

On September 15, 1989, the Commission issued a release requesting comment on proposed increases to the minimum net capital requirements applicable to broker-dealers.¹ The Commission was concerned that the minimum net capital requirements, which in some cases dated back to 1972, were no longer adequate.

In that release, the Commission proposed increases in the minimum capital requirements for registered broker-dealers, based on the nature of the business of the firm, and the extent to which a broker-dealer has contact with customer funds or securities. Briefly, under the proposal, firms that carry customer accounts would be required to maintain at least \$250,000 in net capital. Broker-dealers that clear customer accounts in accordance with Securities Exchange Act Rule 15c3-3(k)(2)(i) (and therefore, although they may receive funds or securities, they may not hold them beyond the settlement of a transaction) would be required to maintain at least \$100,000 in net capital. Firms that introduce customer accounts to other broker-dealers would be required to maintain a minimum net capital of \$100,000 or \$50,000, depending upon whether the firm routinely or occasionally receives customer funds or securities. Under the proposal, broker-dealers that never receive customer funds or securities would be allowed to maintain minimum net capital of \$5,000.

The minimum net capital required to be maintained by firms that make markets in securities also would be raised under the proposed amendments. Under the net capital rule, a market maker is required to maintain the greater of the base minimum net capital requirements referred to above or an amount of net capital determined by the number of securities in which the firms makes markets. The net capital rule currently draws a distinction in this regard based on the price of the security. Securities priced \$5 and below require capital of \$500 each, while securities priced above \$5 require capital of \$2,500 each. Under the proposal, the amount to be maintained for securities priced under \$5 per share would be raised to \$1,000 per security. The ceiling on this net capital requirement would have been raised to \$1,000,000, from the present \$100,000.

*3 The proposed amendments also included provisions that would standardize the deductions under the rule for proprietary positions in equity securities. Currently, the applicable deduction (or "haircut") depends on the method the broker-dealer elects to compute its net capital requirement. Broker-dealers calculating their net capital under the basic method incur a different haircut charge than those computing haircuts on the alternative method, which generally results in lower haircut charges than the basic method.

Further, broker-dealers computing net capital under the basic method would realize reductions in aggregate indebtedness charges for liabilities associated with mutual fund and securities lending transactions. Finally, the Commission proposed that, for the purpose of calculating haircuts, stripped debt instruments be accorded the same treatment, for haircut purposes, as equity securities. The Commission's proposal will be discussed in greater detail in the appropriate sections of this release.

The Commission believes that the concerns articulated in the proposing release are valid, and is therefore adopting most of the proposed amendments. Certain changes to the original rule amendments have been made however, and these changes will necessitate the proposal of additional amendments to the net capital rule. Therefore, the Commission is issuing two releases that relate to the minimum net capital standards applicable to broker-dealers. This release discusses the proposals that are

being adopted by the Commission. In a separate release, the Commission is proposing for comment further amendments to the minimum net capital standards.

B. Brief Summary of Comments.

The Commission received almost 275 letters in response to the proposed rule changes. Approximately 200 of the commentators objected generally to the proposed increases in minimum net capital requirements. Most of the commentators writing in protest against the increases objected to the proposed increases to the net capital requirements for introducing and mutual fund broker-dealers. Primarily, these firms feared that an increase in minimum net capital requirements would restrict entry into the securities business and force existing entities to close. A frequently voiced complaint was that the proposal discriminated against smaller firms in favor of larger enterprises without sufficient justification.

Self-regulatory organizations and other groups including the New York Stock Exchange ("NYSE"), the Securities Industry Association ("SIA"), the American Bar Association, the Chicago Bar Association, the Philadelphia Stock Exchange ("Phlx"), and the Midwest Stock Exchange generally supported the proposal. These commentators acknowledged the need to increase minimum net capital requirements and concurred with the general concerns set forth in the release proposing the amendments for comment. In particular, the National Association of Securities Dealers, Inc. ("NASD") expressed support for raising minimum net capital levels generally and made specific recommendations regarding the appropriate levels for introducing firms. The NASD's recommendation has, in large part, served as the framework for the requirements for introducing firms set forth in the releases being issued today.

*4 Comments with respect to the increased net capital requirements for firms that carry and clear customer accounts were split; a number of commentators objected to the potential anti-competitive effects of the increases. However, others recognized the risks created by firms that hold customer funds and securities and acknowledged the need for regulatory action.

The Commission received mixed comments with respect to its proposal to increase the minimum capital requirements of firms that make markets in over-the-counter securities. The NASD and the SIA supported the proposal; a number of broker-dealers criticized it, claiming that an increase in capital requirements would drive some market makers away from the over-the-counter securities market, reducing liquidity.

Firms that commented on the proposed new haircuts for zero-coupon and stripped securities opposed the measure on the ground that the proposed haircut was not reflective of the risks or volatility associated with stripped debt securities. In this regard, the Public Securities Association ("PSA") provided data on the volatility of stripped securities to be used in determining haircuts for these instruments. The proposals to standardize haircuts and alter the computation of aggregate indebtedness were generally supported by the commentators.

C. The Net Capital Rule.

The Commission's net capital rule requires that every registered broker-dealer maintain a certain specified minimum level of net capital.² Rule 15c3-1 requires registered broker-dealers to maintain sufficient liquid assets to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding.³ The rule prescribes required minimum levels based upon both the method the firm adopts in computing its net capital and the type of securities business it conducts. A firm engaging in a general securities business (which would include the ability to clear and carry customer accounts) calculating its net capital under the basic (or aggregate indebtedness method) must maintain a minimum net capital level of the greater of \$25,000 or 6 2/3 percent of its liabilities (with certain exclusions). If the firm chooses the alternative method of computing its net capital (presently found in paragraph (f) of the rule), it must maintain net capital equal to the greater of \$100,000 or 2 percent of its customer-related receivables.

The current rule prescribes different minimum levels of net capital for firms based on categories of business activity. These levels were designed to address the risks perceived in the different types of businesses engaged in by broker-dealers. For example, if a

broker-dealer carries no customer accounts and limits its business to certain specified activities, it needs to maintain only \$5,000 in net capital, rather than the \$25,000 that would otherwise be required under the basic method of computing net capital.⁴ One of the specified activities permitted is the introducing, on a fully disclosed basis, of customer accounts to another broker-dealer that clears and carries the accounts.

II. Rule Amendments—Minimum Net Capital Requirements

*5 The following section of this release addresses, in greater detail, the Commission's amendments to the net capital rule concerning minimum net capital requirements.

A. Clearing Firms.

(i) The Commission's Proposal and the Need for Increases.

The Commission's proposal would raise the minimum net capital requirements of firms that clear customer accounts and hold customer funds and securities from \$25,000 (or \$100,000 for firms on the alternative method) to \$250,000. Because of the reduced risk, clearing firms that receive customer funds and securities but do not maintain custody of such assets beyond the settlement of a transaction (and are therefore exempt from the customer protection rule by virtue of paragraph (k)(2)(i)) would have a minimum net capital requirement of only \$100,000.⁵

The Commission believes it is appropriate to require the highest minimum level of net capital for broker-dealers that are entrusted with the money and securities of customers, who are, in most instances, incapable of assessing the financial condition of custodian firms. The required minimum net capital level for custodian firms should not be such that the slightest financial adversity will cause the collapse of the broker-dealer, an event that may cause delays and possible losses to customers and the Securities Investor Protection Corporation ("SIPC") fund.

Several liquidations supervised by the NASD illustrate the potential dangers more dramatically. One firm held \$70 million of customer securities, although it maintained only \$61,000 of net capital. Another held \$8 million of customer securities against only \$42,000 in net capital. In both instances, the NASD became aware of financial difficulties in time to have the firms transfer the customer accounts to other broker-dealers, thereby avoiding SIPC liquidations.

During a self-liquidation, the expenses of a firm continue while its revenues drop significantly, often to zero. For example, employees of the firm being liquidated are retained in order to perform the services associated with transferring customer accounts to other firms. The salaries of these employees, along with the costs associated with maintaining the premises of the firm and transferring securities are borne out of the remaining capital of the firm. A self-liquidation can take from three weeks to several months, depending on the condition of the records of the broker-dealer and whether other broker-dealers willing to take the customer accounts can be readily located.

Self-liquidation costs incurred by the self-regulatory authorities are difficult to measure, because a large portion of the expenses are for non-incremental employee salaries, although for broker-dealers located outside the commuting distance of an NASD regional office, there could be substantial employee per diem and travel expenses. The staff of the NASD has advised the Commission that, on average, even the smallest self-liquidation requires two to three NASD employees on premises for a minimum of two weeks. By contrast, a recent large liquidation required approximately 25 NASD employees on premises for almost ten weeks.

*6 Above and beyond accounting for costs, the Commission notes that customers of a firm undergoing a SIPC liquidation are usually unable to access their accounts during the liquidation. Aside from possible financial harm to customers, the delay in a liquidation causes considerable customer anxiety. Although every attempt is made to transfer the accounts of the insolvent broker-dealer to a healthy firm as quickly as possible, or to disburse the assets of the accounts directly to customers, delays

can occur for many different reasons. A supervised self-liquidation can avoid the delays that might arise in the context of a court-imposed liquidation.

While requiring additional amounts of capital will not prevent firms from failing, the additional capital serves as a fund from which the expenses associated with a liquidation can be paid. Moreover, the greater sum will act as a more reliable cushion against the use of SIPC money to liquidate a failed broker-dealer. In most instances, a \$250,000 minimum net capital requirement should prove to be a sufficient cushion for a reasonably conducted self-liquidation before a broker-dealer's insolvency. The self-regulatory organizations will be less hesitant to intervene and supervise a self-liquidation if there are thereby fewer questions concerning the liquidity of the firm's assets or if there is less of a threat by outside creditors to move against the broker-dealer. This is the most desirable situation for the customers of a firm that is no longer viable.

Other organizations have expressed concern about the minimum levels of net capital. The Commodity Futures Trading Commission ("CFTC") recently approved amendments to National Futures Association ("NFA") rules that increased the minimum net capital requirements of futures commission merchants from \$50,000 to \$250,000.⁶ The Options Clearing Corporation requires its new members to maintain \$1 million in net capital and other members to maintain \$750,000 in net capital.⁷ The National Securities Clearing Corporation requires its member broker-dealers to maintain \$50,000 in excess net capital over that required by Rule 15c3-1.⁸

(ii) Industry Response.

Generally, the self-regulatory organizations, SIPC, and the SIA expressed approval of the higher requirements. Both the NYSE and the NASD specifically endorsed the proposal for clearing and carrying firms. However, approximately twenty-five broker-dealers expressed their opposition to the proposed \$250,000 requirement. Many of these firms are small to mid-size regional firms that carry customer accounts and clear their own securities transactions but do not clear the accounts of other broker-dealers. Primarily, these firms feared that the proposal would drive them out of the securities business and therefore reduce competition. It should be noted however, that even among this group of firms that objected to the proposed minimum, almost one-half stated that some increase in minimum net capital requirements is warranted. One firm candidly acknowledged that the current minimum of \$25,000 is far below what is needed to operate a securities business.

*7 Other small broker-dealers opposed the increase and disagreed with the contention that clearing firms could avoid the increased costs associated with obtaining the capital necessary to comply with the amendments by opting to become introducing broker-dealers.⁹

(iii) Impact of Increased Requirements.

It is clear that the recommended amendments will require some firms to raise additional capital. The firms that will need extra capital to comply are, the Commission believes, currently operating a securities business with an inappropriately, and in some instances dangerously, low level of net capital. While the Commission agrees with those commentators who point out that regional clearing firms provide important services to investors, the Commission also believes that undercapitalized firms endanger investors and undermine the consumer confidence upon which all firms rely. Investors who choose to leave their funds and securities with a regional self-clearing firm will be better served if that firm maintains an amount of net capital sufficient to ensure its continuity and stability in the industry.

