

CLIENT ALERT

SEC Proposes Changes to Broker-Dealer Customer Protection Rule

July 27, 2023

AUTHORS

James E. Anderson | **Brian Baltz** | **Justin L. Browder** | **P. Georgia Bullitt**
Jakob Edson

On July 12, 2023, the Securities and Exchange Commission (“SEC”) unanimously proposed to amend Rule 15c3-3 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), known as the “Customer Protection Rule.”¹ The Customer Protection Rule requires broker-dealers that maintain custody of customer securities and cash (“carrying broker-dealers”) to have a special reserve account at a bank that must hold cash or qualified securities in an amount determined by a computation of the net cash owed to the broker-dealer’s customers. The Customer Protection Rule also imposes similar requirements for carrying broker-dealers with respect to securities and cash held in proprietary securities accounts of broker-dealers, referred to as PAB accounts.

Generally, carrying broker-dealers are required to perform the computation and make any required deposits weekly. The proposed amendments would require carrying broker-dealers with average credit balances (i.e., amount of cash owed to customers and PAB account holders) totaling \$250 million or more on a rolling 12-month basis to perform the computation daily and make any required deposit no later than one hour after the opening of banking business on the second following business day. The proposed amendments are designed to address situations where, for a period of days, the net amount of cash owed to customers and PAB account holders is substantially greater than the amount held in the customer and PAB reserve bank accounts. Chair Gensler noted that the greater frequency of computations contemplated by the proposed

¹ Daily Computation of Customer and Broker-Dealer Reserve Requirements under the Broker-Dealer Customer Protection Rule, Exchange Act Rel. No. 97877 (July 12, 2023), 88 Fed. Reg. 45836 (July 18, 2023), available [here](#) and [here](#) (the “Proposing Release”).

SEC Proposes Changes to Broker-Dealer Customer Protection Rule

amendments “would better align with the inflows, swings, and balances that broker-dealers experience in today’s markets.”² He also indicated that the proposed amendments would “reduce the likelihood and duration of a mismatch between the size of the reserve bank account and the amount of net cash owed to customers and other broker-dealers” and “would better help to protect the SIPC Fund.”³ Comments on the proposed amendments are due September 11, 2023.

Overview of the Customer Protection Rule

The Customer Protection Rule requires a carrying broker-dealer to take two primary steps to safeguard customer funds and securities. First, a carrying broker-dealer must maintain physical possession or control over customers’ fully paid securities and excess margin securities as those terms are defined under the rule.⁴ The carrying broker-dealer must hold these securities in one of several locations specified in the rule and free of liens or any other interest that could be exercised by a third party to secure an obligation of the carrying broker-dealer.⁵ Second, the carrying broker-dealer must maintain a reserve of funds or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers that is titled “Special Reserve Bank Account for the Exclusive Benefit of Customers.”⁶

Under the current rule, a carrying broker-dealer is required to determine the net cash owed to customers (the “customer reserve computation”) weekly as of the close of the last business day of the week. The amount of net cash owed to customers is computed by adding up customer credit items (e.g., credit balances in customer accounts, funds obtained through the use of customer securities) and subtracting from that amount customer debit items (e.g., money owed by customers, securities borrowed to effectuate customer short sales, margin required and on deposit with certain clearing agencies as a consequence of customer securities transactions).⁷ A carrying broker-dealer is also required to perform a similar reserve computation for PAB accounts.

If credit items exceed debit items, the carrying broker-dealer must place the net amount on deposit in the customer or PAB reserve bank account in the form of cash or “qualified securities” (i.e., U.S. government obligations or securities of which principal and interest are guaranteed by the U.S. government). Any amounts required to be deposited following the computation must be deposited by 10 a.m. of the second business day following the “as of” date of each computation.

² Statement on Customer Protection Rule, Gary Gensler (July 12, 2023), available [here](#).

³ *Id.*

⁴ See Rule 15c3-3(d).

⁵ See Rule 15c3-3(c).

⁶ See Rule 15c3-3(e).

⁷ See Rule 15c3-3a.

SEC Proposes Changes to Broker-Dealer Customer Protection Rule

Proposed Amendments to the Customer Protection Rule

The proposed amendments would require carrying broker-dealers with “average total credits” that are \$250 million or more to perform the customer and PAB reserve computations daily as of the close of the previous business day, rather than weekly.⁸ The SEC has proposed to define “average total credits” as the arithmetic mean of the sum of total credits in the customer and PAB reserve computations reported in the twelve most recently filed month-end FOCUS Reports.⁹ A carrying broker-dealer would add up the sum of the total credits reported in the customer and PAB reserve computations in each of the twelve most recently filed month-end FOCUS Reports and divide that amount by twelve to calculate the arithmetic mean of the total credit.¹⁰ A carrying broker-dealer subject to daily reserve computations would be required to deposit any required funds in the customer and PAB reserve bank accounts no later than one hour after the opening of banking business on the second following business day.

