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Minimum Capital Requirements of Broker-Dealers

The basic function of a broker-dealer\(^1\) is the execution of orders for the purchase and sale of securities either for himself or his customers. The activities\(^2\) of broker-dealers result in the accumulation of a large aggregate of customers' property. Today more than 46 billion dollars in securities and one billion dollars in cash are entrusted to broker-dealers by customers.\(^3\) Large customer cash accounts result from dividends paid on shares held in street name, proceeds of sales, and deposits in anticipation of future purchases. Brokers hold shares as security until payment is made by customers for their purchases. Shares listed in street name or customer name are often left with a broker for trading convenience. Shares are also held by the broker-dealer to secure the loans of margin customers, to whom the broker-dealer has advanced a portion of the purchase price.\(^4\) In addition, the broker-dealer's business activities go beyond that of trading; he may engage in underwritings, carry inventories of stock in which he makes a market, or trade extensively for his own account, all accomplished largely by borrowing from banks and other broker-dealers or by using funds of his customers. With a large extent of borrowing by the broker-dealer,

\(^1\) Sections 3(A)(4) and 3(A)(5) of the Securities Exchange Act of 1934 define the terms "broker" and "dealer" as follows: a broker is "any person engaged in the business of effecting transactions in securities for the account of others . . . ." 48 Stat. 882, 15 U.S.C. § 78c(a)(4) (1958); a dealer is "any person engaged in the business of buying and selling securities for his own account . . . ." 48 Stat. 882, 15 U.S.C. § 78c(a)(5) (1958). The term "broker-dealer" is used here to indicate a situation where an individual (including sole proprietorships, partnerships, and corporations) combines the activities of both broker and dealer, or where there is uncertainty as to whether a person is acting in one capacity or the other. Furthermore, "broker-dealer" refers to one that affects purchases or sales of securities that take place on the over-the-counter markets.

\(^2\) There are approximately 6,000 broker-dealers engaged in the over-the-counter business in the United States. About 5,000 are registered with the SEC, meaning that they use the mails and instrumentalities of interstate commerce to effect transactions. The remainder do business that is exclusively intrastate or exclusively in exempt securities such as federal government, state and municipal issues. The bulk of the over-the-counter business is handled by the approximately 5,500 broker-dealers who are members of the NASD. LEFFLER, THE STOCK MARKET 402-09 (3d ed. 1963).

\(^3\) Note, 77 HARV. L. REV. 1290 (1964).

\(^4\) Id. at 1292.
coupled with the accumulation of customer's property, any insolvency on the part of the broker-dealer and resulting inability to meet loan calls and other financial obligations presents a serious danger to the investing public. Thus, the financial responsibility of broker-dealers is necessary to afford protection to the individual customer and the investing public in general.

The financial responsibility of broker-dealers is subject to regulation by one or all of three sources: (1) the federal government, (2) the self-regulatory bodies, i.e., the stock exchanges and the National Association of Securities Dealers (NASD), and (3) state governments. We shall examine the tripartite imposition of net capital requirements that take three forms: (1) net capital-to-indebtedness ratios, (2) minimum net capital requirements, and (3) bonding requirements.

I. Federal Regulation

Federal regulation of the financial responsibility of broker-dealers is accomplished mainly by rule 15c3-1, promulgated under the Securities Exchange Act of 1934. However, section 8(b) of the Exchange Act, which establishes a net capital-to-indebtedness ratio requirement for brokers-dealers who are members of national securities exchanges or those broker-dealers who transact business through members of such exchanges, also regulates broker-dealers in this area. Therefore, it is necessary to investigate this provision briefly before examining rule 15c3-1.

A. Section 8(b)

Section 8(b) makes it unlawful for any broker-dealer who is a member of a national exchange or who transacts a business in securities through the medium of an exchange member, directly or indirectly,

to permit in the ordinary course of business as a broker, his aggregate indebtedness to all other persons including customers' credit balances (but excluding indebtedness secured by exempted securities) to exceed such percentage of the net capital (exclusive of fixed assets and the value of exchange membership) employed in business, but not exceeding in any case 2,000 per centum, as

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6 SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1964).

the Commission may by rates and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.  

The section's obvious purpose is to safeguard customers against the risk of a broker-dealer's insolvency by prohibiting him from borrowing more than twenty times his net capital. But section 8(b) is inapplicable to dealers who do no brokerage business, even though they may hold customer's funds or securities, or to brokers who do not transact business through the medium of an exchange member. Even as to those broker-dealers covered by section 8(b), it applies only to indebtedness incurred in the normal course of business as a broker-dealer and not to any obligations outside of that business.

The SEC applied the 20:1 ratio of section 8(b) in a few early cases of broker-dealer insolvency. However, the section has never been implemented by rule, and for approximately four decades, the Commission has generally chosen to proceed against broker-dealers under rule 15c3-1 rather than under section 8(b).

B. Rule 15c3-1

The rule was first announced in 1942 in the case of National Association of Securities Dealers, Inc. v. SEC, where the Commission stated that it had promulgated its own net capital-to-indebtedness ratio rule applicable to the entire over-the-counter industry because it recognized a need for general rules to achieve customer protection against financially unsafe broker-dealers. The rule was adopted under section 15(c)(3) of the Exchange Act, which prohibits any broker-dealer from using the mails or interstate facilities to effect any transaction in or to induce the purchase of any security otherwise than on a national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility of brokers and dealers.

