

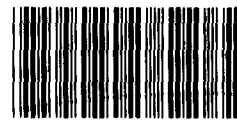
GAO

Report to the Chairman, Subcommittee  
on Commerce, Consumer, and Monetary  
Affairs, Committee on Government  
Operations, House of Representatives

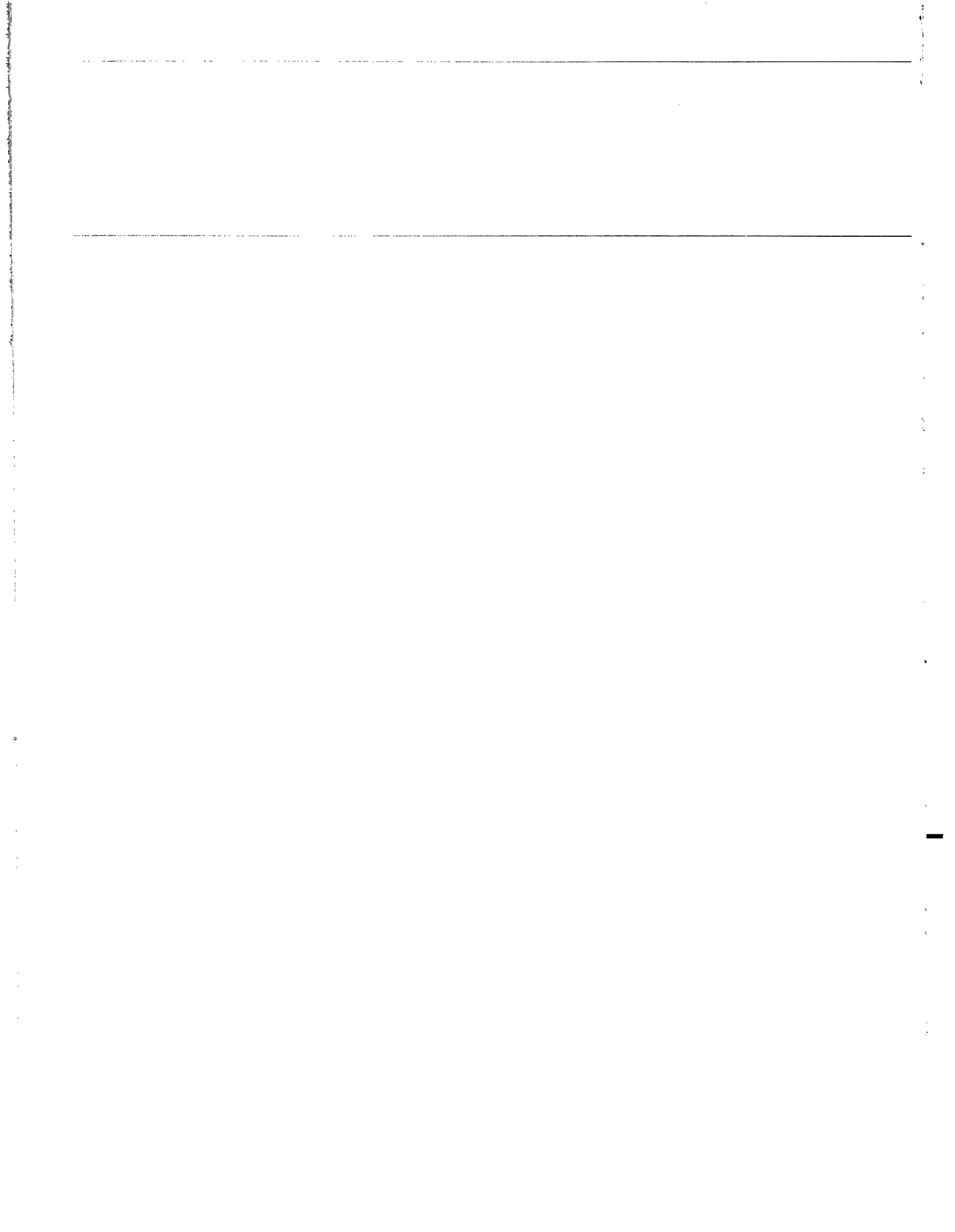
November 1991

SECURITIES  
REGULATION

Customer Protection  
Rule Oversight  
Procedures Appear  
Adequate



145303



**General Government Division**

B-246252

November 21, 1991

The Honorable Doug Barnard, Jr.  
Chairman, Subcommittee on  
Commerce, Consumer, and Monetary Affairs  
Committee on Government Operations  
House of Representatives

Dear Mr. Chairman:

This report responds to the Subcommittee's request that we review the Securities and Exchange Commission's (SEC) oversight and enforcement of SEC Rule 15c3-3, known as the customer protection rule. The Subcommittee was concerned about how SEC ensures that broker-dealers protect customer assets. As agreed with the Subcommittee, we examined how SEC determines whether broker-dealers are in compliance with the possession or control requirement of the rule<sup>1</sup> and whether SEC has written procedures or methodologies for testing compliance. We also examined the procedures SEC uses to monitor the examinations done by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD), both self-regulatory organizations (SRO), to determine their members' compliance with the rule.<sup>2</sup>

---

**Results in Brief**

SEC, NYSE, and NASD have written procedures, called examination guidelines, for reviewing broker-dealer compliance with the possession or control requirements specified by Rule 15c3-3. These guidelines address all the requirements of the rule needed to determine broker-dealer compliance or noncompliance with the possession or control requirements of Rule 15c3-3.

NYSE and NASD told us that they annually examine all of their member broker-dealers who are required to comply with Rule 15c3-3. SEC officials said they examine about 6 percent of the broker-dealers that NYSE and NASD have previously examined to ensure broker-dealer compliance with securities laws and to evaluate and provide feedback to NYSE and NASD on the quality of their examination programs. Between 1988-1990, SEC found possession or control violations in 57 examinations of

---

<sup>1</sup>The rule requires broker-dealers to maintain physical possession or control of securities owned by their customers and restricts broker-dealers' use of those securities.

<sup>2</sup>The Securities Exchange Act of 1934 created a system in which SEC and the SROs work cooperatively to ensure compliance with federal securities laws and regulations and SRO rules. Under this system, the SROs oversee their members, and SEC in turn oversees the SROs.

---

broker-dealers where NYSE and NASD had not discovered the violations during their previous examinations. We found that for the 17 examinations in 1990, SEC had encouraged NYSE and NASD to correct the violations, and NYSE and NASD had taken steps designed to remedy the deficiencies identified.

---

## Background

Rule 15c3-3 implements provisions of Section 15(c)(3) of the Securities Exchange Act of 1934 as amended by Section 7(d) of the Securities Investor Protection Act of 1970. These provisions give SEC authority to (1) prescribe rules for the protection of investors and (2) provide safeguards regarding broker-dealers' acceptance of custody and use of customers' securities. SEC promulgated the rule in 1972 in response to severe problems in the securities industry, particularly from 1968 to 1970. Industry analysts reported that, during this time period, it was not unusual for broker-dealers to place customer securities and funds at unwarranted risk by using them for their own business purposes. The analysts reported that a virtual breakdown occurred in control over the possession, custody, location, and delivery of securities, as well as the payment of money obligations to customers. SEC officials stated that the breakdown, which included the failure of more than a dozen NYSE broker-dealers and customer losses exceeding \$100 million, caused a severe loss of public confidence in the securities industry.

Rule 15c3-3's restrictions on the use of customer securities and requirement to take possession or control of securities were designed to protect customer assets and increase customer confidence. The rule's possession or control requirements, which separate customer assets from firm assets on the books of the broker-dealer, are meant to ensure that in the event of a liquidation, the broker-dealer will have sufficient assets to cover customer accounts. Under Rule 15c3-3, a broker-dealer must

---

promptly obtain and maintain the physical possession or control<sup>3</sup> of all fully paid and excess margin securities<sup>4</sup> carried for customers.

The rule requires broker-dealers to make a daily determination of the number of fully paid and excess margin securities in their possession or control, as well as the number of fully paid and excess margin securities not under possession or control. If the broker-dealer has less shares of a security in its possession or control than is required, it has a “deficit” position in this security; if the broker-dealer has more shares of a security in its possession or control than is required, it has “excess” shares of this security.<sup>5</sup>

The rule specifies time frames by which a broker-dealer must act to obtain possession or control of a customer’s securities to eliminate deficit positions. A broker-dealer violates Rule 15c3-3 if it creates or increases the number of shares that are in a deficit position by delivery of securities.<sup>6</sup> Once a deficit has been created, a broker-dealer violates

---

<sup>3</sup>Paragraph (c) of Rule 15c3-3 specifies the locations in which a security will be considered in the control of the broker-dealer. These control locations are a clearing corporation or depository, free of any lien; a Special Omnibus Account under Regulation T with instructions for segregation; a bona fide item of transfer of up to 40 days; foreign banks or depositories approved by SEC; a custodian bank; in transit between offices of the broker-dealer or are being held by a guaranteed corporate subsidiary of the broker-dealer; in the possession of a majority controlled subsidiary of the broker-dealer; and any other location designated by SEC, such as in transit from or to any control location for no more than 5 business days.

