

NET CAP RE-CAP

The regulatory environment is constantly changing and the past year was a prime example of that. Over the last year, there have been substantial changes to the reporting requirements of broker-dealers. Beyond abiding by the new rules, firms must continue to comply with the ongoing requirements of SEA 15c3-1. Net Capital compliance is a moment to moment requirement and firms must ensure that they are not only in compliance at month end, but at any given moment. During last year we identified two often misunderstood Net Capital deficiencies. One was relating to treatment of erroneous trades and the other was the improper Net Capital treatment of cash at an affiliated bank.

Supplemental Statements

On February 28th FINRA implemented Rule 4524 which allows them to designate supplemental financial and operational schedules and reports as they deem necessary and appropriate to protect the public. Two new supplemental schedules, the Supplemental Statement of Income (SSOI) and Supplemental Schedule for Inventory Positions (SIS) are identified in Regulatory Notices 12-11 and 13-05, respectively, and as of now, the SSOI has been adopted and the SIS is still in the proposal stage.

The SSOI was adopted with Regulatory Notice 12-11, under FINRA Rule 4524. The initial filing date of the SSOI was October 26, 2012. The SSOI is generally a detailed version of the current Statement of Income on the FOCUS report. To deal with this new requirement many firms have had to re-categorize their General Ledger in order to track revenue and expenses at a detailed level. The SSOI is an ongoing requirement and it requires firms to look forward and classify new business line items within the

guidelines of the SSOI to ensure proper categorization. Many firms realized that they were not prepared for this change and ended up having to re-file their first SSOI. One lesson to take from the implementation of the SSOI, is that firms should try to continually look forward to identify future regulatory issues and work early on to address them. Adequate planning and sufficient time are paramount when implementing new systems.

The SIS, was proposed in Regulatory Notice 13-05 also under FINRA Rule 4524. The SIS would provide FINRA with more detail on the inventory positions that firms are holding. FINRA seeks this information to provide them with a greater knowledge of the market risks associated with inventory positions and to assess the impact those positions have on a firm's net capital, liquidity and funding needs. If approved, the SIS would require firms to break out long and short positions by category of security. All firms that hold inventory positions will be subject to the new reporting requirements, with the exception of firms that have inventory positions consisting of only U.S. Treasury securities or money market funds and firms that are required to file the FOCUS Part II CSE. The SIS would be due on the 20th business day of each month in which a firm is required to file a FOCUS.

Firms should currently have access to information required by the SIS. As we have learned from the implementation of the SSOI, while the data may be available, a system has to be implemented to parse out the data in the format requested by FINRA. While it is not necessary to develop a system before a rule has been implemented, there is a high likelihood that this rule will be approved. Therefore, firms should review the proposed SIS and strategize

ways that they can manipulate the data they currently have into the format FINRA requires.

Trending Net Capital Deficiencies

Last year we identified reoccurring topics that seem to give firms difficulty with their Financial Reporting requirements. There were Net Capital violations related to introducing brokers inadvertently taking on larger position than anticipated or erroneously booking positions to a firm inventory, rather than a customer's account. Even if it is a back office error, in both instances the firm would need to book the transaction on the firm's financials and take the necessary haircut. Firms must be careful in these situations as it not only opens up the firm to financial risk; it also opens up the firm to regulatory risk. As discussed earlier, the Net Capital Rule is a moment to moment requirement. Firms should monitor these situations as on a real time basis and determine the effects of the error on Net Capital. If the firm determines that the error would have a substantial impact on Net Capital, a full Net Capital computation should be performed to assess the impact. If the firm finds that the error has caused them to go under their required Net Capital, the firm must promptly file 17a-11 notification with FINRA and the SEC. By doing so, a firm can limit their exposure to the Net Capital Violation and stem a second violation for not filing a 17a-11 notification.

We have also seen a number of deficiencies relating to the impact of a broker dealer being owned by or affiliated with a bank. If a broker dealer is owned or affiliated with a bank, the broker dealer may only treat the amount of the deposit held at the affiliated bank as an allowable asset up to an amount which represents normal day-to-day activities. We have seen a number of acquisitions happen this past year which resulted in a broker-dealers becoming owned

by or affiliated with a bank. In these instances the bank has requested that the firm keep their cash deposits with them. When making the decision to make deposits with a Parent or affiliated bank, firms should ensure that they have sufficient capital to stem the impact of making the transition. In order to calculate the allowable portion of the deposit (day-to-day expenses), the general practice is to use a rolling twelve month average of expenses. Anything over that amount would be considered non-allowable for Net Capital purposes.

Conclusion

With the ever changing regulatory environment, it is important to keep your firm up to date on newly implemented and proposed financial reporting rules. Net Capital violations remain one of the most common findings in regulatory examinations, and with the broad breath of the Net Capital rule and new FINRA financial reporting rules, it doesn't look like that is going to be changing anytime soon.

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