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8 Ibid.
9 2 Loss, Securities Regulation 1350 (2d ed. 1961).
12 National Ass'n of Sec. Dealers, Inc. v. SEC, 12 S.E.C. 322 (1942).
The rule itself, as adopted under section 15(c)(3), is simple in statement: "No broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 2,000 per centum of his net capital."\textsuperscript{14}

It should be emphasized from the outset that rule 15c3-1 is both an entry requirement for the broker-dealer and a continuous, operational requirement that the broker-dealer must meet throughout the course of business. However, it is not so much a qualification device as it is a continuous, operational requirement.\textsuperscript{15}

The rule is vigorously enforced by the SEC and is one of the most important weapons in the Commission's arsenal for assuring the solvency of broker-dealers. By limiting the ratio of broker-dealer's indebtedness to his capital, and thereby restricting the amount which he may borrow, the rule operates to some extent to assure confidence and safety to the investing public.\textsuperscript{16}

\textbf{C. Definition of Rule 15c3-1 and Explanation of Its Operation}

Although the rule itself is simple in statement, it is complex in its definition of the terms "net capital" and "aggregate indebtedness." The complexity has been justified, however, because the rule, and its technical wording, is intended for particular application to those with expertise in the specific business of executing orders for the purchase and sale of securities.\textsuperscript{17}

The rule is imposed on all broker-dealers who are subject to the broad jurisdictional language of the registration section\textsuperscript{18} of the Exchange Act, with two exceptions. First, those brokers who act solely as agents for issuers in soliciting subscriptions to issuers' securities, promptly transmitting the securities and proceeds, and who hold or owe no customers' securities or funds are not covered

\textsuperscript{14} SEC Rule 15c3-1(a), 17 C.F.R. § 240.15c3-1(a) (1964).
\textsuperscript{15} Special Study, pt. 1, at 86.
\textsuperscript{16} Blaise D'Antoni & Associates, Inc. v. SEC, 289 F.2d 276, 277 (5th Cir. 1961).
\textsuperscript{17} SEC v. Fairfax Investment Corp., CCH Fed. Sec. L. Rep. ¶ 91432 (1964). Any objections to the accounting techniques required by the rule on grounds that the procedures are not in accord with standard accounting practices have been rejected thus: "Unless it can be shown that rule 15c3-1 is clearly an abuse of the Commission's rulemaking power, it is not incumbent on the courts to look behind the rule and determine how it might have been drafted more in accordance with concepts of good accounting. So long as the accounting procedure is in conformity with the rule, it must be deemed proper." SEC v. Graye, 156 F. Supp. 544, 546 (S.D.N.Y. 1957).
Clearly, there is little possibility of large borrowing by the broker-dealer in such a transaction and hence no immediate fear of insolvency. Also, since the broker-dealer holds no customer funds or securities, there is no danger to the customer. Second, members of seven specified stock exchanges whose rules and settled practices impose more comprehensive requirements than rule 15c3-1 are also exempted from coverage.\(^2\)

The rule defines "aggregate indebtedness" as the total money liabilities of a broker-dealer arising in connection with any transaction he engages in, including such items as money borrowed, money payable against securities loaned and securities "failed to receive" that have not been sold by the broker-dealer, market value of securities borrowed, and credit balances in any customers' accounts that have "short positions" in securities.\(^2\) It has been held that a reasonable provision for accrued taxes must also be included under "aggregate indebtedness."\(^2\) However, certain items are excluded from "aggregate indebtedness." They are:

1. Indebtedness that is "adequately collateralized" by securities owned by the broker-dealer.\(^2\) An "adequately collateralized" indebtedness is one that would be considered a fully secured loan by banks in the community making comparable loans to broker-dealers.\(^2\) For example, if banks generally were lending fifty per cent of the value on collateral consisting of common stock, a 10,000 dollar indebtedness secured by at least 20,000 dollars of common stocks would be "adequately collateralized." The term has the same meaning throughout the rule.

2. Indebtedness to other broker-dealers that is "adequately collateralized" by securities owned by the broker-dealer.\(^2\)

\(^{19}\) SEC Rule 15c3-1(b)(1), 17 C.F.R. § 240.15c3-1(b)(1) (1964).


\(^{21}\) SEC Rule 15c3-1(c)(1), 17 C.F.R. § 240.15c3-1(c)(1) (1964). For a discussion of the borrowing and loaning of money and securities on the part of a broker-dealer, "fails to receive," and "positioning" in securities, see LEFFLER, op. cit. supra note 2, at 409-10, 432-33.


\(^{23}\) SEC Rule 15c3-1(c)(1)(A), 17 C.F.R. § 240.15c3-1(c)(1)(A) (1964).

\(^{24}\) SEC Rule 15c3-1(c)(6), 17 C.F.R. § 240.15c3-1(c)(6) (1964).

\(^{25}\) SEC Rule 15c3-1(c)(1)(B), 17 C.F.R. § 240.15c3-1(c)(1)(B) (1964).
(3) Amounts that are payable against securities that have been loaned if the securities are owned by the broker-dealer. This exclusion operates to qualify the definition of "aggregate indebtedness," for, as seen above, the term includes money payable against any securities loaned. The result is that only money payable against securities loaned, but not owned by the broker-dealer, are included in the computation of "aggregate indebtedness."

(4) Amounts that are payable against securities "failed to receive" that were purchased for the account of the broker-dealer and have not been sold by him. This exclusion also operates to qualify "aggregate indebtedness," leaving included in "aggregate indebtedness" money payable against securities "failed to receive" that have not been sold by the broker-dealer but were not purchased for the account of the broker-dealer.

(5) Indebtedness that is "adequately collateralized" by exempted securities, i.e., federal government or state and municipal issues.

(6) Fixed liabilities that are secured by real estate or any other assets that are not included in the computation of "net capital" under rule 15c3-1— in other words, as we shall see under the definition of "net capital," any other asset that can not be readily converted into cash.