In any event, the Commission's analysis of cost of capital data and the present net capital of clearing firms tends to refute the arguments of the commentators. Based on data received from the NASD reflecting financial information for firms designated to the NASD for examination ("NASD Data"), the approximate effect the increased requirements will have on the marketplace was calculated.¹⁰ Of the 458 NASD firms that clear customer accounts or hold customer property, 349 had net capital in excess of \$250,000. These firms had a total combined revenue of \$9.7 billion that represented 99 percent of the total revenue generated by all NASD clearing firms during the past year. Put another way, the rule amendments will affect 109 firms whose combined

revenues of \$105 million represent about 1 percent of the total \$9.8 billion of clearing firm revenues. The Commission believes that this data demonstrates that the amendments will have a minimal effect on competition among clearing firms because, for the most part, investors already deal with well capitalized entities when making investment decisions.

The Commission recognizes that a precise estimate of the costs the recommended amendments would impose on clearing firms is difficult, if not impossible to calculate, especially considering the so-called "opportunity costs" involved in tying up additional resources in minimum net capital. Nonetheless, rough estimates based on the relative cost of capital demonstrate that the effect of the amendments should not be unduly harsh.

Typically, broker-dealers are organized as corporations or partnerships. In either instance, the individual or individuals who establish the firm can deposit into the entity money either as equity capital or subordinated debt that has been borrowed personally. These deposits are deemed to be the net capital of the broker-dealer, so long as the broker-dealer incurs no liability on the personal loan.

*8 Once in the entity, the net capital of the broker-dealer may be invested in high-grade commercial paper, bank certificates of deposit or short-term government securities, all of which, as money market instruments, receive little or no haircut under the net capital rule. The Commission estimates the difference between the lending rate and the rate a broker-dealer could earn on the above mentioned instruments to be approximately three to four percent annually before taxes. Based on the NASD Data, the analysis shows that 109 clearing firms would need, on average, an additional \$120,520 each to comply with the \$250,000 requirement. Using a four percent spread to determine the cost of capital, it would cost each of the 109 clearing firms on average approximately \$4,821 per year to comply with the new requirement. This is a small insurance premium to pay to protect the investing public and the SIPC fund.

Rather than raise additional capital, many of the self-clearing firms that would be unable to meet the \$250,000 net capital requirement would have another option available. These firms could lower their minimum required capital by conducting business in accordance with paragraph (k)(2)(i) of Rule 15c3-3, or by introducing their customer accounts to a clearing firm. All but 41 of the 109 NASD clearing firms that would not meet the \$250,000 requirement would meet the \$100,000 minimum capital requirement applicable to (k)(2)(i) firms. All but 12 of these firms would be able to meet the \$50,000 requirement applicable to introducing firms.

With respect to those firms that receive funds and securities, but do not hold them pursuant to paragraph (k)(2)(i) of Rule 15c3-3, the NASD data indicates that, at the end of 1991, 62 out of the 242 firms that conduct a general securities business and operate under that exemption would be unable to meet the \$100,000 standard. Those firms would need a total of \$ 2.7 million, or an average of \$43,000 per firm, to meet the new requirements. Further, in 1991, NASD firms conducting business under the paragraph (k)(2)(i) exemption produced revenues of \$3.1 billion. The 62 firms that would not be able to meet the new \$100,000 standard had \$24 million of revenues or .75 percent of the total amount. Thus, it does not appear that the \$100,000 standard will have a significant impact on competition among this class of clearing firm.

Several commentators disputed the Commission's cost of capital estimates. Others argued that a four percent spread was too low. The Commission recognizes that broker-dealers may incur economic costs other than the estimated four percent cost of capital. For example, if a principal of a broker-dealer borrows funds personally, he or she will likely be required to pledge personal assets as collateral for the loan. Additionally, there may be other inestimable opportunity costs associated with raising and using additional capital to comply with the amendments. However, even if the estimated cost of capital were eight percent, the average cost of capital for the 109 clearing firms that need to acquire extra capital would only be \$9,642 per year, before taxes. It does not appear that these costs will be prohibitive, given the added protection the rule amendments will provide.

*9 As a concession to those firms required to meet the higher minimum requirements, the Commission's proposal would have relaxed the haircut charge associated with securities underwritings, known as the "contractual commitment haircut". The contractual commitment haircut applies to firm commitment underwritings and requires a charge on each net long securities position contemplated by any open contractual commitment in the broker-dealer's proprietary account. Currently, firms are required to take a 30 percent haircut (minus unrealized profits) on their open contractual commitments in equities. The size of

this contractual commitment haircut can discourage smaller firms from participating in securities offerings, since the haircut could threaten their net capital compliance.

Because small broker-dealers play an important role in the local capital formation process, the Commission believes that those firms meeting the higher minimum capital requirement should be permitted to enter into small firm commitment underwritings without incurring a significant contractual commitment charge. Therefore, under the rule amendments, broker-dealers that meet the \$250,000 minimum will not be required to charge its capital for any contractual commitment haircut to the extent that the haircut would not exceed \$150,000. For instance, if a broker-dealer participates in an underwriting in which it has a firm commitment to purchase securities, and the appropriate contractual commitment deduction would be \$150,000 or less, the broker-dealer would incur no haircut. Commitments resulting in potential charges in excess of \$150,000 would result in deductions on the amount in excess of \$150,000. This will benefit smaller broker-dealers that wish to engage in underwritings but were previously subject to the full amount of the contractual commitment charge.

In order to clarify the application of the \$250,000 minimum net capital standard, the amendments contain the following definitions. A broker-dealer shall not be deemed to receive funds from customers if it receives checks, drafts, or other evidences of indebtedness made payable to an entity other than itself (such as another broker-dealer, escrow agent, etc.) and the receiving broker-dealer promptly forwards such funds to the other broker-dealer or escrow agent.¹¹ With regard to securities, a broker-dealer shall be deemed to hold securities if it does not promptly forward such securities received by the firm to a clearing firm, escrow agent or other appropriate entity.

Finally, firms that choose not to meet the new levels, or are unable to do so, will not, as some commentators suggest, be forced to close their doors. Specifically, the lower net capital requirement afforded broker-dealers that operate under the (k)(2)(i) exemption from Rule 15c3-3 will provide many firms that currently hold the assets of their customers an alternative to the higher minimum for clearing and carrying firms. Moreover, they may elect to remain in the securities business with an even lower amount of capital and introduce their accounts to another firm.

*10 The Commission believes that the combined effect of the variety of options contained in the recommended amendments will allow each firm to select an appropriate amount of net capital and tailor its business activities accordingly to meet the requirement it chooses. Thus, firms will not be drawn out of the industry, and the impact on competition will be minimal. For these and the reasons stated above, the Commission is adopting the amendments regarding clearing and carrying firm net capital requirements as proposed.

B. Dealers, Market Makers and Trading Firms

The Commission's proposal would have raised the minimum net capital requirement applicable to dealers, market makers and trading firms to \$100,000 (although market makers are subject to additional net capital requirements discussed below).

(i) Dealers

The types of broker-dealers that fall under the dealer category take risks that far outweigh their present minimum net capital requirements. A minimum net capital level of only \$25,000 is an extremely thin cushion against the risks in a dealer's business, because of the potential for severe market volatility. Additionally, the proliferation of complex securities, including interest-only and principal-only mortgage-backed securities and various option products have added elements of risk not envisioned when the current minimum standards were adopted. There were no substantial adverse comments to the dealer proposals. Accordingly, the Commission believes firms that fall into this category should have a minimum net capital requirement of at least \$100,000 and is adopting the amendments.

For the purposes of determining whether a person is subject to the higher net capital requirements applicable to dealers, the term "dealer" for that purpose would include those persons that endorse or write over-the-counter options, and any broker-dealer that effects more than ten transactions in any one year for its own investment account, but would exclude firms that underwrite

securities on a best efforts or all or none basis, those that engage in certain kinds of riskless principal trading, and certain firms engaged in the sale of redeemable shares of registered investment companies.

(ii) Over-the-Counter Market Makers.

In addition to raising the base minimum requirements for market makers, the proposed amendments would raise the additional market maker capital requirement. Currently, securities priced \$5 and below require net capital of \$500 each, while securities priced above \$5 require net capital of \$2,500 each. Under the proposal, the amount to be maintained for securities priced under \$5 per share would be raised from \$500 to \$1,000 per security. The ceiling on this additional net capital requirement would be raised to \$1,000,000, from the present \$100,000. No change to the existing capital requirement of \$2,500 per share for securities priced over \$5 was proposed. The Commission is adopting these amendments as proposed.¹²

*11 Market maker capital requirements have been a cause for considerable concern since at least the market break of 1987. In its Market Break Report, the Division of Market Regulation (the "Division") stated that there should be a review of the minimum amount of capital necessary to qualify as an over-the-counter market maker. The Division noted that the review should include an analysis of the amount of capital necessary for each security, as well as the appropriateness of the capital ceiling of \$100,000. The Division's concern was precipitated by the cessation of business by 12 over-the-counter market makers immediately following the October 1987 market break. In some cases, the prices of the securities in which they made a market fell dramatically. Customer obligations, which in some cases were secured by the securities, became uncollectible. The Division pointed out that other broker-dealers and customers are also exposed to potential market losses when a significant market maker in a particular security fails. Other, less significant market makers may withdraw from the system or may restrict their purchases, often resulting in a free-fall in the prices of the securities.¹³

The NASD reacted promptly to the 1987 market break by approving amendments to its Small Order Execution System ("SOES"), which required not only mandatory participation in the SOES for all market makers in certain securities, but also maximum SOES order size limits based on the market characteristics of the securities.¹⁴ Under mandatory SOES participation, market makers are required to accept small orders received through the SOES system. Because the financial requirements resulting from the mandatory SOES obligations require higher capital levels of market makers, the NASD's Quality of Markets Committee recommended that the Commission substantially increase capital requirements for market makers.¹⁵

Despite these recommendations, a number of commentators opposed the Commission's proposal, arguing that increases would discourage firms from making markets, resulting in reduced liquidity, particularly in lower priced stocks. The Commission believes this concern is mainly unfounded. Market makers play an integral role in the securities markets and the Commission believes it is essential for these firms to maintain sufficient capital to discharge their market making activities without disruptions that can interrupt the liquidity in a particular security. Market makers that maintain the bare minimum amount of net capital are, however, frequently unable to assume even the smallest positions in the stocks in which they make markets. Indeed, the Commission believes it is those firms that maintain the bare minimum amount of capital that pose a threat to liquidity. To the extent such a firm's capital falls below the minimum, the firm is compelled to withdraw as a market maker in some of its market making securities, which could impair the market. This has been a particular problem in the marketplace for those securities priced under \$5 per share, where the failure of market making firms has resulted in the virtual elimination of a public market for many of the securities in which they made markets. When a broker-dealer holds itself out as making a market in a particular security, it should maintain sufficient capital to stand behind that commitment. That commitment is no less important in the market for securities priced below \$5 per share.

*12 Based on these reasons, the NYSE, the NASD and the SIA supported the proposal. In fact, the SIA stated that the proposal did not go far enough. Specifically, the SIA argued that it is inappropriate to distinguish between securities priced above \$5 per share from those that are priced below \$5 per share in determining capital requirements. The Commission preliminarily agrees with the recommendation of the SIA and believes that a further amendment to the net capital rule is warranted. Therefore, the

Commission, in a separate release, is proposing for comment an amendment that would raise the requirement to \$2,500 per security, regardless of the price of the security.

C. Introducing Firms.

(i) Introduction.

An introducing broker-dealer is one that has a contractual arrangement with another firm, known as the carrying or clearing firm, under which the carrying firm agrees to perform certain services for the introducing firm. Usually, the introducing firm submits its customer accounts and customer orders to the carrying firm, which executes the orders and carries the account. The carrying firm's duties include the proper disposition of the customer funds and securities after trade date, the custody of customer securities and funds, and the recordkeeping associated with carrying customer accounts.¹⁶

The practices regarding the handling of customer funds and securities vary among different introducing and clearing dealers. In many cases, the customer gives funds and securities directly to the introducing firm, which in turn is obligated to forward them to the clearing firm. In other cases, the customer sends funds and securities directly to the clearing firm.¹⁷

The receipt of customer funds or securities by inadequately capitalized introducing firms is a major concern of both the Commission and SIPC. Recognizing this concern, the proposing release would have created three tiers of introducing firm minimum net capital requirements, based on the frequency with which the introducing firm handles customer property. Firms that routinely handle customer funds or securities would have been required to maintain \$100,000 in net capital. Brokers that occasionally handle funds and securities would have been required to maintain \$50,000 in minimum net capital. Firms that never receive funds or securities would remain in a \$5,000 category.