<sup>4</sup>Excess margin securities in customer accounts are securities with a market value in excess of 140 percent of the debit balances (amounts customers owe the firm). For example, assume that a firm has a customer account with 100,000 shares and that each share has a \$10 market value, for a total value of \$1,000,000. The debit balance is \$10,000. Applying 140 percent to \$10,000 results in free securities of \$14,000 usable by the firm for collateral. To calculate the excess margin securities in the account, subtract \$14,000 from \$1,000,000 to get \$986,000 —the market value of securities in the account that must be brought under possession or control by the firm. The 140 percent calculation is used because banks generally discount securities offered as collateral to about 70 percent of their value. The rule uses the reciprocal, roughly 140 percent. From the preceding example, applying 70 percent to the \$14,000 market value of free securities results in \$9,800, the amount a bank will loan a firm. Note that the \$9,800 approximates the \$10,000 debit balance in the account.

<sup>5</sup>As an example of an excess or deficit, assume that a broker-dealer has customer cash accounts showing ownership of 10,000 fully paid shares of security ABC and no margin accounts with ABC; however, the broker-dealer has only 9,000 shares in control locations. At the end of the day, when the broker-dealer determines its daily possession or control position, it will find it has a 1,000 share deficit of security ABC. By contrast, if the firm’s customer accounts showed ownership of the same 10,000 fully paid shares of the securities, but the firm had 12,000 shares of the security in control locations, the firm would have an excess of 2,000 shares.

<sup>6</sup>Deficits created or increased that are merely temporary and solely the result of normal business operations do not result in Rule 15c3-3 violations. For example, a customer pays the balance of his/her margin debit. Under the rule, this payment requires the firm to move margin securities that were in a noncontrol location to a control location because they have become fully paid securities. If such movement of securities created or increased a deficit, a violation would not have occurred. However, broker-dealers must eliminate such deficits by taking action(s) within the required time frames.

the rule if it does not take the required actions to eliminate the deficit within the prescribed time periods. For example, if a deficit exists in a security, and a broker-dealer has securities of the same issue as collateral for bank loans, the broker-dealer should issue instructions to the bank for the release of those securities not later than the next business day. The broker-dealer must obtain physical possession or control of such securities within 2 business days following the issue date of the instructions. For stock loans (securities loaned to another broker-dealer), the broker-dealer should issue instructions to the borrower to return loaned securities not later than the next business day and obtain physical possession or control of such securities within 5 business days following the issue date of the instructions.

Generally, broker-dealers can be exempt from possession or control restrictions only by refusing to hold customer securities or funds. About 88 percent of NYSE and NASD member broker-dealers are exempt from Rule 15c3-3.

## Objectives, Scope, and Methodology

To evaluate how SEC, NYSE, and NASD determine broker-dealer compliance with the possession or control sections<sup>7</sup> of Rule 15c3-3, we reviewed proposals to adopt the rule and the final release of Rule 15c3-3; SEC's, NYSE's, and NASD's broker-dealer examination guidelines for Rule 15c3-3; and selected SEC interpretations of the rule and available literature.

To determine how SEC oversees NYSE's and NASD's Rule 15c3-3 broker-dealer examination programs, we reviewed (1) all 57 SEC broker-dealer examinations (from 1988-1990) in which SEC examiners found a violation that existed during the period of the SRO examination but was not discovered by the broker-dealer's designated SRO; (2) 28 broker-dealer and SRO responses (for 1990) to SEC's findings from 17 examinations; (3) SEC, NYSE, and NASD statistics on broker-dealer violations of Rule 15c3-3 (for 1988-1990); (4) administrative proceedings that imposed remedial sanctions taken by SEC against broker-dealers who committed Rule 15c3-3 violations; (5) NASD educational memorandums and training materials; (6) congressional hearings; (7) SEC oversight guidelines for

<sup>7</sup>In addition to the possession or control sections, Rule 15c3-3 requires broker-dealers to establish a special reserve bank account for the exclusive benefit of customers. The reserve account balance must be calculated weekly (or monthly for certain small firms). The required balance in the account is determined by comparing the amount of money customers owe the firm and the amount of money the firm owes customers. If the amount the firm owes its customers exceeds the amount customers owe the firm, that amount must be on deposit in the special reserve bank account. While we did not review this section of the rule, it plays an important role in protecting customer funds.

broker-dealers and NASD district offices; and (8) documentation of regular SEC meetings with NYSE and NASD on compliance with Rule 15c3-3. During our review of the 57 SEC examinations we determined the nature of the violations found and whether the examination guidelines were applied.