(7) Liabilities on open "contractual commitments." The term "contractual commitments" generally means firm commitment underwritings that have been contracted for, but for which settlement has not been made. Thus, the firm obligation of a broker-dealer, acting in the capacity of an underwriter, to purchase securities to be offered to the public would be an open "contractual commitment" and excluded from "aggregate indebtedness." But the exclusion is limited to firm commitment underwritings and is inapplicable to a best efforts underwriting, presumably on the theory that with a firm commitment underwriting the exact number of securities

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28 SEC Rule 15c3-1(c)(1)(C), 17 C.F.R. § 240.15c3-1(c)(1)(C) (1964).
27 SEC Rule 15c3-1(c)(1)(D), 17 C.F.R. § 240.15c3-1(c)(1)(D) (1964).
to be purchased is known, whereas with a best efforts underwriting the exact number is not known.\textsuperscript{32} The reason why liabilities on open "contractual commitments" are omitted from the computation of "aggregate indebtedness" is that the securities purchased in the underwriting are considered to be in inventory and hence are subject to the net capital "haircut," explained below.\textsuperscript{33}

(8) Indebtedness of the broker-dealer to one who has loaned him cash or securities that is subordinated to the claims of general creditors in accordance with a "satisfactory subordination agreement."\textsuperscript{34} Since the indebtedness is made "junior" to the claims of general creditors, it is not thought necessary to include it in "aggregate indebtedness." Since the indebtedness that is subordinated to such an agreement is also excluded from the computation of "net capital," the effect is to treat the proceeds of such liabilities, more properly denominated loans, as capital.\textsuperscript{35} However, the term "satisfactory subordination agreement" is strictly defined under the rule as a written agreement between the broker-dealer and the lender, binding on the lender and his creditors, that (a) subordinates any right of the lender to demand payment of cash or securities loaned to the claims of general creditors of the broker-dealer, (b) is not subject to cancellation at the will of either party for a term greater than one year, and (c) provides that it will not be rescinded if the effect of such rescission would be to lower the net capital-to-indebtedness ratio below the prescribed limit of 20:1.\textsuperscript{36}

An attempted summary of the above indicates that "aggregate indebtedness" essentially means the money liabilities of a broker-dealer that are not adequately collateralized by his own assets, are not subordinated by a satisfactory subordination agreement, and are not liabilities on an open contractual commitment.

"Net capital" is defined as the net worth (excess of assets over...

\textsuperscript{32} SEC v. Keith Richard Securities Corp., 148 F. Supp. 358, 360 (S.D.N.Y. 1957). See also SEC v. Los Angeles Trust Co., 186 F. Supp. 830, 859 (S.D. Cal. 1960), where the court stated that "open contractual commitment" does not include such items of indebtedness as customers' credit balances, even though the broker-dealer impliedly asserted that it had a contract with a customer with respect to the balances.

\textsuperscript{33} The term "contractual commitments" also includes when issued, when distributed, and delayed delivery contracts. SEC Rule 15c3-1(c)(5), 17 C.F.R. § 240.15c3-1(c)(5) (1964).

\textsuperscript{34} SEC Rule 15c3-1(c)(1)(I), 17 C.F.R. § 240.15c3-1(c)(1)(I) (1964).

\textsuperscript{35} NASD Training Guide 100 (1963).

\textsuperscript{36} SEC Rule 15c3-1(c)(7), 17 C.F.R. § 240.15c3-1(c)(7) (1964).
liabilities) of a broker-dealer, with certain adjustments that are
designed generally to reflect the current liquid position of the broker-
dealer. These adjustments are:

(1) The addition of unrealized profits and the deduction of un-
realized losses in securities held in the broker-dealer's accounts as
inventory or in trading accounts. Broker-dealers will often carry
inventories in securities as part of the function of making markets
in the securities. Any unrealized profits or losses in the inventories
would result in an adjustment of "net capital." But the profits or
losses must necessarily relate to a broker-dealer's inventory in issued
securities and not to trading profits or losses in "when issued"
securities, for, if the shares are not in fact issued, the unrealized
profits or losses will be permanently unrealized.

(2) The deduction of all assets that cannot be readily converted
into cash. This would include such non-liquid assets as real estate,
furniture and fixtures, insurance, and good will. Where there is an
indebtedness secured by such an asset, the deduction made is the
excess of the value of the asset over the amount of the indebted-
ness. In some cases the Commission has softened this provision
by allowing non-marketable assets a value to the extent that a
broker-dealer can demonstrate that he has received a firm bid for
such assets or that they would be taken as collateral for a bank
loan. There is no fixed policy here; it is simply a discretionary
withholding by the SEC, in certain circumstances, of compliance
with the letter of the law.

(3) The deduction of specified percentages (colloquially called
a "haircut") of the market value of all securities, except exempted
securities, in long or short positions of the inventory or trading
accounts of a broker-dealer. The "haircut" percentages to be de-
ducted vary from zero per cent for the exempted securities to thirty

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57 SEC Rule 15c3-1(c)(2), 17 C.F.R. § 240.15c3-1(c)(2) (1964).
58 SEC Rule 15c3-1(c)(2)(A), 17 C.F.R. § 240.15c3-1(c)(2)(A)
(1964).
1958).
60 SEC Rule 15c3-1(c)(2)(B), 17 C.F.R. § 240.15c3-1(c)(2)(B)
(1964).
62 Loss, op. cit. supra note 9, at 1354 n.257.
63 SEC Rule 15c3-1(c)(2)(C), 17 C.F.R. § 240.15c3-1(c)(2)(C)
(1964).
per cent. In the case of undefaulted, non-convertible debt securities with a fixed interest rate and maturity date, the deduction is five per cent, unless the securities are selling at a discount of more than five per cent, in which event the deduction is the amount of the discount up to a maximum of thirty per cent. With cumulative, non-convertible first preferred stock not in arrears as to dividends, the deduction is twenty per cent. On all other securities, the deduction is thirty per cent. The effects of these deductions, in addition to providing a margin of safety, is to provide a salutary brake on the accumulation of securities by a broker-dealer and to prevent him from over-extending himself. Thus, if a broker-dealer invested 100,000 dollars from his capital in the purchase of stock for his own account, it would be necessary to provide an additional 30,000 dollars of capital in order to remain in the same net capital position as he had before the purchase. Similarly, if he contracted to purchase 100,000 dollars worth of securities, he would have to enter the full purchase price as a liability, but would value the stock to be acquired at only 70,000 dollars, so that 30,000 dollars in cash would be required to carry the commitment. Arguments have been interposed by broker-dealers to the effect that whether or not they are within compliance with rule 15c3-1 is not in their control, as a market fluctuation may so vary the value of their securities that they could be thrown out of compliance through no fault of their own. While this is the case, such an argument has been rejected by at least one court as merely going to the wisdom of the rule.

