

## Net Capital Deduction for Stock Borrow Transactions

Starting March 31, 2005, broker-dealers will need to collect margin on their non-purpose stock borrow transactions or take a capital charge. On January 6, 2005, the New York Stock Exchange, Inc. issued Information Memo 05-2 which included an SEC staff interpretation concerning non-purpose equity securities borrowed transactions.<sup>1</sup> A non-purpose stock borrow transaction occurs when a broker-dealer borrows stock against cash collateral for a non-permitted purpose under Section 220.10(a) of Regulation T.<sup>2</sup> A stock borrow transaction is for a permitted purpose if it is to make delivery of the securities in the case of short sales, fails or other similar situations.

The new interpretation requires that a broker-dealer maintain equity (*i.e.*, margin) at least equal to the haircut deduction required under SEC Rule 15c3-1(c)(2)(vi) and (c)(2)(vii) when it “engages in equity securities borrowed transactions (versus cash collateral) solely for financing the positions of another broker-dealer, where the equity securities were initially borrowed without a ‘permitted purpose’ . . . . and placed in

a box location.”<sup>3</sup> The required margin ranges from 15% to 100% of the value of the securities borrowed, depending on the marketability of those securities.<sup>4</sup> In addition, the broker-dealer is required to establish on its books and records a separate identifiable “non-purpose” securities borrowed account to record such stock borrow transactions and the margin collected on those transactions.

In the event that a broker-dealer fails to collect and maintain the required margin, the broker-dealer must charge its own net capital for the margin deficiency. If the non-purpose securities borrowed account liquidates to a deficit, the capital charge is the sum of the deficit and the applicable margin deficiency. The requirement to maintain margin on non-purpose borrow transactions continues even if the securities that were originally borrowed

<sup>1</sup> NYSE Information Memo 05-2 (Jan. 6, 2005). Also in January 2005, the NASD Inc. published the same interpretation on its web site. See Securities Borrowed, Non-Purpose, Haircut Deduction is Required, available at [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_013166&ssSourceNodeId=304](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013166&ssSourceNodeId=304).

<sup>2</sup> 12 C.F.R. § 220.10(a) (2004).

<sup>3</sup> The requirement to maintain margin on non-purpose borrow transactions applies to all broker-dealers, including an “exempted borrower” under Regulation T. See 12 C.F.R. § 220.2 (2004) for the definition of “exempted borrower.”

<sup>4</sup> The margin requirement excludes any concentration charges that may be required under the net capital rule.

without a permitted purpose are subsequently used for a permitted purpose.

Based on our discussions with NASD staff, we understand that the interpretation is intended to address the situation where a broker-dealer lends its stock to another broker-dealer for 100% cash collateral where the loaned stock has limited market value. Unfortunately, the interpretation was not narrowly drafted and applies to all stock loan transactions between broker-dealers that are not for a permitted purpose and that otherwise meet the requirements of the interpretation. The SEC staff clarified that the requirement to collect margin on stock loan transactions does not apply to transactions that are

conducted as part of a matched book business. As a result, if a broker-dealer borrows stock for the purpose of lending the stock to another party, the firm is not required to collect margin on the transaction. This is because the transaction was not conducted solely for the purpose of financing the original lender's position. Finally, the staff of the NYSE stated that due to questions concerning how the required margin is to be calculated, it plans to amend the interpretation to clarify the calculation. We understand that in order to avoid a capital charge, the firm borrowing the stock may only provide cash collateral equal to 85% of the value of the stock borrowed for stocks subject to a 15% capital charge.

Whether the SEC staff has issued an interpretation as opposed to adopting an entirely new margin requirement is an open question in our minds. The interpretation's goal was clearly to impose a margin requirement on stock loan transactions where such a requirement does not currently exist. This raises the question of whether the staff has issued an interpretation of the Commission's net capital rule, or whether it has enacted a new margin requirement in contravention of Section 7 of the Securities Exchange Act of 1934 ("Exchange Act") and without complying with the Administrative Procedures Act's "notice and comment" requirements.

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