The Commission has decided to take a two-step approach to the minimum net capital requirements applicable to introducing firms. First, the Commission is abandoning the three-tier distinction that was based on the occasional versus routine receipt of securities in favor of a two-tier system which would have a \$50,000 minimum for firms that receive any securities, and a \$5,000 minimum for those that do not. The second phase of the Commission's action with respect to introducing firms will be the additional proposal of an amendment raising the \$5,000 minimum to \$25,000. Discussed more fully below are the specifics of the Commission's action and the reasons for the increases.

(ii) Need For Increases.

*13 The net capital rule requires introducing brokers to promptly forward all customer funds and securities to the clearing broker-dealer. Even when this requirement is complied with, as the commentators pointed out, many customers make checks payable or endorse securities directly to the introducing firm. SIPC has expressed its concern to the Commission regarding "... situations where the SIPC member involved in the customer protection proceeding is a broker-dealer exempt from the provisions of SEC Rule 15c3-3, and subject to less than the full net capital requirements of SEC Rule 15c3-1." SIPC reported in August 1991, that since January 1986, twenty introducing firms have become the subject of SIPC proceedings. In those proceedings, SIPC has paid \$8,226,330 to satisfy customer claims and \$3,405,385 for administrative expenses. SIPC has also informed the Commission that in one of these customer protection proceedings the trustee has received and is reviewing claims for customer protection of approximately \$6 million.

Although the firms that are the subjects of these proceedings were prohibited from holding customer property, they were nevertheless in a position where they were able to obtain access to customer assets through a variety of schemes. Some of the SIPC proceedings involved firms that obtained customers' funds by soliciting those funds directly from the customers for investment in a "certificate of deposit" or other instruments issued by the broker-dealer. Some SIPC proceedings involve introducing firms that misappropriated funds by instructing clearing firms to place customer funds into accounts controlled by the introducing firm. Other cases involve introducing firms that failed to transmit customer monies entrusted for investment;

in these cases, introducing firms converted the customer funds by forging the endorsement on the checks given to them by customers.

In one case, for example, principals of a firm converted \$4.3 million of checks written by at least 129 customers made payable to the firm. Those funds were entrusted to the firm for purchase of certificates of deposit and mutual funds. Instead of investing them as instructed by the customer, the principals of the firm diverted the funds for their personal use. Although the firm misappropriated \$4.3 million of customer property, SIPC reimbursed customers for only \$2.9 million. For the most part, most of the shortfall was due to claims that exceeded the limitations on SIPC advances.¹⁸

Two recent Commission proceedings further illustrate the Commission's concerns. In the first, the broker misappropriated over \$1.1 million of customer funds that were intended to be invested in securities. In the second, a particularly egregious case, a broker-dealer in Florida solicited money from investors by advertising, among other places, in local church flyers. Customers alleged they were purchasing certificates of deposit from the broker-dealer to be held by the broker-dealer. However, the owner of the broker dealer converted the funds, and after his scheme was discovered, committed suicide. It appears that the amount of stolen funds could reach \$4 million. The case is further complicated by the fact that SIPC may not reimburse the customers on the grounds that the investments in question may be characterized as a loan to the broker-dealer.

*14 Investors who give funds and securities to broker-dealers do so with some degree of assurance that their property is safe when entrusted with an entity registered with and regulated by the Commission. However, many investors are not able to ascertain the difference between a registered broker-dealer that is well capitalized and one that is not, and under what circumstances SIPC coverage is provided.

A second element of concern for the customers of introducing firms involves the customers' relationship with the clearing firm. Customers can be stranded if the introducing firm fails or closes temporarily due to a capital violation. Generally, the clearing firm will not accept orders directly from the customers because the clearing firm will consider the customers as those of the introducing firm. As a result, customers may be unable to liquidate their securities positions or open new positions until their accounts are transferred to another broker-dealer. Although higher minimums will not eliminate this risk, the increased standards will increase the likelihood that the firm can quickly find a purchaser for its assets and avoid an NASD supervised self-liquidation.

Aside from the impact on customers, there is a risk of sudden losses to clearing firms when introducing firms fail. For example, during periods of market decline, customer accounts may become unsecured due to sharp drops in the value of securities in margin accounts or because of changes in the value of customer short option positions. If a customer fails to meet margin calls made by the clearing firm or fails to pay the settlement amount for securities it has purchased, the introducing firm, because most clearing arrangements place liability on the introducing firm for deficits in introduced accounts, will bear the loss from the default. If the introducing firm does not have adequate resources to pay the clearing firm, the clearing firm incurs the loss.¹⁹

Two examples are illustrative. During the October 1987 market break, Haas Securities Corporation, a fully disclosed introducing broker-dealer and a market maker in eleven securities, ceased operations. As a result of unsecured customer accounts introduced by Haas, its clearing firm incurred a reduction in its net capital between \$15 and \$20 million.²⁰ More recently, an introducing broker was involved in a manipulation scheme wherein three registered representatives at the introducing firm attempted to corner the market in a particular security by placing large amounts of unauthorized purchases of the security in a number of customer accounts. As a result of the manipulation, the security rose in value, but trading in the security was suspended after the scheme was discovered and never resumed. The security served as margin for debits owed by customers of the registered representatives and became worthless when trading was suspended. As a result of this occurrence, the clearing firm incurred losses in excess of \$20 million. The introducing firm could not cover losses of this magnitude. At the time of the manipulation, the clearing firm was owned by another broker-dealer. Mainly as a result of the losses incurred through the manipulation, the clearing firm was acquired by another broker-dealer and then eventually liquidated. Before the liquidation, the clearing firm cleared for 154 introducing brokers.

*15 Indeed, many clearing firms require introducing firms to maintain net capital in excess of that required by the net capital rule (in addition to a clearing deposit) before they will transact business with an introducing firm. One firm will not clear for an introducing broker-dealer unless the firm has at least \$150,000 in net capital. However, because industry practice is not uniform, weaknesses tend to develop. Assuming that risk-conscious clearing firms require their introducing firms to maintain the greatest amount of capital, the Commission is concerned that clearing firms that are not as sensitive to risk will tend to have a higher concentration of poorly capitalized introducing firms. The failure of one large introducing firm could weaken such a clearing firm, with a ripple effect that could expose other firms that clear through the same broker-dealer. If such a firm fails, not only will customers of that firm suffer, but a large number of market makers in lower priced securities might fail with it, resulting in significantly reduced liquidity in the markets for their securities.

(iii) Interpretation of Introducing Accounts on a Fully Disclosed Basis

There is a general misunderstanding among customers of securities firms as to the relationship between a clearing firm and an introducing firm and the responsibilities of each firm as to the customers' assets. Even in instances where those responsibilities are clearly outlined, customers are generally unable to distinguish an introducing firm from a full service broker-dealer that is authorized to maintain custody of their investment property. Customers are often not aware that their funds and securities are located at the clearing firm (rather than at the introducing firm). When an introducing firm fails, Commission staff members frequently receive inquiries from the introducing firm's customers regarding the whereabouts of their funds and securities.

The Division has interpreted the net capital rule and Rule 15c3-3 to require that, for the purposes of the Commission's financial responsibility rules and SIPC, the introducing firm's customers should be treated as customers of the clearing firm.²¹ The Division has also interpreted revised paragraphs (a)(2)(i) and (a)(2)(iv) of the net capital rule to require an introducing firm, in order to fall under the terms of paragraph (a)(2)(iv), to have in place a clearing agreement with a registered broker-dealer that states, for the purposes of SIPA and the Commission's financial responsibility rules, customers are customers of the clearing, and not the introducing, firm. Furthermore, the clearing firm must issue account statements directly to customers. Each statement must contain the name and telephone number of a responsible individual at the clearing firm whom a customer can contact with inquiries regarding the customer's account. Finally, the account statement must disclose that customer funds or securities are located at the clearing broker-dealer, and not the introducing firm.

*16 An introducing firm without such an arrangement will not be considered, for the purposes of the Commission's financial responsibility rules, to be a firm that "introduce[s] transactions and accounts of customers to another registered broker or dealer that carries such accounts on a fully disclosed basis." Absent such an arrangement, the introducing firm would be required to comply with the greater minimum net capital requirements required of a clearing firm.²²

(iv) Industry Response and Commission Action.

When the amendments were proposed, the Commission was sensitive to the potential impact of the increases. Accordingly, the Commission solicited comment from the introducing firm community on their potential impact.

Approximately 100 small broker-dealers objected to the proposals, arguing that the increases would either eliminate smaller firms, or prevent small broker-dealers from entering the industry. Other commentators objected to the size of the increases or the asserted lack of any need for them. As an alternative, a number of firms suggested that the Commission could accomplish its regulatory goals more fairly by drafting a net capital rule that would call for incremental increases for different types of business activity. For example, if a firm transacted a margin business, its minimum net capital requirement would increase by a pre-established factor. However, this approach would require the net capital rule to make dozens of distinctions that would further complicate the regulatory process. It is important for the net capital rule to be based on readily identifiable minimum classification requirements. Therefore this suggestion does not provide a workable alternative to the base requirement approach currently in place.

It appears that the primary objection to the proposed increases concerned the costs associated with raising additional capital and the impact on competition in the industry. To assess the cost of the proposed rules, using the NASD Data, the Division examined the capitalization of the industry to determine how many firms would need to raise additional funds. The Division also estimated the approximate costs of raising the additional capital.

The NASD Data does not distinguish between introducing brokers that receive funds and securities and those that do not. The assumption was made that all firms receive customer property to assess the maximum impact of the recommended amendments. Under this assumption, the calculations demonstrate that 919 introducing brokers (out of 2,301) would need total additional capital of \$25 million to comply with the new \$50,000 standard, or an average of \$27,180 per firm. Based on an eight percent spread of cost of capital,²³ the new standards would cost each broker an average of approximately \$2,174 per year. The Commission believes this is a slight insurance premium in light of the benefits that would be derived from the increase.

To assess the impact of the proposal on the industry, introducing firm revenue data was examined. Out of a total \$4.96 billion in annual revenues generated by NASD member introducing firms, only \$304 million is accounted for by firms with less than \$50,000 in net capital. In other words, the amendments would at most affect the 919 firms that account for 6.1 percent of the total introducing firm revenues.

*17 Thus, the data suggests the impact of the increases will not be dramatic. Notwithstanding, the Commission believes certain refinements to the original proposal are warranted. For example, a number of commentators, including the NASD, objected to the Commission's classification of minimum net capital levels based on the distinction between occasional and routine receipt of customer funds and securities.²⁴ The NASD suggested a reconsideration of the \$100,000 category which would apply to those introducing firms that routinely receive customer funds or securities. Such introducing brokers would have the same capital requirement as broker-dealers that receive funds and securities pursuant to the provisions of paragraph (k)(2)(i) of Rule 15c3-3. As the NASD pointed out, introducing firms could, without changing their capital requirement, clear accounts under the (k)(2)(i) method. To prevent this, the NASD recommended the establishment of two classifications of introducing firms: a \$50,000 minimum for firms that receive securities and a \$25,000 minimum level for those that do not.

The Commission believes that the NASD's approach represents a reasonable compromise between the Commission's and the commentators' concern regarding the impact of the amendments on introducing firms. Accordingly, the three tier approach that would distinguish between occasional and routine receipt of funds and securities is not being adopted and will be supplanted by the approach recommended by the NASD.