(4) The exclusion of liabilities subordinated under a "satisfactory subordination agreement," the term having the same definition as it did under "aggregate indebtedness." The result of excluding such liabilities in computing both "aggregate indebted-

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48 For an example of how such a situation might occur, see Special Study, pt. 1, at 409 n.386.
50 SEC Rule 15c3-1(c)(2)(F), 17 C.F.R. § 240.15c3-1(c)(2)(F) (1964).
ness," as seen above, and "net capital" is to handle the proceeds of such liabilities, cash and securities, as capital.

(5) For broker-dealers who are sole proprietors, the deduction of the excess of liabilities not incurred in the securities business over assets not used in the business.\(^5\)

In summary, "net capital" means the liquid net assets of a broker-dealer reduced by certain percentages of the market value of most securities and excluding indebtedness subordinated by a satisfactory subordination agreement.

D. Is Rule 15c3-1 Sufficient?

By the terms of the rule, aggregate indebtedness cannot be more than twenty times greater than net capital. Thus, so long as a broker-dealer maintains a minimal amount of indebtedness, he may enter the market and continue to operate on a limited net capital. For example, each 10,000 dollar increment of indebtedness requires an increase of only 500 dollars in net capital to satisfy the rule. Thus, it appears that the rule is of limited effectiveness in fulfilling the purpose of assuring the financial responsibility and stability of broker-dealers. While it may be of importance in helping to insure the solvency of broker-dealers, it does not guarantee any minimum capital commitment and does little to screen broker-dealers at the crucial point of entry. The SEC has expressed its opinion of the rule thus: "The ease with which almost anyone can start his own securities firm has permitted many an amateur to embark on the deep water of broker-dealer entrepreneurship."\(^6\)

The SEC has recommended in its *Report of Special Study of Securities Markets*\(^3\) that broker-dealers be subjected to a "minimum net capital requirement" as a requisite of entry into the over-the-counter market and as an operational requirement thereafter.\(^4\) Such a requirement would be adopted, as was rule 15c3-1, under section 15(c) of the Exchange Act. The *Special Study* listed several reasons why a minimum capital rule should be adopted. First, securities laws depend heavily on the sanction of civil liability

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\(^1\) SEC Rule 15c3-1(c)(2)(G), 17 C.F.R. § 240.15c3-1(c)(2)(G) (1964).

\(^2\) Wall Street Journal, July 31, 1964, p. 6, col. 3.


\(^4\) *Id.*, pt. 1, at 161.
in favor of those who may be injured by violation of the laws by a broker-dealer; if a broker-dealer has little or no capital, he may be judgment proof, and hence the securities laws will not have the effect intended. Second, no broker-dealer should be permitted to carry on business on so thin a margin of capital that he must depend on day-to-day transactions to continue business; nor should he be permitted to rely on customers' funds and securities as a source of working capital. Third, the "smooth and speedy handling of securities transactions within the financial community itself require that all members of that community have at least such minimum of personnel and resources that they may reasonably rely on one another's ability to do business responsibly."\(^5\) Finally, a minimum capital rule would insure that broker-dealers entering the securities business have such a sense of commitment to their business as is likely to produce responsible, reliable operations.\(^6\) The minimum net capital rule recommended was 5,000 dollars, plus 2,500 dollars for each branch office and 500 dollars for each salesman employed at any time.\(^7\) The nature of the recommendation suggests that the Special Study recognizes that the requirement should not be uniform for all broker-dealers, but should reflect the type and size of business engaged in.

Although the SEC has yet to follow the suggestion of the Special Study, it is very likely to adopt a minimum net capital rule in the near future. In the spring of 1964, the Commission informally circulated a proposed minimum net capital rule. It followed the Special Study recommendation by proposing a minimum figure of 5,000 dollars, plus 500 dollars for each salesman, but did not use the number of branch offices as a standard of scaling up the minimum. For broker-dealers dealing exclusively in mutual fund shares, the requirement would have been 2,500 dollars minimum net capital plus 250 dollars for each salesman. No action was taken, and the rule has not been formally proposed, evidently because of substantial industry opposition. Later in 1964, the SEC again informally circulated a proposed minimum net capital rule. This proposal would have required broker-dealers to maintain liquid reserves equal to at least twenty-five per cent of the cash left with them by customers. However, it too received criticism, and no formal action

\(^5\) Id. at 84.
\(^6\) Id. at 84.
\(^7\) Id. at 162.
was taken. The Commission has announced that a new proposal is being drafted.\textsuperscript{58}

The industry's principal objections to a minimum net capital rule are that it alone cannot assure financial or other responsibility of a broker-dealer and that a broker-dealer can engage in overly risky business practices, either in the selection of debtors or by way of speculative ventures, even though he is required to maintain a prescribed level of capital. Also, the objection is made that worthy individuals without capital may be excluded from the business.\textsuperscript{59} Nevertheless, it appears likely that a minimum capital rule will be adopted by the SEC.