With regard to both broker-dealer compliance with the rule and SEC oversight of NYSE and NASD, we interviewed (1) officials at SEC's New York Regional Office and headquarters officials at SEC, NYSE, and NASD; (2) a Securities Industry Association panel of operations experts from five of the nation's largest broker-dealers; (3) officials from the Depository Trust Company (DTC) and the National Securities Clearing Corporation; (4) officials from a service bureau;<sup>8</sup> and (5) officials from the Securities Investor Protection Corporation. We also discussed possession or control rule requirements with personnel responsible for compliance with Rule 15c3-3 at four broker-dealers. These officials demonstrated for us and provided examples of how they comply with the rule.

We did our work between March and August 1991 in accordance with generally accepted government auditing standards.

## SEC, NYSE, and NASD Have Examination Procedures to Determine Broker-Dealer Compliance With Rule 15c3-3 Possession or Control Requirements

SEC, NYSE, and NASD all review broker-dealer compliance with Rule 15c3-3. Unlike SRO examinations, whose sole purpose is to ensure member broker-dealers' compliance with securities laws and SRO rules, SEC's oversight examinations have two primary goals: (1) to ensure broker-dealer compliance with securities laws and (2) to evaluate and provide feedback to SROs on the quality of their examination programs. In this section, we address SROs' monitoring of their member broker-dealers and broker-dealer compliance with the possession and control requirements of Rule 15c3-3.

NASD officials told us the scopes of NYSE and NASD examinations differ because NYSE member broker-dealers are on average larger and more involved in complex activities that are affected by the rule, such as securities lending, than NASD firms. The scopes of SRO and SEC examinations also differ. NYSE and NASD officials told us they annually examine

<sup>8</sup>Rather than developing their own computer information systems, broker-dealers can contract with service bureaus that provide the data processing and back-office computer support services used to comply with Rule 15c3-3.

---

their member broker-dealers that must comply with Rule 15c3-3. In contrast, SEC officials stated they annually examine about 6 percent of the broker-dealers examined by SROs.

While the goals and scopes of the examinations may differ, the basics of the review processes used during the possession or control part of the examination are similar for SEC, NYSE, and NASD. SROs and SEC provide their examiners with an examination checklist that requires the examiner to determine the broker-dealer's compliance with possession or control requirements. Our review of the three examination checklists indicated that they were similar, and each addressed all the requirements of Rule 15c3-3.

According to SEC, NYSE, and NASD officials, examiners plan the focus of each Rule 15c3-3 examination on the basis of information gathered primarily from broker-dealer financial reports and past examinations. SEC officials told us that because of SEC's oversight function, its examiners also review SRO examination workpapers when planning their own examinations. Additionally, unlike the SROs who examine all of their member broker-dealers, SEC must choose which broker-dealers to examine.

In the examinations we reviewed, SEC and SRO examiners reviewed the broker-dealers' written procedures, required by the rule, which describe the means by which broker-dealers comply with possession or control requirements. SRO and SEC examiners verified, through security counts and confirmation of broker-dealer records with third-party sources,<sup>9</sup> the accuracy of the records used by the broker-dealer to comply with the rule.

The examinations we reviewed indicated that examiners verified the accuracy of reports, commonly called excess/deficit reports, used by the broker-dealer to determine if it has an excess or deficit in a security. Examiners determine the accuracy of excess/deficit reports because the rule requires that broker-dealers make a daily determination of each security's possession or control status. Flaws in an automated excess/deficit reporting system can lead to repetitive violations of possession or control requirements by a broker-dealer. While reviewing the automated systems used by broker-dealers to determine if an excess or deficit existed, examiners ascertained whether the system correctly categorized

---

<sup>9</sup>For example, SEC and SRO examiners reconcile the number of securities that the broker-dealer's records indicate are at DTC against DTC's records.



securities as fully paid, excess margin, or margin. Additionally, examiners ensured that locations the broker-dealer considered to be under control were, in fact, acceptable control locations as defined by the rule.

Our review indicated that examiners also reviewed a sample of deficit positions taken from excess/deficit reports to determine whether

- the deficit was created through a violative action;
- the deficit was increased through a violative action;
- the broker-dealer took the action required by Rule 15c3-3 to eliminate the deficit; and
- the broker-dealer eliminated the deficit within the time frames prescribed by Rule 15c3-3.

In particular, examiners looked for deficits caused by (1) loaning securities to another broker-dealer or (2) using a security as collateral for a loan from a bank. These transactions are potential means by which a broker-dealer could use customer funds to finance its proprietary activities. Securities used in stock loans as collateral for bank loans are in locations not under the control of the broker-dealer and thus would pose a threat of loss to customers if a broker-dealer were liquidated.