Therefore, the Commission is adopting the proposal that would increase the minimum net capital requirement of introducing firms that receive securities to \$50,000. The Commission is also adopting, on a temporary basis, the proposed \$5,000 minimum requirement. Under the approach adopted by the Commission, an introducing broker-dealer that receives customer checks made payable to itself would be subject to a \$250,000 minimum net capital requirement. An introducing broker-dealer that receives securities as well as customer checks made payable to its clearing firm or other appropriate third party (e.g., escrow agent) that it promptly forwards to such third party would be subject to a minimum net capital requirement of \$50,000. An introducing broker-dealer that receives no securities and only receives customer checks made payable to appropriate third parties would be subject to a \$5,000 minimum net capital requirement.²⁵

In a separate release, the Commission is proposing for comment the additional amendment that would raise the net capital requirements of this second tier of introducing firms to \$25,000. The Commission considers the increased requirements to be more reasonably related to the level of capital needed to maintain successfully a securities business.

In addition to raising the base minimum capital requirements, the Commission's original proposal would have required an introducing firm to maintain additional net capital equal to one quarter of one percent of the customer debit balances introduced to its clearing firm. This requirement was designed to further address the situation where clearing firms have their capital endangered by the failure or financial difficulty of an introducing firm. The commentators, including the NASD, pointed out that

the requirement would be difficult to calculate, and therefore difficult to enforce. Moreover, it would add very little to the capital requirements of most introducing firms. Based on these comments, the Commission has decided not to adopt this proposal.

*18 The final component of the original proposal with regard to introducing firms was an amendment that would allow firms to participate in underwritings in which other members of the dealer group have firm commitments (an activity not allowed the current \$5,000 broker-dealer) so long as the introducing firm is not the statutory underwriter, but a marketing agent with no commitment to purchase any of the securities. The rule amendments make it clear that this is a dealer activity (that would ordinarily subject the firm to a minimum requirement of \$100,000), but permit introducing firms that maintain minimum net capital of at least \$50,000 to engage in this activity.

In conclusion, the Commission believes it is appropriate to raise the minimum net capital requirements for introducing firms in the amounts indicated. The Commission believes the increases are justified because of the large amounts of customer assets handled by introducing firms, and the impact such firms' failures can have on customers and the SIPC fund. Permitting undercapitalized introducing firms to handle, even for a short period of time, the assets of investors has proven to be a regulatory problem that the Commission believes will be alleviated by requiring a greater cushion of net capital to insulate customers from loss. Finally, the Commission notes that it is taking today's action at the request of the NASD, which is the primary supervisory entity for the majority of the firms affected by the increases, and SIPC, which serves as the investor's last resort for recovery in broker-dealer failures.

D. Other Broker-Dealers

This section of the release will address the minimum net capital treatment for all other categories of broker-dealers not specifically referred to above.

(i) Mutual Fund Firms.

Under the Commission's proposal, the minimum net capital requirement applicable to broker-dealers that limit their activities to transactions in shares of registered investment companies, and which receive customer funds or securities, would increase from \$2,500 to \$25,000. For those mutual fund firms that do not handle any customer funds or securities, and are not direct wire order firms, a \$5,000 minimum was proposed. The Commission is adopting these amendments.

The firms that commented on the increase from the current \$2,500 minimum to \$25,000 were generally opposed to it. These firms feared that increasing minimum capital requirements would eliminate firms and stifle competition in the mutual fund industry. However, the Commission considers a capital requirement of \$2,500 to be far too small for a firm that handles funds and securities. Moreover, the NASD Data does not indicate that the proposed increases would have a dramatic effect on competition. The Division has calculated that of a total 409 NASD mutual fund firms, 195 firms would require a total of \$3 million or an average of \$15,325 each to meet the \$25,000 level. These firms generated revenues of \$15.6 million, which represented only 1.2 percent of the total \$1.31 billion in revenues produced by all NASD member mutual fund firms during the last year.

(ii) Best Efforts Underwriters.

*19 Under the current rule, firms that participate, as a broker or dealer, in underwritings on a "best efforts" basis and that promptly forward all customer funds and securities to an issuer or an independent escrow agent designated for the underwriting are required to maintain minimum net capital of only \$5,000. In effect, these firms are treated as introducing firms. Currently, broker-dealers that sell direct participation programs in real estate syndications also many avail themselves of this standard, so long as any funds or securities are promptly forwarded to an issuer or escrow agent. The original proposal did not propose an increase in minimum capital requirements for these firms; rather it added a provision which prohibited these firms from receiving any customer funds or securities. This aspect of the proposal is being adopted.

(iii) Miscellaneous Brokers.

The original release did not propose any increases applicable to the residual category of broker dealers that would include broker-dealers that are tangentially related to the securities business, such as firms that act as finders for potential merger and acquisition opportunities on behalf of their clients. Such firms do not take customer orders, hold customer funds or securities or execute customer trades, yet must register as broker-dealers with the Commission because they accept compensation based upon a percentage of securities transactions. Firms with this low required minimum will be those that cannot be classified in any of the categories enumerated above. This category also would include floor brokers on the national securities exchanges.

(iv) Further Proposals.

As to each of the categories of firms described in paragraphs (i) through (iii) above, in a separate release, the Commission is proposing for comment an increase in the minimum net capital requirements to \$10,000.

E. Phase-In Schedule

Because of the burden that the amendments may have on the industry, the proposal contained a provision that would have staggered the increases over a period of four years. Some commentators suggested that the phase-in schedule was unnecessary. Others suggested that the time period should be reduced, although others recommended an increase in time. The Commission has decided to adopt a modified phase-in period of one year, commencing six months from the effective date. The Commission considers this to be a fair period of time within which additional capital could be acquired, particularly since the proposal has been outstanding since 1989. The timing of the increases is summarized below:

i. Firms That Carry Customer Accounts

(Aggregate Indebtedness Standard)

a.	Current Rule:	\$25,000
b.	By 6/30/93:	\$100,000
b.	By 12/31/93:	\$175,000
c.	By 6/30/94:	\$250,000

ii. Firms That Elect The Alternative Standard

a.	Current Rule:	\$100,000
b.	By 6/30/93:	\$150,000
c.	By 12/31/93:	\$200,000
d.	By 6/30/94:	\$250,000

iii. Clearing Firms That Do Not Generally Maintain Custody of Customer Funds or Securities

a.	Current Rule:	\$25,000
b.	By 6/31/93:	\$50,000
c.	By 12/31/93:	\$75,000
d.	By 6/30/94:	\$100,000

iv. Mutual Fund Dealers That Receive Customer Funds

a.	Current Rule:	\$2,500
b.	By 6/30/93:	\$10,000
c.	By 12/31/93:	\$17,500
d.	By 6/30/94:	\$25,000

v. Mutual Fund Dealers That Do Not Receive Customer Funds

a.	Current Rule:	\$2,500
b.	By 6/30/93:	\$3,300
c.	By 12/31/93:	\$4,100
d.	By 6/30/94:	\$5,000

vi. Introducing Firms That Receive Customer Securities

a.	Current Rule:	\$5,000
b.	By 6/30/93:	\$20,000
c.	By 12/31/93:	\$35,000
d.	By 6/30/94:	\$50,000

*20 The Commission's original proposal, in addition to addressing the minimum net capital standards discussed above, also contained proposed rule amendments with respect to equity haircuts and certain aggregate indebtedness charges. The following sections of this release will address these topics.

III. Election of the Alternative Standard

The Commission proposed to make the alternative available only to firms that clear and carry customer transactions. That would have altered the present rule which allows trading firms and introducing firms to elect the alternative method of calculating net capital. After careful consideration, the Commission has determined to make the alternative standard available to all firms.

The Commission believes the amendment that would have prevented the election of the alternative standard by firms that do not carry customer accounts is not appropriate for several reasons. First, a firm could easily render the prohibition ineffective by accepting one customer account. Secondly, under the amendments as adopted, a firm must maintain at least \$250,000 in order to compute under the alternative.²⁶ The Commission believes that the \$250,000 capital requirement will provide sufficient cushion to compensate for the additional capital that would have been required for those firms under the aggregate indebtedness standard. Indeed, a firm will have to have more than approximately \$3.8 million in aggregate indebtedness before its net capital requirement would exceed the \$250,000 minimum. Finally, the Commission's concern with respect to leverage that can be attained by trading firms was addressed by the Commission's recent adoption of a new early warning level under paragraph (e) of the net capital rule based on 25 percent of haircuts. That early warning level change will address some of the Commission's concerns and constrain firms with large trading positions from removing capital from the broker-dealer in the event of financial distress.

IV. Equity Securities Haircuts

A. General

The net capital rule provides two separate methods for calculating haircuts related to a broker-dealer's equity securities positions. The method used by a broker-dealer depends on the election the broker-dealer makes with respect to its net capital requirement. A firm calculating its net capital requirement under the basic method incurs a haircut equal to 30 percent of the market value

of the greater of its long or short positions, plus 15 percent of the lesser positions, but only to the extent that those positions exceed 25 percent of the market value of the greater of the long or short positions. In effect, the first 25 percent of the lesser position incurs no haircut.²⁷

Under the current rule, a broker-dealer electing the alternative method of computing net capital incurs a 15 percent haircut on its long equity securities positions. That haircut is increased by 30 percent of the broker-dealer's short equity positions, but only to the extent those short positions exceed 25 percent of the long positions.²⁸

*21 The basis for the distinction between long and short positions is, for haircut purposes, no longer valid. The distinctions based upon the method chosen are, the Commission believes, even less significant when the increases to the minimum requirements are taken into account. The premise underlying the alternative method of calculating haircuts was that long positions have to be financed by an outside entity that will demand more margin than the 15 percent haircut. Short positions, by contrast, are self-financing.

Broker-dealers are not necessarily constrained by the ability to finance their long positions by a bank or another broker-dealer. For example, broker-dealers are able to receive cash collateral in excess of the market value of the long position by lending the security to another broker-dealer. Moreover, except for situations such as tender offers, the long position would seem to be no less volatile or damaging to the broker-dealer than the short position.

One commentator expressed the view that, given the volatility of the equity markets, all haircuts should remain at 30 percent. However, the Commission believes that a 15 percent haircut provides an adequate safeguard and is adopting the proposal. Thus, under the amended rule, all broker-dealers will incur a deduction of 15 percent on the market value of the greater of the long or short equity position, and a deduction of 15 percent on the market value of the lesser position, but only to the extent this lesser position exceeds 25 percent of the greater position.²⁹

In addition to standardizing the deduction for equity securities positions under the net capital rule, the proposal would have required broker-dealers to apply the equity securities haircut (15 percent), rather than the lower, government securities haircut (6 percent), to their positions in interest and principal only instruments. In response to this proposal, the Public Securities Association submitted data suggesting that a lower haircut should be applied. The Commission is not adopting this amendment, and will await a further recommendation by the Commission staff in this regard.

B. Undue Concentration Charge

Paragraphs (c)(2)(vi)(M) and (f)(iii) currently include extra deductions for securities positions that are large relative to a firm's net capital. These "undue concentration charges" currently vary slightly depending on the firm's election of either the basic or alternative method. The Commission's proposal would eliminate this difference, and standardize the deduction, so that all concentration charges would be calculated according to the method previously set forth in paragraph (f) of the rule. There were no comments on this aspect of the proposal; therefore, the Commission is adopting this amendment as proposed.³⁰

C. Contractual Commitments

The Commission's proposal, although it would standardize equity securities haircuts at 15 percent, would have nonetheless required a 30 percent charge for the contractual commitment haircut in certain securities. The Commission is adopting this amendment as proposed. Therefore, the contractual commitment haircut applicable to equity securities shall remain at 30 percent unless the class and issue of the securities are listed on a national securities exchange or are designated as NASDAQ National Market System Securities.

V. Aggregate Indebtedness

*22 The aggregate indebtedness test has been included in the net capital rule since its adoption in 1942. The term aggregate indebtedness includes all of the liabilities and/or obligations (actual or otherwise) of a broker-dealer. The test applies to broker-dealers computing net capital under the basic method and limits the leverage that they are able to attain. The rule however, specifically excludes from aggregate indebtedness certain prescribed liabilities. In the two classes of liabilities described below, the Commission believes the 6 2/3 percent aggregate indebtedness charge is not appropriate, particularly in light of the increases in the minimum requirements. Therefore, the Commission's proposal would have reduced the 6 2/3 percent charge to one percent in the two areas discussed below. Both of these amendments are being adopted as proposed.

