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NYSE

MEMORANDUM

DEC 8 1970

TO: The Commission

FROM: Division of Trading and Markets **B**

SUBJECT: Net Capital Problems

A major factor in the deteriorating financial condition during the past year of many firms, such as Goodbody & Co., has been the net withdrawal of capital by partners, stockholders and subordinated lenders. Due to the decreased profitability and increased risk of an investment in a brokerage firm at this time, capital outflows can be expected to continue unless and until regulatory action is taken. At the end of October, the Commission specifically requested that the New York Stock Exchange prevent further capital withdrawals at Goodbody & Co., and, to that end, was willing to have the Exchange state that its action was dictated by the Commission. However, the Exchange held to its previously expressed position that it could not legally interfere with the contractual right of subordinated lenders to the repayment of their funds other than when a firm was insolvent. Although the Commission's net capital rule requires that subordinated capital be subject to an agreement preventing withdrawal at a time when the firm is in net capital violation (or would be so after such withdrawal), there is no comparable provision in the Exchange's rule and the Exchange is not in favor of such a modification.

① Significant capital withdrawals are scheduled to occur at various firms during the next six months, and additional withdrawals are possible, due to the short-term nature of many subordination agreements. In our judgment, action by the Commission is necessary if additional customers are not to be jeopardized. The most direct approach would be for the Commission to pass a rule, applicable to all broker-dealers, prohibiting capital withdrawals (including the pay-off of subordinated indebtedness or the return of subordinated securities) at a time when a firm's ratio exceeded 1200%, the Exchange's warning line. While we do not believe that such a rule would, as claimed by the Exchange, "impair" the contracts already in force between firms and their capital contributors, to obviate the question we recommend that the Commission take a different approach. We suggest an amendment to Rule 15c3-1 which would make it illegal for a firm to continue in business subsequent to permitting a capital withdrawal at a

time when the firm's ratio exceeded 1200%, (or thereby was caused to exceed 1200%). As part of the same rule, or by means of the attendant release, the Commission should also provide that any withdrawal made when a firm's ratio exceeded 2000% was inherently fraudulent, and thus prohibited. Also as a part of the same rule, the Commission should require the filing, at least 10 days prior to a capital withdrawal, of a "certified computation" establishing that the firm's ratio would not exceed 1200% subsequent to the withdrawal.

*Exemption*

A freeze on capital withdrawals would be of little use, however, as long as capital ratios are computed for the troubled firms by the New York Stock Exchange on the basis of its net capital rule. Accordingly, we further recommend that the Commission act immediately to remove the exemption from its net capital rule (Rule 15c3-1 under the Exchange Act) accorded to member firms of the New York Stock Exchange and other specified stock exchanges. As the Commission is thoroughly familiar with the financial condition of the industry and its largest firms, and with the events of the past year, we will only summarize the factors which have led to our recommendation:

1. The Exchange's net capital rule, as interpreted, is substantially less restrictive than that of the Commission and fails to afford customers and members of the industry sufficient protection.
2. Despite repeated urging and guidance from the Commission, the Exchange has not adopted those changes to its rule which would restore its former efficacy.
3. The Exchange has not enforced its net capital rule, even as weakened by interpretations, against large member firms. In this regard, the Exchange has knowingly accepted erroneous computations which have created the appearance of capital compliance by taking credit for restricted stock (as in Goodbody) and other unacceptable items. Not only has the Exchange intentionally taken steps to avoid finding violations of its rule, it has failed to take the necessary preventative or corrective actions in the financial area. And, by threatening the withholding of its trust fund monies, the Exchange has in the past attempted to foreclose the Commission's intervention in certain situations.
4. The Exchange has consistently underestimated and understated the extent of the operational and financial problems being experienced by the industry and by particular firms. In part, this has been due to the lack of an adequate system for identifying and monitoring troubled firms. In this regard, it should be noted that the Exchange last fall rejected the Commission's suggestions which would have resulted in significantly expanded reporting by member firms. While

the Exchange this year stepped up its monitoring activities, the Chairman of the Exchange's Special Committee on troubled firms recently wrote to the Board of Governors: "I think the New York Stock Exchange should consider whether...it can really talk seriously about having an effective early warning system...."

5. The Exchange has taken the position that: "the Exchange Constitution and Rules do not authorize immediate suspension of a member firm simply because of a net capital deficiency". Thus, the purpose of the net capital rule has been vitiated by the Exchange in allowing firms to operate while in capital violation.
6. The Exchange presently is financially unable to protect the customers of member firms which it permits to operate in violation of its net capital rule, or which it permits to operate without adequate restrictions at a time when their financial condition endangers customer funds and securities.
7. Congress has voiced a determination that the Commission act to tighten the standards governing the financial condition of brokerage firms. For example, in the recent SIPC debate, Chairman Staggers stated: "The bill...will also mandate a general upgrading of financial responsibility requirements of brokers and dealers." We know of no step which the Commission could take which would have such an immediate, profound, and beneficial effect toward that goal as the withdrawal of the net capital exemption from all exchange members.