\section*{E. Relief for Violation of Rule 15c3-1}

Basically, the forms of relief available to the Commission for violation of its net capital-to-indebtedness ratio rule are injunctive relief, revocation or suspension of the registration of the broker-dealer with the SEC, and, if the broker-dealer is a member of a registered national securities association, suspension or expulsion from that association. Violations of the rule are detected by the Commission under section 17(a), where authority is given to make such inspection of the books and records of a broker-dealer "as the Commission may deem necessary or appropriate in the public interest or for the protection of investors."\textsuperscript{60}

1. Injunction.—The issuance of an injunction under the Exchange Act is governed by section 21(e), which conditions the right to injunction upon sufficient proof that "any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation" of the act or of any rule or regulation prescribed under its authority.\textsuperscript{61} An injunction does not seek to put the broker-dealer out of business or to harm him. It seeks only to restrain him from doing business while he is in violation of the Commission's rules.\textsuperscript{62} The Commission is not entitled to an injunction against a broker-dealer for violation of rule 15c3-1 unless it can make a clear showing of a violation of the rule—a showing that the broker-dealer

\textsuperscript{58} Wall Street Journal, July 31, 1964, p. 6, col. 3. See also N.Y. Times, Nov. 23, 1964, p. 59, col. 5.

\textsuperscript{59} National Ass'n of Sec. Dealers, Inc. v. SEC, 12 S.E.C. 322, 325 (1942).


subjected his customers to risk by conducting its business with an excess of indebtedness. Furthermore, where the violation is the broker-dealer’s first and the deficit is made good immediately after the commencement of the SEC’s action, an injunction will not likely issue, because it is improbable that the violation will be resumed. But where there have been repeated violations of the rule in the past, an injunction will lie.

2. Revocation or Suspension of Registration with the SEC.—Section 15(b)(5)(D) of the Exchange Act provides that the Commission, after notice and hearing, may revoke the registration of a broker-dealer for a period not exceeding twelve months or suspend him if it finds it is in the public interest and that such broker-dealer has willfully violated any of the provisions of the act or any rule or regulation thereunder. This provision also authorizes the Commission to censure a broker-dealer for violation of the act. Censure can be an effective sanction against a broker-dealer, for it puts the investing public on notice that he has willfully violated the securities laws. The Commission has held that where a broker-dealer permits his aggregate indebtedness to exceed more than twenty times his net capital, this, in and of itself, is a willful violation of rule 15c3-1. Substantially the same principles apply here as with injunctions. If the violation is remedied as soon as it is called to the broker-dealer’s attention, there will be no suspension, revocation, or censure. But where the broker-dealer continuously violates the rule and it is likely that he will continue to do so, suspension, revocation, or censure will follow.

3. Expulsion or Suspension from NASD.—Section 15A(1)(2)(b) authorizes the Commission, after opportunity for notice and hearing, to suspend for a maximum period of twelve months or to expel from a national registered securities association any member

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Hammill & Co., 28 S.E.C. 634 (1948).
thereof who has violated any provision of the Exchange Act or any rule or regulation thereunder. As the NASD is the only national securities association registered with the SEC, violation of rule 15c3-1 would result in the suspension or expulsion from that association, assuming the broker-dealer was a member.

6. Other Forms of Relief.—Section 32(a) of the Exchange Act, which provides for fines up to 10,000 dollars or imprisonment up to two years for violations of the act, is inapplicable to the net capital-to-indebtedness ratio requirement, because section 32(c) specifically exempts any violation of any rule prescribed pursuant to section 15(c)(3).

The general fraud provisions of federal securities regulation would seem to give rise to civil liability on the part of a broker-dealer if any refusal or failure to comply with rule 15c3-1 could be interpreted as a manipulative, deceptive, or fraudulent action. However, there appear to be no cases or rulings where a civil liability was imposed on a broker-dealer for a violation of the rule under the general fraud sections. Section 18(a) of the Exchange Act would appear to be another possible source of civil liability on the part of the broker-dealer for violation of the net capital-to-indebtedness ratio rule. It provides that any person who makes any statement in a report or document that is required to be filed with the SEC under the act and was false or misleading with respect to a material fact will be liable to any person who, in reliance on the statement, purchased or sold a security at a price that was affected by such statement. Thus, if a broker-dealer filed a false or misleading statement in the financial ledgers required by rule 17a-3 in an attempt to portray compliance with rule 15c3-1, when in fact his aggregate indebtedness exceeded net capital by more than 2,000 per cent, and a person purchased or sold a security in reliance upon such compliance, it would seem that such person could bring a civil action against the broker-dealer under section 18(a).

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75 SEC Rule 17a-3, 17 C.F.R. § 240.17a-3 (1964).
ever, there are no cases or rulings indicating that a civil action could be brought under section 18(a) in such a situation. At any rate, it would be difficult to show that a person bought or sold securities in reliance on a statement in a financial ledger which indicated compliance with rule 15c3-1.

II. REGULATION BY THE SELF-REGULATORY BODIES—THE STOCK EXCHANGES AND NASD

A. The Stock Exchanges

The purpose of this section is to inquire into the net capital requirements that are imposed on broker-dealers who are members of the New York Stock Exchange (NYSE) and the major regional stock exchanges. Our concern will be primarily with the NYSE. Any reference to broker-dealers here will be to those who have memberships on one or more of the organized exchanges. Such broker-dealers usually have specialized departments that engage in trading on the over-the-counter market. The members of seven specified stock exchanges—the American, Boston, Midwest, New York, Pacific Coast, Philadelphia-Baltimore-Washington, and Pittsburgh—are exempted from rule 15c3-1 because their “rules and settled practices are deemed by the Commission to impose requirements more comprehensive than the requirements of this rule.”

