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Client Alert

A report for clients and friends of the firm

December 2003

Broker-Dealer Expense Sharing Arrangements

NASD recently advised its members that by December 1, 2003 they must be able to demonstrate compliance with the requirements of a letter ("Letter") issued by the Securities and Exchange Commission's ("SEC") Division of Market Regulation[1] concerning the application of the SEC's financial responsibility and record keeping rules to expense sharing agreements between broker-dealers and third parties, including parent and affiliate companies.[2] The Letter was issued in response to concerns raised by NASD and the New York Stock Exchange ("NYSE") that some broker-dealers were relying on expense sharing agreements with third parties to avoid recording expenses and liabilities on their books and records and to artificially inflate profitability and net capital computations. NASD's NTM reiterates the Letter's nine requirements and provides additional commentary.

Brokerage firms which have expense sharing arrangements with a third party, including a parent, holding company or affiliate, should review those agreements if they haven't done so already. Among other things, expense sharing agreements which do not enumerate the services or products being provided, with a reasonable cost assigned to each, should be revised to include this information. This and the Letter's other requirements are discussed below. Additionally, we discuss the informal advice we received from the SEC on the upstreaming of profits to a parent which pays the expenses of its subsidiary broker-dealer.

Expense Sharing Arrangements and Record Keeping

A broker-dealer which has some or all of its expenses or liabilities paid by a third party and does not record those expenses in its reports filed with the SEC or its designated examining authority ("DEA") must enter into a written expense sharing agreement with that third party, notify its DEA of the existence, date and names of the parties to that agreement and provide a copy to the DEA upon request. The agreement must state clearly which party is obligated to pay each expense, whether the broker-dealer has any obligation to reimburse the expense and when the broker-dealer records the expense in accordance with an allocation made by the third party, the method of allocation.

In addition, a broker-dealer must maintain records of all expenses relating to its business. Under SEC Rules 17(a)(1) and (2), a broker-dealer must record all such expenses, regardless of whether the liability is joint or several or a third party has agreed to pay the expense. This requirement applies even if an expense is not required to be recorded under generally accepted accounting principles ("GAAP") or whether the expense is considered a liability for net capital purposes. Expenses include all costs for which a broker-dealer derives a direct or indirect benefit and all expenses for which it would be responsible if another party had not agreed to pay them (e.g., rent, telephone, copy services, etc.). The Letter confirms that expenses may be recorded in amounts determined according to a reasonable allocation made by the third party. However, the allocation must be applied consistently and equate the proportional costs to the actual benefits derived by the broker-dealer. The broker-dealer must be prepared to provide proof of the reasonableness of the allocation, including providing access to records of the third party, even if it is not regulated. Failure to provide such access will result in a rebuttable presumption that the broker-dealer was not in capital compliance during the period covered by the expense sharing agreement.

NASD's NTM cautioned that the payment of certain expenses, particularly compensation of registered personnel by the third party, may raise an issue as to whether the party paying those expenses, itself, needs to register as a broker-dealer. To reduce this concern, we believe it is important to provide in any expense sharing agreement covering registered personnel that the broker-dealer has responsibility for their supervision and control.

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1 Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Elaine Michitsch, Member Firm Regulation, NYSE, and Susan Demando, Director, Financial Operations, NASD, July 11, 2003.

2 See NASD Notice to Members ("NTM") 03-63.

Net Capital

Expenses of a broker-dealer for which a third party agrees to assume responsibility and which are not recorded on the broker-dealer's reports to the SEC and its DEA will be considered a liability for net capital purposes unless:

- for payments owed to a vendor or other party, the vendor or other party agrees in writing that the broker-dealer is not directly or indirectly liable for the expense,
- the third party agrees in writing that the broker-dealer is not directly or indirectly liable for the expense,
- there is no other indication that the broker-dealer is directly or indirectly liable to any person for the expense,
- the liability is not a liability of the broker-dealer under GAAP and
- the broker-dealer can demonstrate that the third party has adequate independent resources to pay the expense.[3]

Withdrawals of Capital

When a broker-dealer enters into an expense sharing arrangement with a third party which is a shareholder or investor in the broker-dealer and the expenses to be paid or assumed by the third party are not recorded on the broker-dealer's filings with the SEC or its DEA, any capital contribution such third party makes to the broker-dealer is considered good regulatory capital only if the broker-dealer can demonstrate that the expenses have been paid by the third party or the third party has adequate independent resources to pay such expenses (with the same evidence as described above) and the broker-dealer has no direct or indirect obligation to pay the expense. If the capital contribution can be withdrawn at the option of the contributor, the broker-dealer must regard it as a liability and not capital in its net capital calculations.

Further, any withdrawal of equity capital[4] from the broker-dealer by the third party within three months before or one year after the broker-dealer incurs an expense which the third party has paid or agreed to pay will be presumed to have been made to repay the third party, unless the expense or liability is recorded in the broker-dealer's books and records. A firm which improperly records a capital contribution withdrawn during this 15 month window will be required to recalculate its net capital.

Importantly, the SEC has advised us informally that this presumption does not apply to capital withdrawals where the broker-dealer and the third party record the expense and a corresponding payable and receivable in inter-company accounts, or the broker-dealer pays the third party a service fee for administrative costs pursuant to an expense sharing agreement and the fee is reasonably related to the actual services provided by the third party and/or the expenses incurred on behalf of the broker-dealer.[5] So, for example, in situations where the broker-dealer typically upstreams excess profits to its parent company, it may continue to do so provided these conditions are met and any capital contributions intended to cover broker-dealer expenses are not withdrawn.

Conclusion

Broker-dealers which operate under expense sharing agreements with a parent or affiliate (or any other third party) should review such agreements, including the method of allocating expenses, for net capital and record keeping purposes under these interpretations. It is our understanding that NASD examiners will now begin scrutinizing such arrangements.

3 Adequate independent resources of the third party can be demonstrated by: (i) relying on the third party's public filings, if it is a reporting company under the Securities Act of 1933, (ii) if it is not a reporting company, relying on a signed and dated copy of the third party's most recent audited financial statements with an as of date no older than 12 months or (iii) for shareholders, partners or other owners of the third party, relying on copies of their audited financial statements or federal income tax returns, using the same 12 month parameters.

4 Distributions for the purpose of paying taxes or reasonable compensation to the partners under SEC Rule 15c3-1(e)(4)(iii) are not included in this presumption.

5 The presumption would, however, be applicable in situations where the parent of a broker-dealer assumes responsibility for the brokerage firm's expenses, but the broker-dealer does not book the corresponding liabilities.

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Proskauer's Corporate Law Department includes over 140 attorneys with significant and diverse corporate law experience. The following individuals serve as contact persons and would welcome any questions you might have.

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