INTERNAL AUDITORS DIVISION
An Affiliate of SIFMA

SEC Rule 15c3–1

Updated December 2006

Note: The following guideline is to assist the internal auditor in reviewing their firm's compliance with SEC Rule 15c3-1. At the time of updating this guideline, IAD was aware of proposed Rule changes that are not reflected in this document. Moreover, due to the frequency of updates to the Rule, this guideline should be used in conjunction with the current version of the Rule and the related interpretations.

I. BACKGROUND

History of Securities & Exchange Commission ("SEC") Rule 15(c)3-1:

SEC Rule 15(c)3-1 (the "Rule") was introduced as part of the Securities Exchange Act of 1934 in the aftermath of the "Crash of 1929." Although the Rule required broker-dealers to maintain certain minimum capital, it allowed certain national securities exchanges to exempt members from the requirements and the Rule originally did not extend to broker-dealers engaged in municipal securities activities.

In response to investors' concerns about the liquidity of broker-dealers, and their ability to meet creditors' claims resulting from the "paperwork crisis" of the 1960's, Section 15(c)(3) of the Exchange Act, as amended by the 1975 amendments, required the Commission to establish no later than September 1, 1975 minimum financial responsibility requirements for all brokers and dealers.

Purpose of the Rule:

The purpose of the Rule is to ensure that a broker-dealer maintains adequate regulatory capital to meet investors', creditors' and government concerns about liquidity. In general, the adequacy of a broker-dealer's capital is measured in comparison to a firm's aggregate indebtedness or, alternatively, in comparison to aggregate customer debits as defined. The broker–dealer's capital is defined as stockholders equity and qualified subordinated debt (as defined by the Rule) reduced by haircuts to reflect the liquidity of the broker-dealer's inventory position (long and short) and capital charges for operational and other conditions. The resulting capital is referred to as "net capital". The Rule is based upon a liquidation premise and attempts to consider the value which would be received upon liquidation of the assets of a broker-dealer to satisfy customers and other creditors.

Components of net capital:

Net capital, as defined by the Rule, is comprised of ownership equity and certain qualified subordinated debt, reduced by the following capital charges:

- *Non-allowable assets* - that are not readily convertible to cash (e.g. fixed assets, exchange memberships, prepaid expenses, goodwill, etc.).
- *Other deductions or charges* - Charges on certain operating conditions such as undermargined customer accounts, aged operating items (fails, dividends, net unfavorable bank reconciliation differences, unsecured receivables, etc.), aged suspense items, securities count differences, repurchase and reverse repurchase agreement deficits, stock borrow deficits and undue concentration/ marketplace blockage of security holdings.
- *Securities haircuts* - Predetermined percentage deductions on the market value of all securities, money market instruments or option positions in the proprietary or other accounts of the broker or dealer.
- *Open Contractual Commitments* - A percentage deduction on open or unsettled securities and commodities transactions, including futures transactions in the proprietary or other accounts of the broker or dealer. This would cover commitments on underwritings, charges on forward contracts, and to-be-announced (TBA) transactions.

Minimum net capital requirements:

The rule requires that every broker-dealer shall meet the greatest of the three following requirements-

1. Net Capital of at least 1/15 of aggregate indebtedness (or 1/8 aggregate indebtedness in the first year of operation)
2. The minimum dollar requirement determined by the type of business conducted by the broker-dealer; specifically-

Minimum (activities) requirements (a)(2):	
Broker-dealers that act as a prime broker	$1,500,000
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	$1,000,000
Broker-dealers electing the alternative method and who carries customer or broker-dealer accounts and receives and holds funds or securities for those accounts [see 15c3-1 (a)(2)(i)].	$250,000
Broker-dealers who carry customer accounts and are exempt from Rule 15c3-3 under paragraph (k)(2)(i) [see 15c3-1 (a)(2)(ii)].	$100,000
Broker-dealers who endorse or write options otherwise than on a national securities exchange or facility of a national securities association [see 15c3-1(a)(2)(iii)(A)].	$100,000
Broker-dealers who affect more than ten transactions in any one calendar year for its own investment account [see 15c3-1 (a)(2)(iii)(B)].	$100,000
Broker-dealers who introduce customer accounts and receive but do not hold customers or other broker-dealer's securities [see 15c3-1 (a)(2)(iv)].	$50,000
Broker-dealers whose activities are limited to the sale of redeemable shares of registered investment companies and certain other share accounts [see 15c3-1(c)(2)(v)].	$25,000
Other brokers-dealers that do not receive directly or indirectly, or hold funds or securities for, or owe funds or securities to customers and do not carry accounts of, or for customers and do not engage in any of the activities described in the preceding paragraphs [see 15c3-1 (a)(2)(vi)].	$5,000

Note: For Consolidated Supervised Entities (CSE) the minimum net capital requirement is $500 million. At this time, relatively few firms fall within this category. Please refer to Appendix L and M in the AICPA Audit and Accounting Guide for Brokers and Dealers in Securities for sample control letters and the net capital computation.

