new york state society of
NYSSCPA
certified public accountants
530 fifth avenue, new york, ny 10036-5101
www.nysscpa.org

August 24, 2004

Mr. Michael Macchiaroli
Associate Director
Division of Market Regulation
Securities and Exchange Commission
Washington, D.C. 20549

Dear Mr. Macchiaroli:

The New York State Society of Certified Public Accountants, the oldest state accounting association, represents approximately 30,000 CPAs.

The NYSSCPA Stock Brokerage Committee has prepared the attached comments on the application of Statement of Financial Accounting Standard No. 150 to make you aware of their concerns about its negative effects on business succession planning among broker-dealers. If you would like additional discussion with the committee, please contact Robert J. Kaufmann, chair of the Stock Brokerage Committee, at (212) 269-0572, or Robert Colson, NYSSCPA staff, at (212) 719-8350.

Sincerely,

John J. Kearney
President

Attachment

cc: Donald Nicolaisen, SEC Chief Accountant
Harvey Goldschmid, SEC Commissioner

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**NEW YORK STATE SOCIETY OF**

**CERTIFIED PUBLIC ACCOUNTANTS**

# COMMENTS TO SEC DIVISION OF MARKET REGULATION

## Effects of SFAS 150 on Business Succession Plans of Broker-Dealers

## And Related Guidance on

## New York Stock Exchange Information Memo 04-23

**August 24, 2004**

**<u>Principal Drafter</u>**

**David H. Grumer**

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**New York State Society of Certified Public Accountants**
**Stock Brokerage Committee**
**Effects of SFAS 150 on Business Succession Plans of Broker-Dealers**
**And Related Guidance on**
**New York Stock Exchange Information Memo 04-23**

**August 24, 2004**

Committee members work with broker-dealers that are registered with the Securities and Exchange Commission. SEC Rule 15c3-1 of the Securities Exchange Act of 1934 specifies broker-dealers' responsibility to maintain minimum net capital. The committee would like to alert the SEC's Division of Market Regulation Division (DMR) about an important negative effect of SFAS 150 on broker-dealers' business succession plans. The committee would also like to ask for assistance in interpreting DMR guidance on expense sharing arrangements to clarify a paragraph contained in New York Stock Exchange Information Memo 04-23.

## Minimum Net Capital

In reaction to the prospect of recording a new liability (where previously there was none) because of SFAS 150, a number of broker-dealers have evidently removed the mandatory redemption clauses and related funding provisions from their business succession plans. The committee expresses its concern that this accounting standard is discouraging widely accepted and healthy business practices that generally increase a company's value. Broker-dealers are finding it increasingly difficult to take the normal steps that other business owners routinely follow to secure the business' future prospects of serving its clients or customers.

Your letter of February 19, 2004 to the Chair of the Capital Committee of the Securities Industry Association provided temporary clarifications to the many questions that arose after the adoption of SFAS 150 by permitting broker-dealers to add back the SFAS 150 liability to their regulatory capital until December 15, 2004. The committee asks that you again consider providing such regulatory relief to broker-dealers in their computation of net capital, similar to the treatment granted in SEC Rule 15c3-1 for subordinated liabilities, on a permanent basis. Such regulatory relief would surely provide sufficient incentives for broker-dealers to re-institute appropriate buy-sell clauses in their business succession plans.

The following situations merit your attention, where a financial liability resulting from SFAS 150 could be treated as an add-back to equity in the calculation of net capital for regulatory purposes.

(1) Other obligations of a broker-dealer to an owner:

Operating agreements or bylaws may provide that a broker-dealer or several shareholders have an obligation to pay certain amounts to its owners. An example is the payment of all or a portion of a capital account balance upon a specified event.

Such transactions may now be classified as liabilities under SFAS 150. Many owners of broker-dealers have received advice from consultants and regulators about implementing SFAS 150 and, as a consequence, are revising their agreements to exclude these arrangements, contravening the very purpose of business succession plans.

An alternative regulatory approach would treat these liabilities as if they were the equivalent of subordinated liabilities, adding the SFAS 150 liabilities to net capital, consistent with the exclusion to aggregate indebtedness in SEC Rule 15c3-1(c)(xi), cited below. Statutory subordinated liabilities that are added back to net capital can have a remaining time to maturity considerably shorter than the SFAS 150 liability representing manditorily redeemable equity.

The Division of Market Regulation can specify terms and conditions that should be contained in controlling documents to signify a satisfactory subordination in fact of the SFAS 150 liability, and that would also provide for an orderly distribution of assets after the defined event in order to satisfy the SFAS 150 liability.

Section (c)(1)(xi) of Rule 15c3-1 states, regarding exclusions from aggregate indebtedness:

> "Liabilities which are effectively subordinated to the claims of creditors (but which are not subject to a satisfactory subordination agreement as defined in Appendix (D) 17CFR 240.15c3-1(d)), by noncustomers of the broker or dealer prior to subordination, except such subordinations by customers as may be approved by the Examining Authority for such broker or dealer".

The reasoning behind this rule could also apply to:

- Shares subject to redemption upon retirement or termination of employment.
- Owner’s equity shares or units that are manditorily redeemable upon death of a holder.

The assets that would satisfy these commitments are first subject to the claims of the broker-dealer's creditors. In substance, these commitments are subordinated to the claims of creditors until a defined event occurs to require the broker dealer to fund a liability. Once the defined event occurs, the commitment becomes a liability that should be recognized as a reduction of net equity and, therefore, net capital.

(2) Insured arrangements:

Such arrangements occur when insurance is purchased to transfer the risk associated with a commitment. For example, a broker-dealer might buy life insurance sufficient to fund a liability for the mandatory redemption of an equity interest upon the death of an owner. The use of insurance to mitigate the effects this kind of tragedy is a common practice for small businesses. Few would argue that a business without such an arrangement has a higher value than one with a reasonable buy-sell formula funded by insurance.

These arrangements are financial tools designed to keep a broker-dealer's assets intact to safeguard investors and to provide security to owners' families. If the proposal in point (1) above is not possible, to the extent a broker-dealer obtains satisfactory insurance that funds a mandatory redemption, such insurance should be factored into any rule on the net capital treatment of the new SFAS 150 liabilities.

**New York Stock Exchange Information Memo 04-23**

Additional guidance would also assist in correctly implementing New York Stock Exchange Information Memo 04-23, third paragraph, which states:

*"Partnership, limited liability company and corporate capital accounts which have clauses in their agreements which would require the mandatory redemption of capital upon a certain event occurring will have to reflect these capital accounts as liabilities for FOCUS reporting purposes unless the registered broker-dealer has eliminated the applicable mandatory clause from its agreements."*

Some understand that the Information Memo instructs that a broker-dealer which is a subsidiary of a holding company should not reflect in its accounting or net capital computation a mandatorily redeemable financial instrument entered into by any other affiliated organization, including its parent company. Others believe that there are provisions in your July 11, 2003 letter on expense sharing arrangements that may override the above paragraph.

Assistance would be helpful in interpreting this Information Memo and your guidance in situations where the holding company has: (1) sufficient assets to meet SFAS 150 liabilities; and (2) where the holding company does not have sufficient assets to meet FAS 150 liabilities.

**Implementation Dates**

Lastly, the Financial Accounting Standards Board may reconsider certain aspects of SFAS 150, including the classification of ownership interests with attached obligations, during 2005 as part of a larger project dealing with liabilities and equities.

The Committee respectfully suggests that the Division of Market Regulation reconsider the implementation deadline of December 15, 2004 if the FASB plans to address SFAS 150 issues in the near future.