August 6, 2003

SEC STAFF ISSUES NO-ACTION LETTER CONCERNING CERTAIN EXPENSE SHARING ARRANGEMENTS

The staff of the Securities and Exchange Commission (“SEC”) recently issued a letter (the “Letter”) to the New York Stock Exchange, Inc. (“NYSE”) and to NASD Regulation, Inc. (“NASD”) concerning the application of the SEC’s financial responsibility rules to certain expense sharing agreements or arrangements (collectively “Expense Agreements”). Pursuant to these Expense Agreements, a third party, usually a parent or other affiliate of the broker-dealer, either pays, or agrees to pay, one or more of the broker-dealer’s expenses.

In its Letter, the staff promulgated a long list of requirements concerning Expense Agreements in order to curb certain abuses that the NYSE and the NASD stated they had observed with regard to such agreements. As a result, broker-dealers will likely find the administrative convenience associated with Expense Agreements significantly diminished. Broker-dealers that have one or more expenses paid by a third party may now be required to, among other things, file notice with their designated examining authority (“DEA”) and make a separate record of the expenses paid by a third party.

Expense Agreement Regulatory Requirements

A broker-dealer that has one or more of its liabilities or expenses paid or assumed by a third party (including a parent or other affiliate) and that does not

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1 For purposes of the letter, the financial responsibility rules include the net capital rule, Rule 15c3-1 under the Securities Exchange Act of 1934 (“Exchange Act”), and reporting and record keeping requirements under Exchange Act Rules 17a-3, 17a-4 and 17a-5.

2 Examples of Expense Agreements include: (1) an agreement whereby a parent holding company or other affiliate agrees to provide one or more goods or services to a broker-dealer, such as office space or computer equipment, in return for a percentage of the broker-dealer’s revenue, or (2) an agreement between the broker-dealer and its parent or another affiliate, whereby the parent agrees to assume all of the liabilities that the broker-dealer has previously incurred.
SEC Staff Issues No-Action Letter Concerning Certain Expense Sharing Arrangements

record such expenses or liabilities in its financial records or on the reports that it files pursuant to the financial responsibility rules (e.g., FOCUS reports) must:

1. Enter into a written agreement with the third party that, at a minimum, identifies the expenses each party is obligated to pay, the extent of the broker-dealer’s obligation with respect to the expenses paid by the third party, and any method used to allocate expenses between the parties.

2. Notify its DEA that it has entered into an Expense Agreement.

3. Make a separate record of all such liabilities and expenses and provide access to the third party’s books and records in order to demonstrate the completeness of such record. Based on our telephone discussion with the SEC staff, we understand that implicit in this requirement is the concept of materiality; a broker-dealer will not have violated Rule 17a-3 if it fails to make a record of a nominal amount of expenses. As a result of the staff choosing to not include an explicit materiality threshold in the Letter, it is unclear whether such a threshold will be applied by SRO examiners during the course of future examinations.

In addition, in a footnote included in the Letter, the staff stated “[i]f a third party pays certain expenses of a broker-dealer, that party may be required to register with the Securities and Exchange Commission as a broker-dealer.” In our discussion with the SEC staff, they stated that this was not a new requirement and that the “certain expenses” that would necessitate registration with the SEC were primarily salary expenses (the staff also mentioned CRD fees and NASD assessments). The staff stated that if a third party paid the salaries of registered representatives who work for a broker-dealer, the third party would likely have to register as a broker-dealer. It’s by no means clear to us that the existing no-action letter precedent would require this result.

In addition to the above requirements, which apply to all Expense Agreements, the following additional requirements apply in cases where a third party (including a parent or other affiliate) agrees to assume one or more liabilities of a broker-dealer.

1. A broker-dealer must enter into a written agreement with the vendor and the third party that clearly states that the broker-dealer has no liability, direct or indirect, to the vendor and that identifies the expenses the third party has agreed to pay and any methodology for allocating expenses between the broker-dealer and the third party.

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3 A broker-dealer is required to make the separate record even if it is not required to record the liabilities or expenses in its financial records pursuant to GAAP or for purposes of calculating its net capital.
2. A broker-dealer is prohibited from recognizing a capital contribution for the liabilities assumed by a third party and must recognize all assumed liabilities for net capital purposes, unless:

a. The third party and vendor to whom the liability is owed agree in writing that the broker-dealer is not directly or indirectly liable.

b. The liability is not a liability of the broker-dealer under GAAP and there is no other indication that the broker-dealer is liable.

c. The broker-dealer can show that the third party has sufficient resources, separate and apart from the broker-dealer, to pay the liability.

The following additional requirements apply to third parties that have agreed to pay or assume the liabilities of a broker-dealer and that are shareholders of, or have invested capital in, the broker-dealer:

1. A broker-dealer that enters into an Expense Agreement with a third party that is also a shareholder or investor in the broker-dealer may be required to reclassify, for purposes of calculating its net capital, certain expenses and liabilities paid by such third party. In the event that a broker-dealer makes a capital distribution to a third party within a fifteen month period that begins three months prior, and ends twelve months after, the assumption or payment of an expense or liability, the broker-dealer must include the expense or liability in its net capital calculation, unless the broker-dealer records the expense or liability in its financial records.

Based on our discussion with the SEC staff, this requirement does not apply if the third party records the expense and a related receivable, and the broker-dealer records the expense and a related payable, in inter-company accounts. This requirement also does not apply to a situation where a holding company and its subsidiary broker-dealer entered into an arrangement whereby the holding company agreed to pay all of the broker-dealer’s expenses in return for an administrative services fee from the broker-dealer, provided that such fee is reasonably related to the expenses incurred by the holding company on behalf of the broker-dealer. In such a situation, however, the broker-dealer would be required to keep a separate record of expenses paid by the holding company.

2. The SEC staff also cautioned in the Letter that if capital is contributed to a broker-dealer with an understanding that it can be withdrawn at the option of the contributor, the contribution may not be included in the firm's net capital computation and must be re-characterized as a
liability. The staff’s presumption is that any withdrawal of capital by a third party within one year of it assuming or paying the expenses of the broker-dealer was contemplated at the time of the contribution.

Rulemaking/Interpretive Action

The staff appears to have struggled with how to characterize the Letter. Initially, the staff characterized the Letter on its web site as a “no-action” letter — an odd choice in our view since neither the NYSE nor the NASD appears to have requested no-action relief and no such relief was granted. Within a few days of posting the Letter, however, the staff removed the “no-action” heading and appears to now view the Letter as an interpretation.

Whether the Letter is an interpretation is an open question in our minds. The extensive requirements imposed by the Letter raise the question of whether the staff has issued an interpretation of the Commission’s financial responsibility rules, or whether it has engaged in a rulemaking, which would require compliance with the Administrative Procedures Act’s “notice and comment” requirements.

Conclusion

Broker-dealers that have one or more of their expenses paid by a third party, should review their current practices in light of the Letter to ensure that, on a going forward basis, they comply with the regulatory requirements included in the Letter.

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A copy of the SEC staff’s no-action letter is attached for your convenience in PDF format. If you have any questions, please contact:

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