3. Market makers are required to maintain a minimum dollar amount of net capital for each stock in which it makes a market: $2,500 for each stock selling above $5 / share, and

$1,000 for each stock selling for $5 or less. The total market maker requirement cannot exceed $1,000,000.

The alternative method specifies a minimum net capital requirement of 2% of aggregate customer debits (as defined by SEC Rule 15(c) 3-3), and requires minimum net capital of at least $250,000.

Additionally, exemptions are available for certain specialists and two-dollar brokers and may be available to others upon making a proper application with the appropriate regulatory agency. See subparagraph (b) of the Rule for specific guidance relating to exemptive provisions.

For an introducing broker to treat its PAIB assets held at a clearing firm as allowable for purposes of the net capital rule, an introducing broker and its correspondent clearing broker must agree (in writing) to perform the PAIB calculation in accordance with the following provisions ("PAIB Agreement"):

1. The clearing broker must perform a computation for PAIB assets of all its introducing brokers in accordance with the customer reserve computation set forth in Rule 15c3-3.
2. The PAIB reserve computation must include all the proprietary accounts of all introducing brokers covered by the PAIB agreement and all PAIB assets must be kept separate and distinct from customer assets under the customer reserve formula in Rule 15c3-3.
3. The PAIB reserve computation must be prepared within the same timeframes as those prescribed by Rule 15c3-3 for the customer reserve formula.
4. The clearing broker must establish and maintain separate "Special Reserve Account for the Exclusive Benefit of Customers" and for any PAIB reserve requirement.
5. A PAIB reserve deposit requirement can be satisfied by excess debits in the customer reserve formula of the same date. However, a customer reserve deposit requirement cannot be satisfied with excess debits from the PAIB reserve computation of the same date.
6. An introducing broker must notify its Designated Examining Authority (DEA) in writing that it has entered into a PAIB Agreement with a clearing broker within two days of executing such agreement.
7. Commissions receivable and other receivables of an introducing broker from its clearing broker are not to be included in the PAIB reserve computation under certain circumstances.
8. The proprietary account of an introducing broker that is a guaranteed subsidiary of the clearing broker, or who guarantees the clearing broker, is to be excluded from the PAIB reserve computation.
9. Upon discovery that any deposit to the PAIB Reserve Bank Account did not satisfy the deposit requirements, a clearing broker must immediately notify its DEA and the SEC by facsimile or by telegram. In addition, notification to its introducing brokers is to be made unless certain conditions are met.

The following outlines the subsections of the Rule, which is comprised of subparagraphs (a) through (f) and Appendices (A) - (D). Specific capital charges are set forth in subparagraph (c) (2) (iv) through (c) (14). Appendices (A) through (D) represent appendices to the Rule for items not originally contemplated by the SEC.

Subparagraphs of Rule 15 (c) 3-1:

(a) Minimum net capital requirements

(b) Exemptions

(c) Definitions

  1. Aggregate Indebtedness

  2 Net Capital Adjustments and Deductions 3.14. Miscellaneous

(d) Debt-equity requirements (aggregate indebtedness method)

(e) Limitations on capital withdrawals

Appendices:

(A) Options

(B) Commodities

(C) Consolidations

(D) Subordinations

(E) Deductions for Market and Credit Risk for Certain Brokers or Dealers

(F) Optional Market and Credit Risk Requirements for OTC Derivatives Dealers

(G) Conditions for Ultimate Holding Companies of Certain Brokers or Dealers

Regulatory organizations (primarily the New York Stock Exchange) maintain and distribute to member firms interpretation memos relating to various aspects of the Rule which are based on guidance and "no action" letters issued by the Securities and Exchange Commission.

II. RISKS

The primary risk is that the firm may fail to comply with the Rule, can be forced to curtail business activities, and can be liquidated (i.e., forced out of business) or forced into acquisition by another firm. These conditions may arise as a result of:

(a) a lack of understanding of the Rule on the part of those responsible for preparing the computation, resulting in an "omission" error;

(b) a failure of management to consider the impact on net capital as a result of new business products or items which may receive significant capital charges;

(c) lack of supervisory review, such as management review and analysis to detect unfavorable trends or possible errors in the computation;

(d) deterioration of liquidity of assets and/or increase in operational inefficiencies; and

(e) failure to monitor and/or consider new rules or interpretations.

