involving OTC equity securities no later than two trading days following the date of the transaction under review.

FINRA Rule 11894

2.3. FINANCIAL MANAGEMENT

2.3.1. NET CAPITAL REQUIREMENTS

The SEC requires member firms to carry a minimum amount of capital to meet their ongoing financial obligations. It imposes net capital requirements on member firms in order to measure a firm's financial strength and to protect customers from their broker-dealers going out of business. Minimum requirements differ depending on the type of firm. Firms must calculate their net capital daily to make sure they meet these minimum requirements.

Net capital refers to the *liquid* value of a firm. A firm's liquid value is the amount of liquid assets remaining after its liabilities have been paid off. The following equation is used by the SEC to determine a firm's net capital:

net capital = net worth + subordinated debt – non-allowable assets – haircuts

Clear as mud? Let's break it down.

2.3.1.1. Net Worth

Net worth is the difference between assets and liabilities. Assets are what a firm owns and liabilities are what a firm owes to outsiders. Net worth is also called "owners' equity" because it is what is left over of the assets when all the creditors are paid off. On a balance sheet, assets must always equal liabilities plus owners' equity.

Adjustments to net worth. Net worth is usually calculated from the assets and liabilities contained on the firm's balance sheet. For purposes of calculating net capital, the SEC requires certain adjustments to be made to a broker-dealer's net worth.

Unrealized profits are earned profits that have not yet been delivered or cashed in. A stock that has risen in value but not been sold is one example. A listed call option whose underlying security is currently priced higher than its exercise price is another. Unrealized profits or losses on forward contracts are a third. These unrealized profits must be added to the net worth calculation. This is achieved by adding the difference between the market value of a security and its book value (the purchase price of the security).

A **deferred tax liability** represents taxes that a company is able to defer into a future year because of a difference in the tax accounting rules and standard accounting practices. This would include income tax liabilities on unrealized profits and assets subject to haircuts. It also refers to deferred tax liabilities on non-allowable assets. Deferred tax liabilities must be added to the net worth calculation. These liabilities are added because they are counted as liabilities on the balance sheet but don't have to be paid until a later time.

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2.3.1.2. Subordinated Debt

Subordinated debt is debt that ranks below other debt in its claims on assets or earnings. It is not backed by collateral and is the last kind of debt to be paid back to investors if the firm is forced to liquidate.

From an investor's standpoint, subordinated loans have higher risks compared to senior debt. To attract outside investors, a subordinated debt agreement must offer significantly higher interest rates. Investors who take on subordinated debt may also be parties who already have a large stake in the firm, such as a partner or affiliate, and are willing to take on a riskier loan for the firm's benefit.

From the standpoint of the borrowing firm, issuing subordinated debt is often a matter of necessity. For example, many lending agreements prohibit a borrower from incurring an additional loan, unless it is subordinated to the original subordinated loan. At other times, subordinated debt may be incurred for the express purpose of increasing a firm's net capital. Subordinated debt increases the firm's assets without increasing its liabilities.

Since subordinated debt ranks below all other debt in its claims on assets, it is excluded from the firm's liabilities in the net capital calculation. Because subordinated debt was originally included in liabilities and therefore subtracted from assets to calculate net worth, it now must be added back in.

2.3.1.3. Non-Allowable Assets

A firm's assets include cash, securities, property, inventory, and office equipment. **Liquid assets** are assets that can quickly be converted into cash. The securities a firm owns are a liquid asset. So are the securities a brokerage holds on behalf of a customer, just as the cash acquired from a bank loan is a liquid asset.

Non-allowable assets are illiquid assets, assets that cannot be quickly sold at fair market value. These include fixed assets, unsecured receivables, and assets that are unlikely to be collected. Because non-allowable assets should not be included in net capital, their value must be subtracted from net worth.

Fixed assets and prepaid items. Fixed assets, like office buildings, real estate, computers, and other equipment are hard to sell in an afternoon. Prepaid items, such as rent and insurance, are also difficult to recover. These are non-allowable assets.

Unsecured receivables. Receivables are money that is owed a business by its customers or other debtors. Receivables are considered assets, even if they are not currently due. **Accounts receivable** refers to unsecured short-term debt, such as credit card debt. **Notes receivable** refers to short-term debt secured by a promissory note, such as a check. For purposes of computing net capital, notes receivable are secured debt (that is, liquid) and therefore an allowable asset. Accounts receivable, as unsecured receivables, are an illiquid and non-allowable asset.