A. Mutual Fund Payables.

Currently, the net capital rule requires a broker-dealer that owes money to a mutual fund in connection with a purchase of shares of that fund to include that amount in aggregate indebtedness even if offset by a receivable from another broker-dealer related to that transaction.³¹

Currently, the net capital rule requires a charge of 6 2/3 percent on these mutual fund payables. The Commission's proposal would lower this deduction to one percent of the liability amount when an offset from the mutual fund exists. Other than the request for clarification discussed in the following paragraph, the Commission received no comments on this amendment, and is adopting it as proposed.

A number of commentators wrote to the Commission requesting clarification in the method of computation. Specifically, the commentators questioned why the proposed rule amendment contained an 85 percent aggregate indebtedness exclusion when the narrative description of the rule change in the proposing release described a one percent aggregate indebtedness charge. The answer is that 6 2/3 percent of .15 (remaining after .85 is deducted from one) gives the same result as one percent of one. The method chosen for reducing the charge was designed for consistency with the present status of the rule.

B. Stock Loan Payables.

A stock loan payable is a liability arising from the receipt of cash collateral from a person who borrows securities from the broker-dealer. The payable is considered aggregate indebtedness even if the securities that were loaned were borrowed from another broker-dealer.³² The current rule requires a 6 2/3 percent charge on these items. As with mutual fund receivables, the Commission's proposal would reduce this charge to one percent.

Given the matched nature of these related payables and receivables, the Commission does not believe that the risk merits a charge of 6 2/3 percent on the dollar amount of the liability; therefore, the Commission is adopting the amendment as proposed.

VI. Technical Amendments.

Because of the amendments to the minimum net capital requirements and equity securities haircuts, the Commission is merging paragraph (f) into paragraph (a) of the rule. As a result, the rule amendments include several technical changes to the rule. For example, all references to paragraph (f) are deleted and new references to appropriate rule sections are substituted. Other examples include the amendments to the concentration charges under paragraph (c)(2)(vi)(M) and the contractual commitment charge under paragraph (c)(2)(viii). The amendments also delete a provision from paragraph (c)(2)(ix) of Rule 15c3-1 that expired on January 1, 1983.

VII. Summary of Final Regulatory Flexibility Analysis.

*23 The Commission has prepared a Final Regulatory Flexibility Analysis ("Analysis") in accordance with 5 U.S.C. § 603 regarding the amendments. The Analysis notes that the objective of the amendments is to further the purposes of the various financial responsibility rules that provide safeguards with respect to the financial responsibility and related practices of brokers-dealers. The Analysis states that the Commission did not receive any comments concerning the Initial Regulatory Flexibility

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Analysis. A copy of the Analysis may be obtained by contacting Roger G. Coffin, Division of Market Regulation, Securities and Exchange Commission, Washington, D.C. 20549, (202) 272-7375.

VIII. Statutory Analysis.

Pursuant to the Securities Exchange Act of 1934 and particularly Sections 15(c)(3), 17 and 23 thereof, 15 U.S.C. 78o(c)(3), 78q and 78w, the Commission is adopting amendments to § 240.15c3-1 of Title 17 of the Code of Federal Regulations in the manner set forth below.

IX. List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

X. Text of the Amendments.

In accordance with the foregoing, title 17, chapter II, part 240 of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934.

1. The authority citation for Part 240 continues to read as follows: Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78i, 78j, 78l, 78m, 78n, 78o, 78p, 78s, 78w, 78x, 7811(d), 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, and 80b-11, unless otherwise noted.

2. Section 15c3-1 is amended by removing paragraph (f), removing the word “and” from paragraph (c)(2)(xii), removing and reserving paragraphs (a)(3), (a)(5) and (c)(2)(vi)(I), adding paragraphs (c)(1)(xiv) and (c)(1)(xv) and revising paragraphs (a), (a)(1), (a)(2), (a)(4), (a)(6)(i), (a)(7)(i), (a)(9), (c)(1)(xiii), (c)(2)(i)(C)(1), (c)(2)(iv)(B), (c)(2)(iv)(F)(3)(i)(B), (c)(2)(iv)(F)(3)(i)(C), (c)(2)(vi), (c)(2)(vi)(A)(5), (c)(2)(vi)(J), (c)(2)(vi)(M), (c)(2)(viii), (c)(2)(ix), (c)(2)(x)(A)(2) through (5), (c)(9), and (c)(10) to read as follows.

§ 240.15c3-1. Net Capital Requirements for Brokers or Dealers.

(a) Every broker or dealer shall at all times have and maintain net capital no less than the greater of the highest minimum requirement applicable to its ratio requirement under paragraph (a)(1) of this section, or to any of its activities under paragraph (a)(2) of this section. Each broker or dealer also shall comply with the supplemental requirements of paragraphs (a)(4) and (a)(9) of this section, to the extent either paragraph is applicable to its activities. In addition, a broker or dealer shall maintain net capital of not less than its own net capital requirement plus the sum of each broker's or dealer's subsidiary or affiliate minimum net capital requirements, which is consolidated pursuant to Appendix C, § 240.15c3-1c.

RATIO REQUIREMENTS

Aggregate Indebtedness Standard

*24 (1)(i) No broker or dealer, other than one that elects the provisions of paragraph (a)(1)(ii) of this section, shall permit its aggregate indebtedness to all other persons to exceed 1500 percent of its net capital (or 800 percent of its net capital for 12 months after commencing business as a broker or dealer).

Alternative Standard

(ii) A broker or dealer may elect not to be subject to the Aggregate Indebtedness Standard of paragraph (a)(1)(i) of this section. That broker or dealer shall not permit its net capital to be less than the greater of \$250,000 or 2 percent of aggregate debit items

computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3-3, § 240.15c3-3a). Such broker or dealer shall notify its Examining Authority, in writing, of its election to operate under this paragraph (a)(1)(ii). Once a broker or dealer has notified its Examining Authority, it shall continue to operate under this paragraph unless a change is approved upon application to the Commission. A broker or dealer that elects this standard and is not exempt from Rule 15c3-3 shall:

(A) make the computation required by § 240.15c3-3(e) and set forth in Exhibit A, § 240.15c3-3a, on a weekly basis and, in lieu of the 1 percent reduction of certain debit items required by Note E (3) in the computation of its Exhibit A requirement, reduce aggregate debit items in such computation by 3 percent;

(B) include in Items 7 and 8 of Exhibit A, § 240.15c3-3a, the market value of items specified therein more than 7 business days old;

(C) exclude credit balances in accounts representing amounts payable for securities not yet received from the issuer or its agent which securities are specified in paragraphs (c)(2)(vi)(A) and (E) of this section and any related debit items from the Exhibit A requirement for 3 business days; and

(D) deduct from net worth in computing net capital 1 percent of the contract value of all failed to deliver contracts or securities borrowed that were allocated to failed to receive contracts of the same issue and which thereby were excluded from Items 11 or 12 of Exhibit A, § 240.15c3-3a.

Futures Commission Merchants

(iii) No broker or dealer registered as a futures commission merchant shall permit its net capital to be less than the greater of its requirement under paragraph (a)(1)(i) or (ii) of this section, or 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the customer's account).

MINIMUM REQUIREMENTS

See Appendix E (§ 240.15c3-1E) for temporary minimum requirements.

Brokers or Dealers That Carry Customer Accounts

(2)(i) A broker or dealer (other than one described in paragraphs (a)(2)(ii) or (a)(8) of this section) shall maintain net capital of not less than \$250,000 if it carries customer or broker or dealer accounts and receives or holds funds or securities for those persons. A broker or dealer shall be deemed to receive funds, or to carry customer or broker or dealer accounts and to receive funds from those persons if, in connection with its activities as a broker or dealer, it receives checks, drafts, or other evidences of indebtedness made payable to itself or persons other than the requisite registered broker or dealer carrying the account of a customer, escrow agent, issuer, underwriter, sponsor, or other distributor of securities. A broker or dealer shall be deemed to hold securities for, or to carry customer or broker or dealer accounts, and hold securities of, those persons if it does not promptly forward or promptly deliver all of the securities of customers or of other brokers or dealers received by the firm in connection with its activities as a broker or dealer. A broker or dealer, without complying with this paragraph (a)(2)(i), may receive securities only if its activities conform with the provisions of paragraphs (a)(2)(iv) or (v) of this section, and may receive funds only in connection with the activities described in paragraph (a)(2)(v) of this section.

*25 (ii) A broker or dealer that is exempt from the provisions of § 240.15c3-3 pursuant to section (k)(2)(i) thereof shall maintain net capital of not less than \$100,000.

Dealers

(iii) A dealer shall maintain net capital of not less than \$100,000. For the purposes of this section, the term "dealer" includes:

(A) any broker or dealer that endorses or writes options otherwise than on a registered national securities exchange or a facility of a registered national securities association; and

(B) any broker or dealer that effects more than ten transactions in any one calendar year for its own investment account. This section shall not apply to those persons engaging in activities described in paragraphs (a)(2)(v), (a)(2)(vi) or (a)(8) of this section, or to those persons whose underwriting activities are limited solely to acting as underwriters in best efforts or all or none underwritings in conformity with paragraph (b)(2) of § 240.15c2-4, so long as those persons engage in no other dealer activities.

Brokers or Dealers That Introduce Customer Accounts And Receive Securities

(iv) A broker or dealer shall maintain net capital of not less than \$50,000 if it introduces transactions and accounts of customers or other brokers or dealers to another registered broker or dealer that carries such accounts on a fully disclosed basis, and if the broker or dealer receives but does not hold customer or other broker or dealer securities. A broker or dealer operating under this paragraph (a)(2)(iv) of this section may participate in a firm commitment underwriting without being subject to the provisions of paragraph (a)(2)(iii) of this section, but may not enter into a commitment for the purchase of shares related to that underwriting.

Brokers or Dealers Engaged in the Sale of Redeemable Shares of Registered Investment Companies and Certain Other Share Accounts

(v) A broker or dealer shall maintain net capital of not less than \$25,000 if it acts as a broker or dealer with respect to the purchase, sale and redemption of redeemable shares of registered investment companies or of interests or participations in an insurance company separate account directly from or to the issuer on other than a subscription way basis. A broker or dealer operating under this section may sell securities for the account of a customer to obtain funds for the immediate reinvestment in redeemable securities of registered investment companies. A broker or dealer operating under this paragraph (a)(2)(v) must promptly transmit all funds and promptly deliver all securities received in connection with its activities as a broker or dealer, and may not otherwise hold funds or securities for, or owe money or securities to, customers.

Other Brokers or Dealers

(vi) A broker or dealer that does not receive, directly or indirectly, or hold funds or securities for, or owe funds or securities to, customers and does not carry accounts of, or for, customers and does not engage in any of the activities described in paragraphs (a)(2)(i) through (v) of this section shall maintain net capital of not less than \$5,000. A broker or dealer operating under this paragraph may engage in the following dealer activities without being subject to the requirements of paragraph (a)(2)(iii) of this section:

*26 (A) in the case of a buy order, prior to executing such customer's order, it purchases as principal the same number of shares or purchases shares to accumulate the number of shares necessary to complete the order, which shall be cleared through another registered broker or dealer or

(B) in the case of a sell order, prior to executing such customer's order, it sells as principal the same number of shares or a portion thereof, which shall be cleared through another registered broker or dealer.

(3) [Removed and Reserved]

Capital Requirements for Market Makers

(4) A broker or dealer engaged in activities as a market maker as defined in paragraph (c)(8) of this section shall maintain net capital in an amount not less than \$2,500 for each security in which it makes a market (unless a security in which it makes a

market has a market value of \$5 or less, in which event the amount of net capital shall be not less than \$1,000 for each such security) based on the average number of such markets made by such broker or dealer during the 30 days immediately preceding the computation date. Under no circumstances shall it have net capital less than that required by the provisions of paragraph (a) of this section, or be required to maintain net capital of more than \$1,000,000 unless required by paragraph (a) of this section.