A second, yet important risk is the "embarrassment" risk which is associated with publicized instances of failures to comply with the Rule, in addition to the associated fines and assessments.

A third risk is that the Firm may be unable to file the required FOCUS reports on a timely basis, due to its inability to compile the required information, thus resulting in regulatory sanctions, adverse publicity and possible loss of business.

The inability to compile the required information on a timely basis may provide evidence of lack of understanding, of the Rule or a lack of adequate procedures for performing the computation. In particular, the following risks should be considered in determining whether the firm has adequate procedures and knowledge to compile the required information on a timely basis:

(a) failure to consider all accounts, commitments, and operating conditions in determining net capital;

(b) failure of personnel to consider charges on off-balance sheet items (e. g. contractual commitments);

(c) inclusion of nonqualified subordinated debt in net capital;

(d) use of incorrect haircut and other capital charge percentages;

(e) failure to reconcile detailed support to control accounts, as well as the inaccuracy of individual items in the detailed documents;

(f) failure to appropriately classify securities effecting the computation (e.g. risk arbitrage positions, securities with a limited market, etc.), and misclassification of assets between allowable and non-allowable categories;

(g) failure to properly determine account classifications to compute aggregate indebtedness; and

(h) failure to balance all options, commodities and securities positions to related clearing organization and counterparty records.

III. CONTROL POINTS

Management's controls over the preparation of the net capital computation should seek to minimize the risks of failing to maintain adequate minimum net capital and failing to prepare the required information on a timely basis in accordance with the Rule. Typical controls implemented by management to address these risks would include:

(a) establishing procedures for preparing the computation and complying with the Rule and ensuring that these procedures are documented and regularly updated;

(b) ensuring that responsible personnel are familiar with the Rule's requirements and are updated as to changes;

(c) performing an analytical review relating to the consistency of the computation to prior periods;

(d) investigating significant variations and assessing the impact on net capital of new businesses or products;

(e) reviewing the current text of the Rule and related interpretations to ensure consideration of any new requirements of the Rule;

(f) reviewing the balance sheet, general ledger and detail subledgers as they relate to the computation in terms of completeness and classification of accounts and securities;

(g) assessing the impact of "high risk" products on net capital requirements; and

(h) adequate supervisory reviews.

These controls also extend to the preparation of the minimum net capital computation as a means of ensuring completeness, accuracy and proper classification of amounts included in the computation. Such controls would include:

(a) reconciling detail of accounts used in the calculation to control totals;

(b) ensuring the propriety and accuracy of account detail through adequate EDP application and integrity controls;

(c) comparing capital charge percentages to the Rule to ensure propriety;

(d) monitoring relevant operating conditions by using margin activity reports to identify under-margined accounts, deficit reports to identify repurchase and reverse repurchase and stock borrow deficits, reports for aged fails, dividends or miscellaneous receivables, and break reports to identify securities count differences and suspense items;

(e) balancing all options, commodities and securities positions to ensure completeness and accuracy of haircuts; and

(f) recalculating the final net capital computation.

SEC Rule 17a-5 describes the objectives of an examination by independent auditors, which include obtaining reasonable assurance that material inadequacies existing at the audit date in the accounting system, control procedures, and procedures for safeguarding securities would be disclosed. Rule 17a-5(g)(1) states that a specific objective is to review the practices and procedures followed by the broker dealer in:

(a) Making the period computations of aggregate indebtedness and net capital under SEC Rule 15c3-1 and the reserve required by SEC Rule 15c3-3.

(b) Making the quarterly securities examinations, counts, verifications, and comparisons and the recordation of differences required by SEC Rule 17a-13.

(c) Complying with the requirement for prompt payment for securities under sections 8 of Regulation T.

(d) Obtaining and maintaining physical possession or control of all fully paid and excess-margin securities of customers as required by SEC Rule 15c3-3.

(e) If the broker-dealer is also registered as an FCM, making the periodic computations of the minimum financial requirements pursuant to Regulation 1.17, the segregation requirements of section 4d(2) of the Commodity Exchange Act, and the segregation of funds based on such computations.

(f) Identifying undue concentrations compared to tentative net capital for repo agreements by counterparty and reverse repo over collateralization for additional minimum net capital.

IV. AUDIT OBJECTIVES

Prior to reviewing the broker-dealer's computation of net capital and of minimum net capital requirements set forth by the Rule, ensure that the Firm has adequate procedures regarding compliance with the Rule and performance of the computation. Specifically, the auditor should ensure that preparers of the computation consider, and are familiar with, the Rule's requirements and related interpretations. Likewise, determine that management is reviewing computations for propriety, analyzing computations for significant fluctuations, and evaluating the impact on net capital of new business or products. Compliance with the Rule is required at all times; however, the net capital computation is required to be filed with the regulatory body on a monthly basis.