Determining the percentage of total violations that SEC, NYSE, and NASD found using their examination procedures was not possible because the total number of violations that actually occurred is not known. However, SEC, NYSE, and NASD have found numerous broker-dealer violations of possession or control requirements over the last 3 years. For example, examiners determined that broker-dealers (1) failed to obtain required letters from custodian banks noting that customer securities are not subject to liens; (2) had omissions in excess/deficit reports; and (3) commingled customer securities with securities owned by the firm.

## SEC Provided NYSE and NASD Oversight, Evaluation, and Feedback on the Quality of Their 15c3-3 Possession or Control Examinations

We found that during 1990, SEC, through its oversight examination program, evaluated and provided regular feedback to the SROs on the quality of their possession or control examinations. SEC has established an examination activity tracking system designed to capture the number and type of violations SEC examiners find during oversight examinations. The system tracks the number of violations SEC found that SROs did not detect. In 1990, SEC found 17 possession or control violations that were not detected by NYSE or NASD. We reviewed the 1990 examinations in which the 17 violations were found and determined that in each case, the SRO was asked to respond to SEC in writing (or orally) and

---

explain its failure to detect the possession or control violation. SEC officials told us that the SEC regional office that performed the examination determines whether the SRO explanation is adequate. SEC officials also said that the regional office determines whether the SRO needs to change its examination procedures or techniques to prevent such an omission from recurring. Our review of SRO responses to SEC examinations indicated that NYSE and NASD took steps designed to remedy the deficiencies cited by SEC.

SEC's New York Regional Office and Chicago Regional Office, which together performed 71 percent of the oversight examinations we reviewed, meet with SROs quarterly or biannually to discuss deficiencies SEC found with the SROs' examinations. SEC officials told us that these exchanges of information, along with SEC oversight examination results, allow SEC and SROs to discuss both systemic problems in SRO examination procedures and more isolated, nonrepetitive deficiencies. SEC officials said, and examination reports we reviewed confirm, that this oversight process also permits SEC to determine the cause of omissions or defects in SROs' examinations.<sup>10</sup> SEC and SRO officials also told us that SEC regional offices have a regular dialogue with SROs on an informal and "as needed" basis. Additionally, SEC officials said that through the process of interpreting the rule, SEC and SROs maintain a regular dialogue concerning SRO examination programs.

SEC headquarters staff told us they monitor SRO responses to ensure they are received by SEC regional staff in a timely manner. Headquarters staff also rate their regional offices' performance in conducting and managing their oversight examination programs. Finally, SEC headquarters staff meet quarterly with NYSE and NASD to discuss both specific examination issues and broader regulatory issues.

---

## Agency Comments

Responsible SEC officials reviewed a draft of this report and generally agreed with its contents. Where appropriate, we made certain technical changes in response to their comments.

---

<sup>10</sup>Our past report entitled *Securities Industry: Strengthening Sales Practice Oversight* (GAO/GGD-91-52, Apr. 25, 1991), on SEC's oversight of broker-dealer sales practice examinations, concluded that SEC generally cannot determine why it finds violations that SROs miss, because SEC uses different examination methods than the SROs. We did not come to that conclusion for possession or control examinations because SEC uses methods similar to NYSE and NASD.

---

We are sending a copy of this report to the Ranking Minority Member of your Subcommittee. We are also sending copies to SEC, NYSE, NASD, and other interested parties.

Please contact me at (202) 275-8678 if you or your staff have any questions concerning this report. Major contributors to this report are listed in the appendix.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Craig A. Simmons". The signature is fluid and cursive, with a large initial "C" and a long, sweeping underline.

Craig A. Simmons  
Director, Financial Institutions  
and Markets Issues

# Major Contributors to This Report

---

**General Government  
Division, Washington,  
D.C.**

**Michael A. Burnett, Assistant Director, Financial Institutions  
and Markets Issues**  
**Gerald C. Schober, Evaluator-In-Charge**  
**Steven G. Lozano, Evaluator**  
**Ron J. Feldman, Evaluator**

---

### **Ordering Information**

**The first copy of each GAO report is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.**

**U.S. General Accounting Office  
P.O. Box 6015  
Gaithersburg, MD 20877**

**Orders may also be placed by calling (202) 275-6241.**

United States  
General Accounting Office  
Washington, D.C. 20548

Official Business  
Penalty for Private Use \$300

First-Class Mail  
Postage & Fees Paid  
GAO  
Permit No. G100