Generally, the net capital-to-indebtedness ratio rules of the exchanges are the same in principle as rule 15c3-1. The primary differences are three: (1) Many exchanges have a fixed minimum net capital rule as well as a net capital-to-indebtedness ratio rule. Members of such exchanges must meet either one or the other of the rules, depending on whichever requires a greater net capital. (2) The rules of some of the exchanges require a ratio of indebtedness to net capital lower than the 20:1 ratio prescribed by rule 15c3-1. (3) The rules of certain exchanges require greater “haircuts” on certain types of securities and also give the exchanges authority to demand larger “haircuts” on securities than prescribed by the rules, if it is considered necessary and advisable.

1. The NYSE.—The NYSE imposes net capital requirements on broker-dealer members by virtue of its rule 325, which prescribes a net capital-to-indebtedness rule and demands a fixed minimum net capital maintenance requirement. The net capital-to-indebtedness

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76 SEC Rule 15c3-1(b) (2), 17 C.F.R. § 240.15c3-1(b) (2) (1964).
ratio required is identical to the SEC's rule 15c3-1: "No member . . . doing any business with . . . members . . . or with the public . . . , shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 2,000 per centum of his or its Net Capital." As to the minimum net capital requirement, rule 325 demands that member broker-dealers carrying accounts for customers maintain a fixed net capital of at least 50,000 dollars; those members doing business with other members or member organizations, or doing general business with the public but not carrying customers' accounts, must maintain a net capital of at least 25,000 dollars. The rule further provides that initial net capital must be at least 120 per cent of that required to be maintained at all times. Therefore, a broker-dealer carrying customer accounts and thereby subject to the 50,000 dollar minimum capital requirement, would need 60,000 dollars of minimum net capital on initially becoming a member of the NYSE, the required amount dropping to a level 50,000 dollars after admittance. Both the ratio rule and the minimum net capital rule apply with particular force to broker-dealers having transactions with the public. However, rule 325 does not cover floor brokers, traders, and specialists having no public business. The result of prescribing both requirements is that the broker-dealer must meet either one or the other of the rules, depending on whichever requires a greater net capital. For example, assume that a broker-dealer carries no customer accounts and that therefore the 25,000 dollars minimum net capital requirement applies to him. If his aggregate indebtedness exceeded 500,000 dollars, which would be more than twenty times greater than 25,000 dollars, he would then fall under the net capital-to-indebtedness ratio rule (requiring a 20:1 ratio between capital and debt) and would be required to maintain a net capital of more than 25,000 dollars to support that indebtedness and comply with the ratio rule. But if aggregate indebtedness was less than 500,000 dollars, i.e., less than twenty times greater than 25,000 dollars, he would be subject to the minimum net capital requirement and would have to maintain a fixed level of 25,000 in minimum net capital.

2. NYSE's Definition of Net Capital and Aggregate Indebtedness.—Rule 325's definition of "aggregate indebtedness" and "net capital" closely parallels that of rule 15c3-1. "Aggregate indebted-

77 NYSE Rule 325(a), 2 NYSE Guide ¶ 2325.
78 Ibid.
ness" is defined under rule 325 as the total money liabilities of a broker-dealer with specified exclusions such as liabilities adequately collateralized, liabilities subordinated by a satisfactory subordination agreement to the claims of general creditors, liabilities on open contractual commitments, and numerous other exclusions that accord with the SEC's rule.\textsuperscript{79} "Net capital's" definition also conforms with that found under rule 15c3-1. It is defined under rule 325 as net worth less such items as fixed assets, prepaid rent, assets not readily convertible into cash, and so on.\textsuperscript{80} However, the definition does differ in one major respect in that it requires greater "haircuts" than the SEC's rule. For example, it prescribes a thirty per cent "haircut" on all securities in inventory positions instead of the SEC's varying "haircuts" of five to thirty per cent.\textsuperscript{81} Also, percentage deductions from federal and state government securities are required whereas no such deduction is imposed by rule 15c3-1. These deductions decrease as the bonds approach maturity, ranging from zero per cent with less than one year to maturity to ten per cent with five years or more to maturity.\textsuperscript{82} Moreover, the amount of "haircut" deduction on securities not held in inventory may depend on the quality of the security. As an illustration, in the case of a non-convertible bond, the percentage deduction may vary from five per cent to fifteen per cent, depending on the rating given the bond by a nationally known statistical service such as Standard and Poor or Moody's.\textsuperscript{83} The SEC's rule does not inquire into the quality of the security.

It should be emphasized that the definition of "net capital" applies to both the net capital-to-indebtedness ratio rule and the minimum net capital rule. Hence, when rule 325 speaks of requiring a minimum net capital of 25,000 dollars or 50,000 dollars, this refers to a level of net worth reduced by such items as "haircut" deductions.