The auditor should also determine that controls are in place to ensure that applicable requirements of the Rule are being addressed and that the net capital computation is being accurately prepared. These control procedures are required to be documented and tested per NASD Rule 3012, which is certified annually by the CEO pursuant to NASD Rule 3013. Additionally, controls should be in place to ensure that:

(a) appropriate balance sheet accounts, off- balance sheet amounts, and relevant operating conditions affecting net capital (e.g. undermargined accounts, aged items, securities differences. deficits) are identified and included in the computation;

(b) detailed supporting documentation affecting the computation is being agreed to related control accounts to ensure accuracy;

(c) percentages specified in the Rule are being used in the calculation of the various components of the computation;

(d) treatment of certain non-allowable assets whereby they are deemed allowable under the Rule, due to related non-recourse obligations which exist, is appropriate and in compliance with the Rule;

(e) for broker-dealers using the alternative method, controls are in place over the completeness, accuracy and validity of customer debits (including the related stock record allocations) as computed in accordance with SEC Rule 15(c) 3-3 and, for FCMs, the amount required to be segregated under the Commodity Exchange Act;

(f) the net capital computation is mathematically correct; and

(g) recordkeeping requirements are adequate.

V. AUDIT PROCEDURES

A review of the net capital computation should ensure that the firm’s computation is consistent with the Rule and that management is regularly reviewing and analyzing the computation to ensure that significant variations or risks are investigated. In testing the firm’s net capital computation, the auditor should ensure that detail support to the computation is based on accurate and complete information and that the calculation is mathematically accurate and consistent with the Rule.

The following audit procedures should be used to achieve these objectives:

(a) review current text of the Rule to ensure consideration of recent amendments to the Rule and compliance with Rule interpretations;

(b) review relevant interpretations in detail to ensure that all aspects of the Rule are being applied in determining the appropriateness of specific computations (the interpretations can be used as a reference);

(c) examine the firm's procedures for preparing the computation and complying with the requirements of the Rule, and determine the adequacy of the procedures;

(d) determine management’s procedures for assessing the impact of new businesses and products on net capital and determine the adequacy of the procedures:

(e) consider the effectiveness of management's analysis and review of the computation;

(f) request copies and review the most recent regulatory examination report issued by the Company's self regulatory organization;

(g) compare several net capital computations with each other for consistency, and compare the net capital charge/amount with their related balance sheet accounts;

(h) determine what procedures the preparers perform to ensure completeness and mathematical accuracy of the computation;

(i) evaluate EDP application and integrity controls over relevant EDP applications that generate reports used in the preparation of the net capital computation;

(j) review computation to determine and evaluate high exposure areas;

(k) based on the review of internal controls and determination of exposure areas, determine the nature and extent of detailed testing to be performed. Suggested detailed testing as appropriate, would include:

  i) agree detail of accounts used in the calculation to related control totals;

  ii) test foot detail to determine accuracy to totals or run the data against test software;

  iii) for each component of the computation, select a sample of items from the detail and:

    - recalculate capital charges taken
    - determine the correctness of capital charge treatment and percentages (including allocation of positions) by reference to the Rule
    - trace and agree description and amount to supporting documentation (e.g. positions to a previously tested inventory run and to the stock record)

  iv) review details to ensure that all items comprising the detail have been considered in the net capital computation;

  v) select a sample of items from the various deficit exposure reports and:

    - determine the propriety of the calculations and that items are properly categorized
    - Recalculate deficit or exposure amounts
    - agree items to supporting documentation (e.g. customer accounts to customer run)

  vi) select a sample of current and non-current items from fail reports and agree dates to trade tickets and trade corrections to determine propriety of aging;

  vii) select a sample of aged bank reconciliation differences from the capital charge detail and agree to current and previous months' bank reconciliations to determine the propriety of the age of the items;

viii) trace market prices of securities count differences to external sources and trace positions to the stock record and break account detail. Examine break account detail for positions with securities differences not considered in the calculation of the capital charge;

ix) select a sample of items from statements of accounts with counterparties and agree to the stock record and inventory run to determine that there are no unbalanced positions which have not been considered;

(x) agree items from inventory run to capital charge details to determine completeness of haircuts;

xi) perform appropriate tests on inventory positions meeting potential undue concentration or market blockage criteria and which were not considered in the capital charge detail;

xii) trace and agree subordinated debt to qualified subordination agreements and evidence of approval by the appropriate regulatory bodies. Agree amounts to the general ledger;

xiii) verify the mathematical accuracy of the computation;

xiv) verify the minimum net capital requirements; and

xv) evaluate net capital in terms of the net capital requirement.