(5) [Removed and Reserved]

Market Makers, Specialists and Certain Other Dealers

(6)(i) A dealer who meets the conditions of paragraph (a)(6)(ii) of this section may elect to operate under this paragraph (a)(6) and thereby not apply, except to the extent required by this paragraph (a)(6), the provisions of paragraphs (c)(2)(vi) or Appendix A, § 240.15c3-1a, of this section to market maker and specialist transactions and, in lieu thereof, apply thereto the provisions of paragraph (a)(6)(iii) of this section.

Self-Clearing Options Specialists

(7)(i) A dealer who meets the conditions of paragraph (ii) of this paragraph (a)(7) may elect to operate under this paragraph (a)(7) and thereby not apply, except to the extent required by this paragraph (a)(7), the provisions of paragraphs (c)(2)(vi), (c)(2)(x), and (c)(2)(xi) of this section or Appendix A (§ 240.15c3-1a) to this section and, in lieu thereof, apply the provisions of paragraph (a)(7)(iii) of this section.

Certain Additional Capital Requirements for Brokers or Dealers Engaging in Reverse Repurchase Agreements

(9) A broker or dealer shall maintain net capital in addition to the amounts required under paragraph (a) of this section in an amount equal to 10 percent of:

(i) The excess of the market value of United States Treasury Bills, Bonds and Notes subject to reverse repurchase agreements with any one party over 105 percent of the contract prices (including accrued interest) for reverse repurchase agreements with that party; and

(ii) The excess of the market value of securities issued or guaranteed as to principal or interest by an agency of the United States or mortgage related securities as defined in section 3(a)(41) of the Act subject to reverse repurchase agreements with any one party over 110 percent of the contract prices (including accrued interest) for reverse repurchase agreements with that party; and

*27 (iii) The excess of the market value of other securities subject to reverse repurchase agreements with any one party over 120 percent of the contract prices (including accrued interest) for reverse repurchase agreements with that party.

(c) ***

(1) ***

Exclusions From Aggregate Indebtedness

(xiii) Deferred tax liabilities;

(xiv) Eighty-five percent of amounts payable to a registered investment company related to fail to deliver receivables of the same quantity arising out of purchases of shares of those registered investment companies; and

(xv) Eighty-five percent of amounts payable against securities loaned for which the broker or dealer has receivables related to securities of the same class and issue and quantity that are securities borrowed by the broker or dealer.

NET CAPITAL

(2) ***

(i) ***

(C) ***

(1) The aggregate amount resulting from applying to the amount of the deductions computed in accordance with paragraph (c)(2)(vi) of this section and Appendices A and B, § 240.15c3-1a and 240.15c3-1b, the appropriate Federal and State tax rate(s) applicable to any unrealized gain on the asset on which the deduction was computed;

(iv)(A) ***

Certain Unsecured and Partly Secured Receivables

(B) All unsecured advances and loans; deficits in customers' and non-customers' unsecured and partly secured notes; deficits in special omnibus accounts maintained in compliance with the requirements of 12 CFR 220.10 of Regulation T under the Securities Exchange Act of 1934, or similar accounts carried on behalf of another broker or dealer, after application of calls for margin, marks to the market or other required deposits that are outstanding 5 business days or less; deficits in customers' and non-customers' unsecured and partly secured accounts after application of calls for margin, marks to the market or other required deposits that are outstanding 5 business days or less, except deficits in cash accounts as defined in 12 CFR 220.8 of Regulation T under the Securities Exchange Act of 1934 for which not more than one extension respecting a specified securities transaction has been requested and granted, and deducting for securities carried in any of such accounts the percentages specified in paragraph (c)(2)(vi) of this section or Appendix A (§ 240.15c3-1a); the market value of stock loaned in excess of the value of any collateral received therefor; receivables arising out of free shipments of securities (other than mutual fund redemptions) in excess of \$5,000 per shipment and all free shipments (other than mutual fund redemptions) outstanding more than 7 business days, and mutual fund redemptions outstanding more than 16 business days; any collateral deficiencies in secured demand notes as defined in Appendix D (§ 240.15c3-1d);

(F) ***

(3)(i)(A) ***

(B) The excess of the aggregate repurchase agreement deficits with any one party over 25 percent of the broker or dealer's net capital before the application of paragraph (c)(2)(vi) of this section (less any deduction taken with respect to repurchase agreements with that party under paragraph (c)(2)(iv)(F)(3)(i)(A) of this section) or, if greater;

*28 (C) The excess of the aggregate repurchase agreement deficits over 300 percent of the broker's or dealer's net capital before the application of paragraph (c)(2)(vi) of this section.

Securities Haircuts

(vi) Deducting the percentages specified in paragraphs (c)(2)(vi)(A) through (M) of this section (or the deductions prescribed for securities positions set forth in Appendix (A), § 240.15c3-1a) of the market value of all securities, money market instruments or options in the proprietary or other accounts of the broker or dealer.

(A)(4) ***

(5) In the case of a Government securities dealer that reports to the Federal Reserve System, that transacts business directly with the Federal Reserve System, and that maintains at all times a minimum net capital of at least \$50,000,000, before application of the deductions provided for in paragraph (c)(2)(vi) of this section, the deduction for a security issued or guaranteed as to

principal or interest by the United States or any agency thereof shall be 75 percent of the deduction otherwise computed under paragraph (c)(2)(vi)(A) of this section.

(I) [Removed and reserved]

All Other Securities

(J) In the case of all securities or evidences of indebtedness, except those described in Appendix A, § 240.15c3-1a, which are not included in any of the percentage categories enumerated in paragraphs (c)(2)(vi)(A) through (H) of this section or paragraph (c)(2)(vi)(K)(ii) of this section, the deduction shall be 15 percent of the market value of the greater of the long or short positions and to the extent the market value of the lesser of the long or short positions exceeds 25 percent of the market value of the greater of the long or short positions, the percentage deduction on such excess shall be 15 percent of the market value of such excess. No deduction need be made in the case of:

(1) a security that is convertible into or exchangeable for another security within a period of 90 days, subject to no conditions other than the payment of money, and the other securities into which such security is convertible or for which it is exchangeable, are short in the accounts of such broker or dealer; or

(2) a security that has been called for redemption and that is redeemable within 90 days.

Undue Concentration

(M)(1) In the case of money market instruments, or securities of a single class or series of an issuer, including any option written, endorsed or held to purchase or sell securities of such a single class or series of an issuer (other than "exempted securities" and redeemable securities of an investment company registered pursuant to the Investment Company Act of 1940), and securities underwritten (in which case the deduction provided for herein shall be applied after 11 business days), which are long or short in the proprietary or other accounts of a broker or dealer, including securities that are collateral to secured demand notes defined in Appendix D, § 240.15c3-1d, and that have a market value of more than 10 percent of the "net capital" of a broker or dealer before the application of paragraph (c)(2)(vi) of this section or Appendix A, § 240.15c3-1a, there shall be an additional deduction from net worth and/or the Collateral Value for securities collateralizing a secured demand note defined in Appendix D, § 240.15c3-1d, equal to 50 percent of the percentage deduction otherwise provided by this paragraph (c)(2)(vi) of this section or Appendix A, § 240.15c3-1a, on that portion of the securities position in excess of 10 percent of the "net capital" of the broker or dealer before the application of paragraph (c)(2)(vi) of this section and Appendix A, § 240.15c3-1a. In the case of securities described in paragraph (c)(2)(vi)(J), the additional deduction required by this paragraph (c)(2)(vi)(M) shall be 15 percent.

*29 (2) This paragraph (c)(2)(vi)(M) shall apply notwithstanding any long or short position exemption provided for in paragraph (c)(2)(vi)(J) of this section (except for long or short position exemptions arising out of the first proviso to paragraph (c)(2)(vi)(J)) and the deduction on any such exempted position shall be 15 percent of that portion of the securities position in excess of 10 percent of the broker or dealer's net capital before the application of paragraph (c)(2)(vi) of this section and Appendix A, § 240.15c3-1a.

(3) This paragraph (c)(2)(vi)(M) shall be applied to an issue of equity securities only on the market value of such securities in excess of \$10,000 or the market value of 500 shares, whichever is greater, or \$25,000 in the case of a debt security.

(4) This paragraph (c)(2)(vi)(M) will be applied to an issue of municipal securities having the same security provisions, date of issue, interest rate, day, month and year of maturity only if such securities have a market value in excess of \$500,000 in bonds (\$5,000,000 in notes) or 10 percent of tentative net capital, whichever is greater, and are held in position longer than 20 business days from the date the securities are received by the syndicate manager from the issuer.

(5) Any specialist that is subject to a deduction required by this paragraph (c)(2)(vi)(M), respecting its specialty stock, that can demonstrate to the satisfaction of the Examining Authority for such broker or dealer that there is sufficient liquidity for such

specialist's specialty stock and that such deduction need not be applied in the public interest for the protection of investors, may upon a proper showing to such Examining Authority have such undue concentration deduction appropriately decreased, but in no case shall the deduction prescribed in paragraph (c)(2)(vi)(J) of this section above be reduced. Each such Examining Authority shall make and preserve for a period of not less than 3 years a record of each application granted pursuant to this paragraph (c)(2)(vi)(M)(5), which shall contain a summary of the justification for the granting of the application.

Open Contractual Commitments

(viii) Deducting, in the case of a broker or dealer that has open contractual commitments (other than those option positions subject to Appendix (A), § 240.15c3-1a), the respective deductions as specified in paragraph (c)(2)(vi) of this section or Appendix (B), § 240.15c3-1b, from the value (which shall be the market value whenever there is a market) of each net long and each net short position contemplated by any open contractual commitment in the proprietary or other accounts of the broker or dealer.

(A) The deduction for contractual commitments in those securities that are treated in paragraph (c)(2)(vi)(J) of this section shall be 30 percent unless the class and issue of the securities subject to the open contractual commitment deduction are listed for trading on a national securities exchange or are designated as NASDAQ National Market System Securities.

*30 (B) A broker or dealer that maintains in excess of \$250,000 of net capital may add back to net worth up to \$150,000 of any deduction computed under this paragraph (c)(2)(viii)(B).

(C) The deduction with respect to any single commitment shall be reduced by the unrealized profit in such commitment, in an amount not greater than the deduction provided for by this paragraph (or increased by the unrealized loss), in such commitment, and in no event shall an unrealized profit on any closed transactions operate to increase net capital.

(ix) Deducting from the contract value of each failed to deliver contract that is outstanding five business days or longer (21 business days or longer in the case of municipal securities) the percentages of the market value of the underlying security that would be required by application of the deduction required by paragraph (c)(2)(vi) of this section. Such deduction, however, shall be increased by any excess of the contract price of the failed to deliver contract over the market value of the underlying security or reduced by any excess of the market value of the underlying security over the contract value of the failed to deliver contract, but not to exceed the amount of such deduction. The designated examining authority for the broker or dealer may, upon application of the broker or dealer, extend for a period up to 5 business days, any period herein specified when it is satisfied that the extension is warranted. The designated examining authority upon expiration of the extension may extend for one additional period of up to 5 business days, any period herein specified when it is satisfied that the extension is warranted.

(x)(A) ***

(2) In the case of a bona fide hedged position as defined in this paragraph (c)(2)(x)(C) involving a long position in a security, other than an option, and a short position in a call option, the deduction shall be 15 percent (or such other percentage required by paragraphs (c)(2)(vi)(A) through (K) of this section) of the market value of the long position reduced by any excess of the market value of the long position over the exercise value of the short option position. In no event shall such reduction operate to increase net capital.

(3) In the case of a bona fide hedged position as defined in this paragraph (c)(2)(x)(C) involving a short position in a security, other than an option, and a long position in a call option, the deduction shall be the lesser of 15 percent of the market value of the short position or the amount by which the exercise value of the long option position exceeds the market value of the short position; however, if the exercise value of the long option position does not exceed the market value of the short position, no deduction shall be applied.