3. Remedy for Violation of Rule 325.—The NYSE remedy for violation of its ratio rule or minimum net capital requirement is to suspend trading privileges.\textsuperscript{84} In light of the prestige and large customer market this privilege brings, the remedy would appear to

\textsuperscript{79} NYSE Rule 325(b)(2)(A)-(H), 2 NYSE Guide ¶ 2325.
\textsuperscript{80} NYSE Rule 325(b)(4)(A)-(I), 2 NYSE Guide ¶ 2325.
\textsuperscript{81} NYSE Rule 325(b)(4)(B), (C), 2 NYSE Guide ¶ 2325.
\textsuperscript{82} NYSE Rule 325(c)(1)(A), (B), 2 NYSE Guide ¶ 2325.
\textsuperscript{83} NYSE Rule 325(c)(4)-(6), 2 NYSE Guide ¶ 2325.
\textsuperscript{84} NYSE Const. art. XIV, §§ 6, 7, 2 NYSE Guide ¶¶ 1656, 1657.
be most effective in thwarting violations of rule 325. However, the argument can be made that this remedy may add to the difficulties of a broker-dealer firm in a precarious liquidity position and harm the customers by forcing an insolvency. The NYSE is able to detect violations by surprise audits.\textsuperscript{85}

4. Unannounced Policies of NYSE.—In addition to the above two rules, the NYSE has certain unpublished policies which have the effect of rules. While the 20:1 rule is the formal requirement of the exchange, on occasion, when a firm has come close to this level, the exchange staff has recommended to the firm that in the future it should maintain a ratio of aggregate indebtedness to net capital of 17.5:1. Likewise, the exchange staff at times will bring to bear pressure on its members to keep inventories of securities at a value of not more than ten times excess net capital, i.e., the excess of the broker-dealer's net capital over the capital required to support its aggregate indebtedness.\textsuperscript{86}

These policies appear to be specifically authorized by rule 325, for it provides: "The Exchange may at any time . . . in the case of a particular member . . . prescribe greater requirements than those prescribed herein."\textsuperscript{87}

5. Fidelity Bond.—The NYSE recently instituted a requirement under rule 319 that all member broker-dealers doing business with the public or other members carry fidelity bonds covering the broker-dealers' general partners, officers, and employees.\textsuperscript{88} These bonds indemnify member broker-dealers from losses resulting from dishonest or careless acts of officers and employees, such as theft, embezzlement, loss or misplacement of property, check forgery, or fraudulent trading. Although the bond does not confer a right of action directly on the customer who may be adversely affected by such acts, it does serve indirectly as a protection to the public investor since the bond proceeds would add to the broker-dealer's assets and might prevent or ameliorate bankruptcy.\textsuperscript{89} The required minimum coverage of the bond varies with the type of business done by the member broker-dealer and with the amount of net capital he must have to support his aggregate indebtedness. For

\textsuperscript{85} See NYSE Rule 418, 2 NYSE Guide ¶ 2418.
\textsuperscript{86} Special Study, pt. 1, at 408-09.
\textsuperscript{87} NYSE Rule 325(a), 2 NYSE Guide ¶ 2325.
\textsuperscript{88} NYSE Rule 319, 2 NYSE Guide ¶ 2319.
\textsuperscript{89} Note, 77 Harv. L. Rev. 1290, 1293 (1964).
example, for broker-dealers who do business with other members of the exchange and do not carry customers accounts, the minimum coverage required is 100,000 dollars. For broker-dealers who carry customers' accounts and do business with the public, the minimum coverage changes with the net capital required under the ratio rule, ranging from a 200,000 dollar minimum coverage where the net capital required is 50,000 dollars to 5 million dollars where the net capital required is 12 million dollars.\footnote{NYSE Rule 319, 2 NYSE Guide ¶ 2319.}

6. Central Indemnification Fund.—In 1964, the NYSE approved amendments to its constitution that have the effect of providing even greater safeguards for customers of member broker-dealer firms. These amendments provide for a permanent central indemnification fund totaling 25 million dollars for repaying customers of a member broker-dealer that becomes insolvent.\footnote{NYSE Const. art. X, § 9, 2 NYSE Guide ¶ 1459.} This protection was triggered by the collapse of Ira Haupt & Co. When Haupt failed, the firm was holding for customers approximately 9 million dollars in cash and 490 million dollars in securities. The Exchange took the lead in liquidating Haupt, spending 9.5 million dollars of its own funds to repay customers who had left securities with the firm. It then levied on its members a special assessment.\footnote{Wall Street Journal, July 31, 1964, p. 6, col. 3.} The amendments soon followed.

7. Other Exchanges.—Discussion here will be limited to those major regional exchanges that have been exempted from rule 15c3-1 because their requirements are more comprehensive. The requirements of these exchanges are more comprehensive in several respects. First, the net capital-to-aggregate indebtedness ratios are stricter on some exchanges.\footnote{The maximum permissible ratios of the Midwest and Pittsburgh stock exchanges are 15:1 rather than the SEC's 20:1 ratio. Special Study, pt. 1, at 408.} Second, all of the exchanges exempted from coverage by rule 15c3-1 have minimum net capital maintenance requirements in addition to ratio rules. The American Stock Exchange requires of member broker-dealers having public customers a minimum net capital of 50,000 dollars, and of those without public customers a net capital of 25,000 dollars; the Boston Stock Exchange requires members to maintain a minimum net capital of 25,000 dollars; the Midwest Stock Exchange requires
corporate members to have a net capital of 25,000 dollars, whereas individuals must have net capital of 10,000 dollars; the Pacific Coast Stock Exchange requires its members doing business with the public to maintain a minimum net capital in an amount at least 5,000 dollars in excess of five per cent of aggregate indebtedness, or not less than 25,000 dollars, whichever is greater. Similar requirements are in force on the other exchanges exempted from rule 15c3-1. Third, the “haircut” requirements of the exempted exchanges are more comprehensive. A prime example of this is the “haircut” requirements of the Midwest Stock Exchange, where government issues, both federal and state, have a two and one half per cent “haircut,” whereas rule 15c3-1 requires no “haircut” on such securities. Also, it prescribes a flat thirty per cent “haircut” on all securities in inventory instead of the Commission’s varying “haircuts” of five to thirty per cent. Finally, the rules of this exchange provide that “inactive securities” may be discounted in a greater amount than thirty percent, i.e., if a broker-dealer keeps a class of securities in his inventory for a substantial length of time, a higher “haircut” will be required. No comparable rule is found in federal broker-dealer requirements.