The proposed amendments would require that a carrying broker-dealer comply with the daily computation requirement for the customer and PAB reserve bank accounts no later than six months after having average total credits that are greater than or equal to \$250 million.¹¹ Once a carrying broker-dealer begins to perform daily customer and PAB reserve computations, the carrying broker-dealer would be required to continue performing daily customer and PAB reserve computations for at least sixty days after its average total credits fall below the \$250 million threshold.¹² Specifically, if the average total credits of a carrying broker-dealer performing daily computations fall below the \$250 million threshold, the carrying broker-dealer could elect to perform weekly computations by notifying its designated examining authority in writing and waiting sixty calendar days after making such written notification before it could switch to performing weekly computations.¹³ If the carrying broker-dealer again crosses the \$250 million threshold, the carrying broker-dealer would be required to comply with the daily computation requirement for the customer and PAB reserve bank accounts no later than six months after having crossed the threshold.¹⁴

The SEC has also proposed to amend the Customer Protection Rule to provide that computations, other than the daily computations that would be required under the proposed amendments, may be made as of the close of any business day.¹⁵ This would specify that the option to perform a customer or PAB reserve computation more frequently than weekly or

⁸ See Proposing Release at 26, 88 Fed. Reg. at 45844.

⁹ See paragraph (e)(3)(i)(B)(1) of Rule 15c3-3, as proposed to be amended.

¹⁰ See Proposing Release at 27 n.76, 88 Fed. Reg. at 45844 n.76.

¹¹ See paragraph (e)(3)(i)(B)(1) of Rule 15c3-3, as proposed to be amended.

¹² See Proposing Release at 29–30, 88 Fed. Reg. at 45844.

¹³ Based on a review of 2022 FOCUS Reports, the Proposing Release estimates that only one carrying broker-dealer per year would experience such a drop in average total credits. See Proposing Release at 80, 88 Fed. Reg. at 45860.

¹⁴ See paragraph (e)(3)(i)(B)(1) of Rule 15c3-3, as proposed to be amended.

¹⁵ See Proposing Release at 31–32, 88 Fed. Reg. at 45845.

SEC Proposes Changes to Broker-Dealer Customer Protection Rule

monthly (as applicable) remains available to carrying broker-dealers that are required to make such computations on a weekly or monthly basis.

Request for Comment on Reserve Account Requirements for Security-Based Swaps

The SEC is also seeking comment as to (1) whether the Customer Protection Rule should be modified to require broker-dealers, including broker-dealers (other than OTC derivatives dealers) registered as security-based swap dealers (“SBSDs”), to perform daily security-based swap customer reserve computations in addition to daily customer and PAB reserve computations; and (2) whether Exchange Act Rules 18a-4 and 18a-4a should be amended to require SBSBs that are not registered as broker-dealers (other than as OTC derivatives dealers) to perform daily security-based swap customer reserve computations.¹⁶

Conclusion

The proposed amendments are designed to address risk to a carrying broker-dealer’s customers and PAB account holders that the carrying broker-dealer could fail financially and be unable to return all the securities and cash owed to the customers and PAB account holders. The SEC has observed that some carrying broker-dealers have been required to deposit large amounts of additional cash or qualified securities into the customer and PAB reserve bank accounts after their weekly computations.¹⁷ During the 2022 calendar year, the largest required additional deposits into customer reserve bank accounts ranged from \$1.6 billion to over \$6.0 billion, and the largest required additional deposits into PAB reserve bank accounts ranged from \$350 million to over \$4.0 billion.¹⁸ The SEC stated that it believes these large deposit requirements indicate that there may be times when the net amount of cash owed to customers and PAB account holders is substantially greater than the amounts on deposit, which creates the potential risk that a carrying broker-dealer could fail financially and not be able to fully satisfy claims of customers and PAB account holders for securities and cash.¹⁹

If the proposed amendments are adopted as proposed, carrying broker-dealers will need to consider the potential operational and financial accounting implications of the proposed amendments. In the Proposing Release, the SEC noted that, based on regulatory filings for the period of January 2022 through December 2022, the proposed daily computation requirement would apply to approximately sixty-three carrying broker-dealers, eleven of which already voluntarily perform the customer reserve computation daily.²⁰ Carrying broker-dealers that would be impacted by the proposed amendments should consider commenting on the proposal to address relevant issues, including whether the proposed \$250 million threshold is appropriate or should be higher; whether they will need longer than the proposed six-month transition period to

¹⁶ See Proposing Release at 40–41, 88 Fed. Reg. at 45847.

¹⁷ See Proposing Release at 23, 88 Fed. Reg. at 45842.

¹⁸ See Proposing Release at 23, 88 Fed. Reg. at 45843.

¹⁹ See Proposing Release at 24, 88 Fed. Reg. at 45837.

²⁰ See Proposing Release at 28–29, 88 Fed. Reg. at 45844.

SEC Proposes Changes to Broker-Dealer Customer Protection Rule

begin complying with the daily computation requirement; and whether it is clear which computation requirement (i.e., daily or weekly) applies where a carrying broker-dealer crosses the \$250 million threshold but then falls below the \$250 million threshold before transitioning to daily computation. Carrying broker-dealers should also consider the implications of daily inflows and outflows of cash and qualified securities from customer and PAB reserve bank accounts.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

James E. Anderson

202 303 1114

janderson@willkie.com

Brian Baltz

202 303 1094

bbaltz@willkie.com

Justin L. Browder

202 303 1264

jbrowder@willkie.com

P. Georgia Bullitt

212 728 8250

gbullitt@willkie.com

Jakob Edson

202 303 1163

jedson@willkie.com

Copyright © 2023 Willkie Farr & Gallagher LLP.

This alert is provided by Willkie Farr & Gallagher LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This alert may be considered advertising under applicable state laws.

Willkie Farr & Gallagher LLP is an international law firm with offices in Brussels, Chicago, Frankfurt, Houston, London, Los Angeles, Milan, New York, Palo Alto, Paris, Rome, San Francisco and Washington. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.