(4) In the case of a bona fide hedged position as defined in this paragraph (c)(2)(x)(C) involving a short position in a security other than an option, and a short position in a put option, the deduction shall be 15 percent (or such other percentage required

by paragraphs (c)(2)(vi)(A) through (K) of this section) of the market value of the short security position reduced by any excess of the exercise value of the short option position over the market value of the short security position. No such reduction shall operate to increase net capital.

*31 (5) In the case of a bona fide hedged position as defined in this paragraph (c)(2)(x)(C) involving a long position in a security, other than an option, and a long position in a put option, the deduction shall be the lesser of 15 percent of the market value of such long security position or the amount by which the market value of such long security position exceeds the exercise value of the long option position. If the market value of the long security position does not exceed the exercise value of the long option position, no deduction shall be applied.

Promptly Transmit and Deliver

(9) A broker or dealer is deemed to “promptly transmit” all funds and to “promptly deliver” all securities within the meaning of paragraphs (a)(2)(i) and (a)(2)(v) of this section where such transmission or delivery is made no later than noon of the next business day after the receipt of such funds or securities; provided, however, that such prompt transmission or delivery shall not be required to be effected prior to the settlement date for such transaction.

Promptly Forward

(10) A broker or dealer is deemed to “promptly forward” funds or securities within the meaning of paragraph (a)(2)(i) of this section only when such forwarding occurs no later than noon of the next business day following receipt of such funds or securities.

3. By amending § 240.15c3-1a by revising paragraphs (c)(1) through (c)(5), (c)(7), (c)(9) and (c)(10) to read as follows:

§ 240.15c3-1a Options (Appendix A to 17 CFR 240.15c3-1).

(c) ***

Uncovered Calls

(1) Where a broker or dealer is short a call, deducting, after the adjustment provided for in paragraph (b) of this Appendix A, 15 percent (or such other percentage required by paragraphs (c)(2)(vi)(A) through (K) of § 240.15c3-1) of the current market value of the security underlying such option reduced by any excess of the exercise value of the call over the current market value of the underlying security. In no event shall the deduction provided by this paragraph be less than \$250 for each option contract for 100 shares.

Uncovered Puts

(2) Where a broker or dealer is short a put, deducting, after the adjustment provided for in paragraph (b) of this Appendix A, 15 percent (or such other percentage required by paragraphs (c)(2)(vi)(A) through (K) of § 240.15c3-1) of the current market value of the security underlying the option reduced by any excess of the market value of the underlying security over the exercise value of the put. In no event shall the deduction provided by this paragraph be less than \$250 for each option contract for 100 shares.

Covered Calls

(3) Where a broker or dealer is short a call and long equivalent units of the underlying security, deducting, after the adjustments provided for in paragraph (b) of this Appendix A, 15 percent (or such other percentage required by paragraphs (c)(2)(vi)(A) through (K) of § 240.15c3-1) of the current market value of the underlying security reduced by any excess of the current market

value of the underlying security over the exercise value of the call. No reduction under this paragraph shall have the effect of increasing net capital.

Covered Puts

*32 (4) Where a broker or dealer is short a put and short equivalent units of the underlying security, deducting, after the adjustment provided for in paragraph (b) of this Appendix A, 15 percent (or such other percentage required by paragraphs (c)(2)(vi)(A) through (K) of § 240.15c3-1) of the current market value of the underlying security reduced by any excess of the exercise value of the put over the market value of the underlying security. No such reduction shall have the effect of increasing net capital.

Conversion Accounts

(5) Where a broker or dealer is long equivalent units of the underlying security, long an unlisted put written or endorsed by a broker or dealer and short an unlisted call in its proprietary or other accounts, deducting 5 percent (or 50 percent of such other percentage required by paragraphs (c)(2)(vi)(A) through (K) of § 240.15c3-1) of the current market value of the underlying security.

Long Over-the-Counter Options

(7) Where a broker or dealer is long an unlisted put or call endorsed or written by a broker or dealer, deducting 15 percent (or such other percentage required by paragraphs (c)(2)(vi)(A) through (K) of § 240.15c3-1) of the market value of the underlying security, not to exceed any value attributed to such option in paragraph (c)(2)(i) of § 240.15c3-1.

Certain Security Positions With Offsetting Options

(9) Where a broker or dealer is long a security for which it is also long a listed put (such broker or dealer may in addition be short a call), deducting, after the adjustments provided in paragraph (b) of this Appendix A, 15 percent of the market value of the long security position not to exceed the amount by which the market value of equivalent units of the long security position exceeds the exercise value of the put. If the exercise value of the put is equal to or exceeds the market value of equivalent units of the long security position, no percentage deduction shall be applied.

(10) Where a broker or dealer is short a security for which he is also long a listed call (such broker or dealer may in addition be short a put), deducting after the adjustments provided in paragraph (b) of this Appendix A, 15 percent of the market value of the short security position not to exceed the amount by which the exercise value of the long call exceeds the market value of equivalent units of the short security position. If the exercise value of the call is less than or equal to the market value of equivalent units of the short security position no percentage deduction shall be applied.

4. By amending § 240.15c3-1c by revising paragraph (b)(1), to read as follows:

§ 240.15c3-1c Consolidated Computations Of Net Capital And Aggregate Indebtedness For Certain Subsidiaries And Affiliates (Appendix C to 17 CFR 240.15c3-1).

Required Counsel Opinions

(b)(1) If the consolidation, provided for in paragraph (a) of this section, of any such subsidiary or affiliate results in the increase of the broker's or dealer's net capital and/or the decrease of the broker's or dealer's minimum net capital requirement under paragraph (a) of § 240.15c3-1 and an opinion of counsel described in paragraph (b)(2) of this section has not been obtained, such benefits shall not be recognized in the broker's or dealer's computation required by this section.

*33 5. By amending § 240.15c3-1d by revising paragraphs (a)(2)(iii), (b)(6)(iii), (b)(7), (b)(8), (b)(10)(ii)(B), (c)(2), (c)(5)(i), and (c)(5)(ii)(A) as to read as follows:

§ 240.15c3-1d Satisfactory Subordination Agreements (Appendix D to 17 CFR 240.15c3-1).

(a)(2) ***

(iii) The term "Collateral Value" of any securities pledged to secure a secured demand note shall mean the market value of such securities after giving effect to the percentage deductions set forth in paragraph (c)(2)(vi) of § 240.15c3-1 except for paragraph (c)(2)(vi)(J). In lieu of the deduction under (c)(2)(vi)(J), the broker or dealer shall reduce the market value of the securities pledged to secure the secured demand note by 30 percent.

(b)(6)***

(iii) The secured demand note agreement also may provide that, in lieu of the procedures specified in the provisions required by paragraph (b)(6)(ii) of this section, the lender with the prior written consent of the broker or dealer and the Examining Authority for the broker or dealer may reduce the unpaid principal amount of the secured demand note. After giving effect to such reduction, the aggregate indebtedness of the broker or dealer may not exceed 1000 percent of its net capital or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, net capital may not be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3-3a, or, if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater. No single secured demand note shall be permitted to be reduced by more than 15 percent of its original principal amount and after such reduction no excess collateral may be withdrawn. No Examining Authority shall consent to a reduction of the principal amount of a secured demand note if, after giving effect to such reduction, net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1.

Permissive Prepayments

(7) A broker or dealer at its option but not at the option of the lender may, if the subordination agreement so provides, make a Payment of all or any portion of the Payment Obligation thereunder prior to the scheduled maturity date of such Payment Obligation (hereinafter referred to as a "Prepayment"), but in no event may any Prepayment be made before the expiration of one year from the date such subordination agreement became effective. This restriction shall not apply to temporary subordination agreements that comply with the provisions of paragraph (c)(5) of this Appendix D. No Prepayment shall be made, if, after giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements then outstanding the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such Prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such Prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 1000 percent of its net capital or its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1 or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, its net capital would be less than 5 percent of its aggregate debit items computed in accordance with § 240.15c3-3a, or if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or its net capital would be less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of § 240.15c3-1. Notwithstanding the above, no Prepayment shall occur without the prior written approval of the Examining Authority for such broker or dealer.

Suspended Repayment

*34 (8)(i) The Payment Obligation of the broker or dealer in respect of any subordination agreement shall be suspended and shall not mature if, after giving effect to Payment of such Payment Obligation (and to all Payments of Payment Obligations of such broker or dealer under any other subordination agreement(s) then outstanding that are scheduled to mature on or before such Payment Obligation) either (A) the aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital, or in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, its net capital would be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3-3a or, if registered as a futures commission merchant, 6 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or (B) its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1 including paragraph (a)(1)(ii), if applicable. The subordination agreement may provide that if the Payment Obligation of the broker or dealer thereunder does not mature and is suspended as a result of the requirement of this paragraph (b)(8) for a period of not less than six months, the broker or dealer shall thereupon commence the rapid and orderly liquidation of its business, but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of § 240.15c3-1 and § 240.15c3-1d.

(10)(ii)***

(B) The aggregate indebtedness of the broker or dealer exceeding 1500 percent of its net capital or, in the case of a broker or dealer that has elected to operate under paragraph (a)(1)(ii) of § 240.15c3-1, its net capital computed in accordance therewith is less than 2 percent of its aggregate debit items computed in accordance with § 240.15c3-3a or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, throughout a period of 15 consecutive business days, commencing on the day the broker or dealer first determines and notifies the Examining Authority for the broker or dealer, or the Examining Authority or the Commission first determines and notifies the broker or dealer of such fact;

(c)***

Notice of Maturity or Accelerated Maturity

(2) Every broker or dealer shall immediately notify the Examining Authority for such broker or dealer if, after giving effect to all Payments of Payment Obligations under subordination agreements then outstanding that are then due or mature within the following six months without reference to any projected profit or loss of the broker or dealer either the aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital or its net capital would be less than 120 percent of the minimum dollar amount required by § 240.15c3-1, or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, its net capital would be less than 5 percent of aggregate debit items computed in accordance with § 240.15c3-3a, or, if registered as a futures commission merchant, 6 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of § 240.15c3-1.

Temporary and Revolving Subordination Agreements

*35 (5)(i) For the purpose of enabling a broker or dealer to participate as an underwriter of securities or other extraordinary activities in compliance with the net capital requirements of § 240.15c3-1, a broker or dealer shall be permitted, on no more than three occasions in any 12 month period, to enter into a subordination agreement on a temporary basis that has a stated term of no more than 45 days from the date such subordination agreement became effective. This temporary relief shall not apply to

a broker or dealer if, at such time, it is subject to any of the reporting provisions of § 240.17a-11, irrespective of its compliance with such provisions or if immediately prior to entering into such subordination agreement, either:

(A) the aggregate indebtedness of the broker or dealer exceeds 1000 percent of its net capital or its net capital is less than 120 percent of the minimum dollar amount required by § 240.15c3-1, or

(B) in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, its net capital is less than 5 percent of aggregate debits computed in accordance with § 240.15c3-3a, or, if registered as a futures commission merchant, less than 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or less than 120 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of this section, or

(C) the amount of its then outstanding subordination agreements exceeds the limits specified in paragraph (d) of § 240.15c3-1. Such temporary subordination agreement shall be subject to all other provisions of this Appendix D.

(ii)***

(A) After giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements then outstanding, the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 900 percent of its net capital or its net capital would be less than 200 percent of the minimum dollar amount required by § 240.15c3-1 or, in the case of a broker or dealer operating pursuant to paragraph (a)(1)(ii) of § 240.15c3-1, its net capital would be less than 6 percent of aggregate debit items computed in accordance with § 240.15c3-3a, or, if registered as a futures commission merchant, 10 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the option customer's account), if greater, or its net capital would be less than 200 percent of the minimum dollar amount required by paragraph (a)(1)(ii) of this section or

*36 6. By adding § 240.15c3-1e to read as follows:

§ 240.15c3-1e Temporary Minimum Requirements (Appendix E to 17 CFR 240.15c3-1e).

