# *Net Capital Compliance, Net Capital Reliance*

Net Capital Rule deficiencies related to expense sharing agreements, improper accrual of liabilities and capital withdrawals continue to be a frequent source of findings by FINRA and SEC examiners. Our experience has shown that these matters are frequently the result of an innocent misunderstanding of the rules or honest oversights.

Net Capital compliance and adherence to Securities Exchange Act (SEA) Rule 15c3-1 is fundamental to maintaining market integrity and customer protection. Therefore, it will always be a regulatory mandate to ensure that firms accurately calculate their liquid net worth so that the Net Capital reported is an accurate reflection of a firm's financial condition. Net Capital compliance is moment to moment and firms must remain in compliance at all times or cease doing business.

Expense sharing agreements, accrual of liabilities and equity withdrawals have a direct impact on a firm's liquid net worth and as a result are a constant focus in examinations.

***Expense Sharing Agreements***

Many firms use expense sharing agreements to legitimately allocate expenses across affiliates. However, examiners view these arrangements with a skeptical eye, believing that the existence of an expense sharing agreement signals a more sinister intent - to artificially inflate a firm's net income, and therefore the level of Net Capital. In their examinations, SEC and FINRA examiners will test to determine if your broker-dealer is avoiding proper recognition of liabilities and expenses through the use of expense sharing agreements. Discovery can arise from instances where firm's are not properly allocating the expenses or cannot document the basis for the allocations. Firms are also cited in instances where they arbitrarily allocate expenses, resulting in wide swings from month to month. If the examiners uncover an attempt to evade the Net Capital Rule's requirements, depending on the severity, it will likely end up in a deficiency letter or enforcement proceeding.

Expense sharing agreements include any arrangements in which another party pays for costs incurred by a broker-dealer. In accordance with the SEC's July 11, 2003 interpretive letter and FINRA Notice to Members 03-63, if your firm has an expense sharing agreement with an affiliate or other third party, you must make a record of each expense incurred that relates to your business even if the affiliate or another party is responsible for the expense. Any liability relating to the expense is considered a liability of your firm for Net Capital purposes.

SEA Rule 17a-3(a)(1) and (a)(2), requires that all expenses and liabilities of a broker-dealer be recorded regardless of its treatment for purposes of GAAP. The proper recordkeeping method for expense sharing agreements is to record the expense on a separate schedule utilizing a reasonable allocation method that accurately reflects the expenses shared with the other party.

Your firm must also notify, and provide a copy of the agreement to its District Office. The notification must include the date of the agreement and the names of the involved parties.

***Capital Withdrawals***

Another area where examiners find deficiencies is the improper withdrawal of capital. There are several considerations for firms when withdrawing capital. For one, the SEC staff has stated that, with few exceptions, capital contributed to a firm cannot be withdrawn for a period of one year, without being considered a loan. The SEC Staff stated in its letter to NASD and NYSE; February 23, 2000 that capital contributions that are made with the expectation of a withdrawal in less than one year should be regarded as a loan and therefore

recorded as a liability. Exceptions to the rule are outlined in FINRA Rule 4110 and include, among other things, the withdrawal of profits earned, and where written permission is obtained from FINRA.

For situations where the Firm anticipates making temporary capital contributions for less than one year, the Firm should consider executing an approved subordination agreement so that the funds can be considered good capital for the purposes of the Net Capital Rule. This is typically done in the instance where a firm needs temporary capital to fund an underwriting or other short term commitment.

A corresponding violation occurs when the capital withdrawal is done without proper notification to the regulators or exceeds the amounts permissible. Pursuant to FINRA Rule 4110, firms may not withdraw capital in amounts that place the firm in early warning, or that exceed 10 % of the firm's excess Net Capital. In addition, firms must provide 48 hours prior notice to the regulators.

We frequently see firm's incorrectly infuse capital to meet temporary liquidity needs, only to withdraw the Funds when a transaction settles or funds are received. Firms should consider alternative sources of funding to avoid being cited by regulators.

Shareholders must also be careful when personal expenses are paid by a firm. In these cases, the payments should be recorded as either a loan to the shareholder or a capital withdrawal. In the latter case, the Firm must track the payments to ensure that the Firm does not inadvertently violate the capital withdrawal limitations and reporting requirements. We frequently advise Firms to consult with their Certified Public Accountant and tax advisers if shareholder expenses are paid with firm funds.

***Accrual of Liabilities***

Firms are also cited for failing to accrue liabilities for general operating expenses. This includes improperly accruing for telephone or utility bills that are frequently paid in arrears. The Net Capital Rule requires moment to moment Net Capital compliance to ensure that broker-dealers are able to meet their financial obligations to customers, other broker-dealers and third parties. If the Firm were to cease operations at any point, it must have sufficient liquid capital to meet its obligations. Therefore, expenses that are paid in arrears should be accrued on a month to month basis, according to GAAP, and it is generally acceptable to utilize a 12 month rolling period to estimate the monthly accruals.

***Conclusion***

Net Capital violations remain one of the most common findings in regulatory examinations. Accordingly, maintaining your firm's required Net Capital and proper bookkeeping and reporting is critical to your firm's operations. The SEC and FINRA place a significant emphasis on this area through examinations and ongoing surveillance. By ensuring your Financial Reporting staff stays up to date on frequent Net Capital deficiencies found by regulators and having procedures in place to handle them as they arise, your firm can ease the regulatory pressure felt while ensuring that the financial condition of your firm is accurately represented.

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