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Broker-dealer trends and certain issues related to introducing broker-dealers

With increased scrutiny from legislators, investors and the public, broker-dealers must balance performance and regulatory requirements.

by Rich Flowers, audit partner

As the financial services industry continues to grow, broker-dealers look for ways to maximize on emerging opportunities and stay ahead of the curve. However, with increased scrutiny from legislators, investors and the public, broker-dealers must balance performance and regulatory requirements.

With the creation of the Financial Industry Regulatory Authority (FINRA) in July 2007, a continuing effort has been made to harmonize the National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE) rules. The result of this rule harmonization is that the 5,000 NASD-supervised broker-dealers will now be incorporated into the NYSE surveillance umbrella.

Accordingly, such NASD firms should be alert to possible revisions relating to financial and operational rules, including capital compliance, regulatory notification requirements and requests for

examinations by FINRA. Here is a summary of the broker-dealer trends in the fourth quarter of 2007 and their implications, as well as certain issues applicable to introducing broker-dealers.

Trend: Revisions of SFAS* 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, relating to repurchase agreements of same security with same counterparty (FSP 140-d)

The Financial Accounting Standards Board (FASB) has been considering the issue of a sale of a security and subsequent buyback with the same party as not meeting the criteria of a true sale. Instead, it would be characterized as financing with the security remaining on the books of the transferor and the repurchase agreement being reflected as financing of the security. Such a development has the potential to substantially inflate the transferor's (usually a broker-dealer) balance sheet.

*SFAS: Statement of Financial Accounting Standards



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Broker-dealers should closely monitor developments relating to this proposed FASB Staff Position (FSP) 140-d and customize their transactions to avoid the potential consequences of having to not reflect such transfers as sales.

Trend: Impact of SFAS 159, *Fair Value Election Option for Financial Assets and Financial Liabilities*, may be reversed in regulatory computations

SFAS 159 created an opportunity for broker-dealers to record gains on fair valuing or value-issued debt as their credit ratings declined; the financial liability is worth less on a fair value basis with the gain recorded in the income statement. Regulators are understandably not inclined to permit broker-dealers to reflect this gain in their computations of net capital.

Broker-dealers should be alert to potential instructions from the regulators to adjust their net capital computations to remove the consequences of this gain. Since this elective option is part of generally accepted accounting principles (GAAP), the regulators will not advise broker-dealers to change GAAP, but will require adjustments to net capital.

Trend: Valuation adjustments of model-based assets may lead to revisions of net capital for consolidated supervised entities (CSE)

Broker-dealers who had previously requested to be supervised by the Securities and Exchange Commission (SEC) on a consolidated basis (thus including European operations and other non-regulated businesses) were able to develop a risk-based capital regime as opposed to the traditional method of non-allowable assets and haircuts on proprietary inventory.

This risk-based approach generally resulted in a lower capital requirement as many derivative products were assigned 100 percent non-allowable treatment under the traditional method but were assigned a substantially lower charge under the CSE-developed guidelines. The SEC individually approved each broker-dealer.

With the recent substantial write-downs reported by the financial industry, we can expect the SEC to revisit its reviews of the CSE's risk assessments and call for higher measures of capital.

Trend: Outsourcing rules may finally be issued

In the past few years, the NYSE has issued several editions of proposed rules to permit certain regulatory functions to be outsourced to third parties. This has

been in an effort to allow broker-dealers to reduce their operating costs through incorporation of lower-cost providers. The SEC had been hesitant to allow any regulatory function to be outside its scope of regulatory authority.

Broker-dealers should be prepared for possible final action taken by the SEC, which may permit certain regulatory functions to be outsourced to intermediaries who have proven expertise in the functional area. Of course, the ultimate responsibility will remain with the regulated broker-dealer.

Issues of introducing broker-dealers

Introducing broker-dealers allow a firm to participate as a regulated broker without incurring the substantial investments required for a clearing broker.

Issue: Introducing broker-dealers who intend to act in the capacity as an introduced prime broker

In recent years, introducing broker-dealers have expanded their relationships with their customers to include providing services as a prime broker while still retaining the clearing broker for the actual operations and extension of credit roles. This enables the introducing broker-dealer to retain the direct customer relationship and reduce the possibility of surrendering the customer to the clearing broker.

However, this places additional requirements on the introducing broker-dealer, which include:

- Increasing minimum net capital to \$1,500,000.
- Performing the locate for availability of shares to cover any short sales.
- Documenting and disseminating information regarding prime broker policies and procedures currently done by the prime broker, including obtaining customer confirmation of the contract amount, the security involved, number of shares or number of units and whether the transaction was a long or short sale or purchase by the morning of the next business day after trade date.

As a result, introducing broker-dealers will have to expand their operational capacity, but they can benefit from the resultant opportunity to assist in the development of policies and procedures.

Issue: Introducing broker-dealers who have access to clearing broker-dealers' books and records

Introducing broker-dealers are continually seeking to improve their service to customers by monitoring the transactions they have introduced to their clearing firms. Such service includes ensuring that the customer's transactions are properly reflected on the books and records of the clearing broker on a timely basis. Introducing broker-dealers often perform this activity to identify potential errors prior to settlement date or prior to reconciliation by the clearing firm.

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Rich Flowers
Audit partner, financial services

If the clearing broker provides access to its books and records by the introducing broker-dealers, the introducing broker-dealers must demonstrate that they have adequate policies and procedures in place to ensure that such entries are accurate. This also represents an opportunity to assist in their development.

Issue: Capital treatment of introducing broker-dealers' clearing deposit

There is a current requirement that clearing deposit agreements need to permit return of the funds to the introducing broker-dealer within 30 calendar days for the deposit to be considered allowable. Such rules have been interpreted to commence five business days after the transfer of customer assets and not the date of the notice of termination. This allows for situations where the clearing broker may not be able to accomplish a tape-to-tape transfer, resulting in transfer delays.

In addition, in situations where there is a penalty in place for termination of the clearing agreement, introducing broker-dealers would be required to consider such a penalty as a non-allowable asset in the determination of regulatory capital. Such a termination penalty may be reduced if it is subordinate to claims by introducing broker-dealers' customers that have been approved by the trustee appointed by the Securities Investor Protection Corp. •

About the author

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Rich Flowers has been an audit partner in Grant Thornton's financial services practice since 2002. Prior to joining Grant Thornton, Rich had been with a Big Five accounting firm for more than 30 years, spending the last 21 years as a partner. He has an accomplished history serving numerous clients in the financial markets industry, from national retail and clearing brokers to investment banking firms and major foreign banks.

He is a knowledge leader in the securities industry and serves as an adviser on regulatory, operational and technical matters for many of Grant Thornton's brokerage clients. He currently serves as the sole public accounting representative on the FINRA Financial Responsibilities Committee and previously served on the AICPA Stockbrokerage & Investment Banking Committee. He is also a board member of the Financial Management Division of the Securities Industry and Financial Markets Association (SIFMA) and an executive committee member of the Internal Audit Division of SIFMA.

Rich served as an active contributor to the *Brokers and Dealers in Securities – AICPA Audit and Accounting Guide*. He has represented the public accounting industry in presentations to the FASB regarding specialized industry accounting matters, including implementation of SFAS 125 and issuance of SFAS 127 regarding deferral of effective date of certain provisions of SFAS 125, and development of FIN 41 regarding netting provisions of repurchase agreements.

He earned a B.S. in business from Ithaca College in Ithaca, N.Y., and an MBA in accounting and finance from the Amos Tuck School at Dartmouth College in Hanover, N.H.



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