We are fully aware that the removal of the exemption from the Commission's net capital rule now accorded to Exchange member firms probably will occasion considerable controversy. However, we do not believe that there is any alternative if the industry's financial problems are to be brought under control. For two years the Exchange has tried one expedient after another and has only succeeded in exhausting a \$55,000,000 trust fund; shaking the confidence of the nation's small investors, so that Congress has felt it necessary to authorize a loan of public monies to prevent complete panic. Self regulation in this area simply has not been successful.

In recommending that all firms be brought under the Commission's net capital rule, we are not, however, advocating an end to self-regulation. Instead, we would leave the primary obligation for monitoring the industry and taking corrective steps with the Exchange. This would not require new legislation or rules, inasmuch as every exchange, under Section 6(a) of the Exchange Act, has agreed that it will "enforce so far as is within its powers compliance by its members with this title, and any amendment thereto and any rule or regulation made or to be made thereunder." The difference in regulation would be that the key rule of financial responsibility which they would enforce, the net

capital rule, would be the one set forth in the Commission's rules, as interpreted by the Commission. Furthermore, we would ensure the proper monitoring and enforcement of this rule by the exchanges, through additional rules under the Exchange Act. Of course, the exchanges would remain responsible for enforcing their own net capital rules, and these could, conceivably, be strengthened.

We propose that simultaneous action be taken in three directions:

- (1) The Commission should send the ten day written notice to the exchanges specified in Rule 15c3-1, stating that their exemption from the Commission's net capital rule has been withdrawn, in accordance with the terms of the Rule.
- (2) The Commission should adopt, by emergency procedure, a rule under Section 17 of the Exchange Act requiring written reports as follows:
  - (a) A report by any broker-dealer whose net capital ratio exceeds 1200% in a given month, to the Commission and every exchange of which he is a member, and the NASD, stating his ratio.
  - (b) A report by any exchange (or the NASD) which discovers that a broker-dealer's ratio is in excess of 1200% (and has not been so reported), to the Commission, every other exchange of which the firm is a member, and the NASD, stating the firm's ratio. In the event that the firm is in violation of either the Commission's net capital rule or the exchange's, a report to that effect shall be made to the Commission, every other exchange of which the firm is a member, and the NASD, within 24 hours of the discovery.
- (3) The Commission should adopt a rule under Section 17 of the Exchange Act requiring every exchange of which a broker-dealer is a member, and the NASD, to report to the Commission what steps it is taking to protect the customers of a firm (and/or to correct the firm's problems) which reports a net capital ratio in excess of 1200%.
- (4) The Commission should adopt a rule under Section 15 of the Exchange Act by emergency procedure, freezing capital in all firms whose ratios now exceed (or would thereby exceed) 1200%, as computed under the Commission's net capital rule. As an alternative to a freeze, the Commission may wish to lower gradually its maximum net capital ratio from 2000% to 1200%. For example, the ceiling could be dropped to 1800% within sixty days, and could be lowered an additional 100% every six months thereafter until it reached 1200%. The lowering of the net capital ratio would have somewhat the same effect as a capital freeze, in that it would ensure that

a firm had enough capital to repay obligations to customers at the time it was forced to stop doing business.

The only substantive problem which we can foresee as a result of removing the net capital rule exemption arises from the fact that under the Commission's rule, no capital credit is given for subordinated indebtedness unless it is the subject of a "satisfactory subordination agreement", as defined therein. Virtually all of the subordinated indebtedness of NYSE member firms was contributed under agreements which would not meet the rigid standards set forth in the Commission's rule, and thus would not qualify as good capital once the exemption was lifted. In order to avoid a situation where a large number of member firms would be in net capital violation from the outset, it seems appropriate to us that a grace period be provided in the application of the Commission's rule in this respect. That is, the Commission in a release could provide that all subordinated capital presently acceptable under the rules of an exchange, regardless of whether it was the subject of a "satisfactory subordination agreement", would be allowed for computation purposes for three months after the removal of the exemption. A further extension, not to exceed an additional three months, would be granted by the Commission upon application and a showing of good cause by individual firms. The grace period would enable firms to renegotiate their subordination agreements and bring them in line with the Commission's requirements. No withdrawals of capital would be permitted during the grace period unless a firm could certify that it would still be under 1200% as computed under the Commission's rule without giving credit for subordinated indebtedness not acceptable under that rule.

Finally, the Commission should consider various supplemental measures to protect investors from the financial problems of brokerage firms. Among the possibilities are rules which would:

- (1) Prohibit a firm from having a debt to equity ratio in excess of 3:1. This would be comparable to Rule 325(a) of the Exchange, which applies only to corporations.
- (2) Require that a firm furnish the SEC with a net capital computation certified by its auditors, as part of its annual X-17A-5 report.
- (3) Require that a firm inform its customers of its net capital ratio on the account statements mailed out monthly or quarterly.
- (4) Prohibit a firm from accepting as capital monies or securities loaned by a pension or profit sharing trust established for the benefit of its own employees.

- (5) Increase the minimum net capital required to \$100,000 in the case of firms carrying customers' funds and securities.

HBaruch/rmb