Brokers or Dealers That Carry Customer Accounts Aggregate Indebtedness Standard

(a) A broker or dealer that falls within the provisions of paragraph (a)(2)(i) of § 240.15c3-1 and computes its required net capital under § 240.15c3-1(a)(1)(i) shall maintain net capital not less than the greater of the amount computed under that paragraph (a)(1)(i) or:

- (1) \$25,000 until June 30, 1993;
- (2) \$100,000 on July 1, 1993, until December 31, 1993;
- (3) \$175,000 on January 1, 1994, until June 30, 1994; and
- (4) \$250,000 on July 1, 1994.

Brokers or Dealers That Elect the Alternative Standard

NET CAPITAL RULE, Release No. 31511 (1992)

(b) A broker or dealer that elects the provisions of § 240.15c3-1(a)(1)(ii) shall maintain net capital of not less than the greater of the amount computed under that paragraph (a)(1)(ii) or:

- (1) \$100,000 until June 30, 1993;
- (2) \$150,000 on July 1, 1993, until December 31, 1993;
- (3) \$200,000 on January 1, 1994, until June 30, 1994; and
- (4) \$250,000 on July 1, 1994.

Brokers or Dealers That are Exempt From Securities Exchange Act Rule 15c3-3 Under Paragraph (k)(2)(i) and Dealers

(c) A broker or dealer that falls within the provisions of § 240.15c3-1(a)(2)(ii) or (iii) and computes its required net capital under § 240.15c3-1(a)(1)(i) shall maintain net capital not less than the greater of the amount computed under § 240.15c3-1(a)(1)(i) or:

- (1) \$25,000 until June 30, 1993;
- (2) \$50,000 on July 1, 1993, until December 31, 1993;
- (3) \$75,000 on January 1, 1994, until June 30, 1994; and
- (4) \$100,000 on July 1, 1994.

Brokers or Dealers That Introduce Customer Accounts And Receive Securities

(d) An introducing broker that falls within the provisions of § 240.15c3-1(a)(2)(iv) and computes its required net capital under § 240.15c3-1(a)(1)(i) shall maintain net capital of not less than the greater of the amount computed under § 240.15c3-1(a)(1)(i) or:

- (1) \$5,000 until June 30, 1993;
- (2) \$20,000 on July 1, 1993, until December 31, 1993;
- (3) \$35,000 on January 1, 1994, until June 30, 1994; and
- (4) \$50,000 on July 1, 1994.

**Brokers or Dealers Engaged in the Sale of Redeemable Shares of
Registered Investment Companies and Certain Other Share Accounts**

(e) A broker or dealer that falls within the provisions of § 240.15c3-1(a)(2)(v) and computes its required net capital under § 240.15c3-1(a)(1)(i) shall maintain net capital of not less than the greater of the amount computed under § 240.15c3-1(a)(1)(i) or:

- (1) \$2,500 until June 30, 1993;
- (2) \$10,000 on July 1, 1993, until December 31, 1993;
- (3) \$17,500 on January 1, 1994, until June 30, 1994; and
- (4) \$25,000 on July 1, 1994.

Other Brokers or Dealers

(f) A broker or dealer that falls within the provisions of § 240.15c3-1(a)(2)(vi), computes its required net capital under § 240.15c3-1(a)(1)(i) and is not otherwise subject to a \$5,000 minimum net capital requirement shall maintain net capital of not less than the greater of the amount computed under § 240.15c3-1(a)(1)(i) or:

- *37 (1) \$2,500 until June 30, 1993;
- (2) \$3,300 on July 1, 1993, until December 31, 1993;
- (3) \$4,100 on January 1, 1994, until June 30, 1994; and
- (4) \$5,000 on July 1, 1994.

*38 By the Commission.

Jonathan G. Katz
Secretary

Footnotes

- 1 Securities Exchange Act Release No. 27249 (September 15, 1989), 54 FR 40395 (October 2, 1989). All comments are available in File No. S7-28-89 at the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.
- 2 Generally, net capital, as defined by Rule 15c3-1, is a broker-dealer's net worth plus liabilities subordinated in accordance with Appendix D of the rule, minus assets "not readily convertible into cash" and certain percentages, or haircuts, of a firm's securities and commodities positions.
- 3 Self-liquidation of a securities firm in or approaching financial difficulty is specifically contemplated by Section 5(a)(2) of the Securities Investor Protection Act of 1970 ("SIPA").
- 4 See Securities Exchange Act Rule 15c3-1(a)(2); 17 CFR 240.15c3-1(a)(2).
- 5 Under paragraph (k)(2)(i) of Rule 15c3-3, a broker-dealer that does not carry margin accounts, promptly transmits all customer funds and securities to a carrying firm and effectuates all financial transactions with customers through a specially designated bank account is exempt from the possession and control and Reserve Formula requirements of the customer protection rule.
- 6 See National Futures Association Amendments to NFA Financial Requirements Sections 1 & 6, January 25, 1990, (Nat'l Fut. Ass'n Man. (P-H) ¶¶ 7011 & 7041, NFA Financial Requirements §§ 1 & 6. The NFA is a self regulatory organization composed of futures commission merchants, commodity pool operators, commodity exchanges, banks and other organizations that is responsible for regulating the financial responsibility of its members.
- 7 See Options Clearing Corp. Guide (CCH) Rules 301(a) & 302(a).
- 8 See Nat'l Sec. Clearing Corp. Rules Addendum B ¶ I.B.1.a.
- 9 Several commentators objected to the Commission's characterization of the risks created by clearing firms. These firms argued that the Commission should draw distinctions based on the manner in which clearing firms hold their customer securities in order to allow firms that hold customer securities in non-negotiable form to operate under reduced minimum. Presumably, this means that the broker-dealer would have no powers of attorney. The Commission does not believe that developing a minimum requirement containing such a distinction would be a practical solution. It would be virtually impossible to examine for compliance with this type of a requirement. If a clearing firm is holding hundreds of customer securities, examiners would have to inspect for powers of attorney for each customer. Furthermore, the essential risks inherent in allowing firms with little capital to hold securities would still be present under such a scheme. If it means that the broker-dealer would hold powers of attorney, the practical effect of this arrangement diminishes the distinction that the commentators would draw in the way securities are held at the firm. In the event of a SIPC liquidation, these securities are treated as part of the fungible bulk that is shared by all customers in a pro rata form (See SIPA § 8), although SIPC would make every effort to return specific securities to customers.
- 10 None of the firms designated to the NYSE appear to have a problem meeting the new minimum requirements.
- 11 The term "promptly forward" is defined in the net capital rule to mean when "such transmission or delivery is made no later than noon of the next business day after the receipt of such funds or securities." Rule 15c3-1(c)(9).
- 12 Separately, the Commission is proposing for comment an amendment that would require market makers to maintain capital of \$2,500 per share, regardless of the price of the security.
- 13 See the October 1987 Market Break, a Report by the Division of Market Regulation of the U.S. Securities and Exchange Commission, February 1988, (the "Market Break Report") pp. 5-11, 12 and 15.

- 14 See File No. SR-NASD-88-1, Securities Exchange Act Release No. 25791 (June 9, 1988).
- 15 See Report of the Special Committee of the Regulatory Review Task Force on the Quality of Markets, NASD publication, 1988, p. 15.
- 16 A fully disclosed introducing arrangement should be distinguished from an omnibus clearing arrangement where the clearing firm maintains one account for all the customer transactions of the introducing firm. In an omnibus relationship, the clearing firm does not know the identity of the customers of the introducing firm. In a fully-disclosed clearing arrangement, the clearing firm knows the names, addresses, securities positions and other relevant data as to each customer. For the purposes of the net capital rule, broker-dealers that introduce accounts on an omnibus basis are considered clearing firms.
- 17 Under paragraph (a)(2) of the net capital rule, introducing firms are prohibited from holding funds or securities for customers. They are required to promptly forward all funds and securities they receive to their carrying firm. In addition to these requirements, in order to take advantage of the \$5,000 minimum, fully disclosed introducing firms must have a clearing agreement that states that for purposes of SIPA and the financial responsibility rules, the introduced customer accounts are the responsibility of the carrying firm. See Letter from Richard G. Ketchum, Director, Division of Market Regulation to David Marcus, New York Stock Exchange, January 14, 1985, ("Ketchum Letter"). Despite this requirement, SIPC exposure can result from the failure of an introducing firm in possession of customer property.
- 18 Under Section 9 of SIPA, when the amount of customer property present in a failed firm is insufficient to meet the claims of customers, SIPC must make advances to customers to cover the shortfall in each customer's claim. Those advances are limited to a total of \$500,000 of cash and securities per customer, with a \$100,000 limitation on claims for cash.
- 19 In imposing sanctions on an introducing firm for failing to disclose to its carrying firm material facts as to the creditworthiness of one of its customers, the Commission recognized the potential credit exposure of clearing firms and stated: "It is true that [the introducing firm] had a contractual obligation to indemnify [the clearing broker] for losses. However, considering [the introducing firm's] small net capital ... there was a substantial likelihood that the clearing brokers would themselves have to bear all or part of any potential losses." In re Boylan, Securities Exchange Act Release No. 18378 at 45 n. 33 (January 14, 1982).
- 20 See Market Break Report at pg. 5-11.
- 21 See Ketchum Letter, supra note 17.
- 22 Additionally, in order to take advantage of the revised \$5,000 minimum net capital requirement, introducing firms will be required to notify their customers that the firm is prohibited from receiving funds (other than checks made out to third parties) or securities.
- 23 For a discussion of the cost of capital, see section 2(B)(iii) supra.
- 24 The NASD, the self-regulatory organization charged with overseeing the bulk of introducing firms, generally endorsed the new requirements.
- 25 It should be noted that the \$5,000 standard adopted today differs from the previous \$5,000 requirement. Under the new rule, introducing firms will be prohibited from receiving customer securities and funds (other than checks payable to third parties). It will be necessary for these firms to develop procedures to insure that they do not receive customer securities or checks made payable to themselves.
- 26 The rule amendments also require a broker-dealer to notify its designated examining authority of its election to select the alternative standard; the rule previously required the broker-dealer to notify the appropriate Regional Office of the Commission.

27

For example:Position

Long	\$1,000,000	\$300,000
Short	\$500,000	\$37,500 (15% of \$250,000)
Total:		\$337,500

28

For example:Position

Long:	\$1,000,000	\$150,000
Short:	\$500,000	\$75,000 (30% of \$250,000)
Total:		\$225,000

- 29 As proposed, this lowered haircut would have been available to firms only when they crossed the \$100,000 net capital threshold. However, the NASD suggested that this would be difficult to monitor. Based on this recommendation the Commission is not adopting this amendment. The contractual commitment haircut will remain at 30 percent for initial public offerings. Similarly, the haircut assessed for receivables arising in conjunction with subordinated loans will remain at 30 percent.
- 30 A broker-dealer is also required to deduct the portion of a long equity securities position that it holds that is large in relation to the trading volume for that security. This is generally referred to as the "blockage test".
- 31 This payable arises out of a purchase of shares by the broker-dealer directly from the fund for another broker-dealer (presumably for the other broker-dealer's customer). The first broker-dealer owes money to the fund secured by the investment company shares. The second broker-dealer owes money to the first broker-dealer. The debt on the first broker-dealer's books is offset by a receivable from

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the second broker-dealer, classified generally as a fail to deliver. That receivable is also secured by the mutual fund shares, since delivery of the shares will not occur until payment of the obligation by the second broker-dealer.

32 When one broker-dealer lends securities to another broker-dealer, the lending broker-dealer generally receives cash collateral in excess of the value of the securities lent. For financial statement purposes, the lending broker-dealer accounts for the cash collateral as a liability, since that broker-dealer must repay the funds to the borrowing broker-dealer upon return of the securities.

Much of the stock lent by broker-dealers to other broker-dealers is borrowed from a third broker-dealer or other person. If a broker-dealer borrows stock through a stock loan transaction collateralized by cash, the borrowing broker-dealer accounts for the collateral in its financial statements as a receivable from the lending person.

Release No. 31511 (S.E.C. Release No.), Release No. 34-31511, 52 S.E.C. Docket 2694, 1992 WL 356004

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