2.3.1.4. Securities Haircuts

Haircuts are a discount that the SEC applies to the market value of securities held by a

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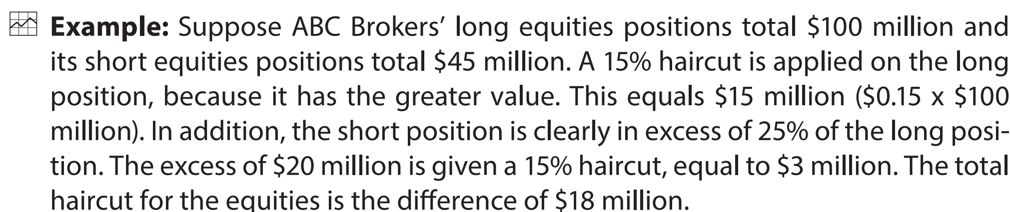
broker-dealer. Since the value of a security is constantly fluctuating, the SEC discounts its current market value to provide a cushion for a possible decrease in value at the time of a firm's liquidation.

Haircut amounts vary depending on the type of security. Riskier securities tend to have higher haircuts. Here is an exhaustive list of securities haircuts.

Equity securities. For common stock, warrants, ADRs, and other equity securities, the haircut is 15% of the market value of the greater of the long or short positions. In addition, if the market value of the lesser of the long or short positions exceeds 25% of the market value of the greater of the long or short positions, the deduction on the amount of that excess will be 15% of market value.



Example: Suppose ABC Brokers' long equities positions total $100 million and its short equities positions total $45 million. A 15% haircut is applied on the long position, because it has the greater value. This equals $15 million ($0.15 x $100 million). In addition, the short position is clearly in excess of 25% of the long position. The excess of $20 million is given a 15% haircut, equal to $3 million. The total haircut for the equities is the difference of $18 million.

Preferred stock. Non-convertible **preferred stock** that ranks ahead of all other classes of stock of the same issuer will generally receive a haircut equal to 10% of the market value of the greater of the long or short position. Other non-convertible preferred stock generally will receive a 15% haircut.

Money market funds. Redeemable securities of an investment company consisting solely of cash or money market instruments must deduct 2% of the market value of the greater of the long or short position.

Non-marketable securities. Haircuts are 100% of market value for securities that have no ready market or that cannot be publicly offered or sold because of contractual arrangements or regulatory restrictions.

2.3.1.5. Sample Net Capital Calculation

XYZ Brokerage Inc. carries the accounts of many customers and has custody over their assets. The following is selected balance sheet information from XYZ Brokerage.

Asset	
Cash	$100,000
Prepaid insurance	$40,000
Customer debit balances	$280,000
Securities inventory—marked to the market	$200,000
Accounts receivable	$70,000
Total assets	**$700,000**

Liability	
Accounts payable	$25,000
Customer credit balances	$175,000
Stock loaned	$45,000
Bank loans	$130,000
Subordinated loans	$250,000
Total liabilities	**$625,000**

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Step 1: Calculate *net worth* by subtracting total liabilities from total assets.

$700,000 – $625,000 = $75,000

Step 2: Add the amount of subordinated loans to the net worth, resulting in the *total available capital*.

$250,000 + $75,000 = $325,000

Step 3: Subtract all the non-allowable assets from the total available capital. This will include accounts receivable ($70,000) and prepaid insurance ($40,000), for a total of $110,000.

$325,000 – $110,000 = $215,000

Step 4: Subtract any haircuts. Note that haircuts are based upon market prices and must be marked to the market daily. As the example states above, the market value of the securities inventory is $200,000. Assuming the securities are all marketable equity securities, we take 15% of $200,000, which will give us a total of $30,000.

Subtract the haircuts for the total net capital amount.

$215,000 – $30,000 = $185,000

The total net capital amount is $185,000.

2.3.2. CUSTODY AND CONTROL OF SECURITIES

2.3.2.1. Customer Protection Rule

Between 1968 and 1970, more than a dozen broker-dealers went bankrupt, resulting in customer losses in excess of $100 million. The SEC responded with Rule 15c3-3, known as the customer protection rule. Prior to that time, broker-dealers had been in the habit of pledging customer securities as collateral for bank loans, and customer credit balances had been used to finance the broker-dealers' business. The main focus of the customer protection rule is to ensure that customer funds and securities are kept separate from the firm's funds and safe from the risks associated with the firm's business operations.

Rule 15c3-3 has two parts:

1. The first part requires broker-dealers to promptly obtain and maintain physical possession or control of all fully paid and excess margin customer securities.

2. The second part requires broker-dealers to segregate all customer monies obtained from the use of customer assets that have not been used to finance transactions on behalf of other customers.

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