B. National Association of Securities Dealers

1. Membership.—Membership in the NASD is not required by the SEC, although it has proposed that membership be made compulsory for all broker-dealers engaged in an interstate over-the-counter business. Even though membership is not compulsory, of the approximately 6,000 broker-dealer firms actively engaging in the over-the-counter business only about 620 firms are not mem-

\[94 \text{Id. at 408.} \]
\[95 \text{Halsted, Rules and Regulations of Midwest Stock Exchange, 1961 U. Ill. L.F. 257, 258.} \]
\[96 \text{In 1938, Congress passed the Maloney Act, which amended the Exchange Act of 1934 by expressly authorizing the voluntary formation by over-the-counter broker-dealers of “national securities associations.” Act of June 23, 1938, 52 Stat. 1070, 15 U.S.C. § 78o-3 (1958). A national securities association may be registered with the SEC if it adopts rules for the regulation of its members that conform to certain requirements, such as demonstrating to the SEC that “such association will be able to comply with the provisions of this title [the Exchange Act]. . . .” 78 Stat. 574 (1964), 15 U.S.C. § 78o-3(b)(1) (Supp. 1964). The NASD is the only association registered with the SEC, and since 1939, it has been the major self-regulatory arm of the over-the-counter business.} \]
\[97 \text{Special Study, pt. 1, at 159. The proposal was rejected by Congress when it enacted the 1964 amendments without such a requirement.} \]
bers of the NASD; the bulk of the nonmembers are broker-dealers engaged in issues not considered to be securities, such as oil royalties and savings and loan shares.\textsuperscript{98}

2. Pre-1964 Amendments.—Before the 1964 amendments to the Exchange Act, the fundamental philosophy of the act was one of free entry by broker-dealers into the over-the-counter business. This philosophy was evident in the lenient requirements for membership in the NASD, which in effect allowed membership in the association if broker-dealers conducted an honest and responsible business.\textsuperscript{99} Accordingly, although the NASD enforced the SEC's rule 15c3-1, it did not have any minimum capital or bonding requirements on which it could have based a refusal to grant membership.\textsuperscript{100} Previous attempts by the NASD to impose such requirements had been opposed by the SEC as inconsistent with congressional intent that NASD membership be open to anyone conducting an honest and responsible business. The SEC felt that such a rule would result in the expulsion of over one-fourth of the association's membership and restrict it to the larger broker-dealer concerns.\textsuperscript{101}

3. The 1964 Amendments.—The 1964 amendments to the Exchange Act abandoned this philosophy of free-entry, because of congressional belief that it made entry too easy for the inexperienced and unqualified broker-dealer.\textsuperscript{102} The result is that Congress has now provided the NASD with broad authority to impose stricter requirements for membership. Section 15A(b)(5) authorizes and requires the NASD to prescribe rules barring from membership any broker-dealer that does not meet "specified and appropriate" requirements with respect to the financial responsibility of such member.\textsuperscript{103} It provides that a national securities association will not be registered with the SEC unless it appears to the Commission that "the rules of the association provide... no person shall become a member... unless such person is qualified to become a member in conformity with specified and appropriate standards with respect to... the financial responsibility of such member."\textsuperscript{104} This new authority will in all

\textsuperscript{98}LEFFLER, THE STOCK MARKET 405 (3d ed. 1963).
\textsuperscript{99}SORG PRINTING CO., SECURITIES ACT AMENDMENTS OF 1964 WITH EXPLANATION 31 (1964).
\textsuperscript{100}Special Study, pt. 1, at 86.
\textsuperscript{101}National Ass'n of Sec. Dealers, Inc. v. SEC, 12 S.E.C. 322, 325 (1942).
\textsuperscript{102}SORG PRINTING CO., op. cit. supra note 99, at 31.
probability result in the adoption of a minimum net capital require-
ment for broker-dealers as a condition of membership in the NASD.
The amount of such a requirement is difficult to forecast. However,
in view of the new provision that NASD rules may classify pro-
spective members by taking into account their type of business, it
appears unlikely that there will be a uniform minimum capital
requirement for all NASD members. Account will probably be
made for size of the broker-dealer, number of employees, or the
type of business the broker-dealer engages in. Any indication of
what the exact dollar amounts will be can only be had from the
Special Study recommendations.

4. Disciplinary Powers.—The Exchange Act provides that an
association cannot be registered as a national securities association
unless “the rules of the association provide that its members . . .
shall be appropriately disciplined, by expulsion, suspension, fine,
censure, . . . or any other fitting penalty, for violation of its rules.”
The NASD has established such power. Thus, if the NASD
does adopt a minimum net capital rule, it will have effective sanc-
tions against a member broker-dealer for violation of such a rule
as it does now for members who violate rule 15c3-1.

5. “Mirror” Provision.—As noted above, Congress rejected the
SEC’s proposal that all broker-dealers engaged in interstate over-
the-counter business be required to join the NASD. However, by
the enactment of a new section, 15(b)(8), Congress has pro-
vided for regulation of broker-dealers who refuse to join the NASD.
This regulation is comparable to that which the NASD is authorized
and required to adopt under section 15A(b)(5) for its members.
The new law provides that, even though a registered broker-dealer
is not a member of the NASD, he may not engage in the over-the-
counter business unless he meets standards relating to training, ex-
perience, and other necessary and desirable qualifications as the
SEC may prescribe. The point to be noted here is that, while the
SEC has been given power to provide standards and rules for broker-
dealers who are not members of the NASD that largely “mirror”

107 See text accompanying notes 53-59 supra.
109 NASD Rules of Fair Practice, art. VII, § 3(c), NASD Manual at
   C-40 (1962).
those given to the association, the new provision makes no mention of standards of financial responsibility for nonmember broker-dealers. As seen above, however, the NASD has been given express authority to establish standards of financial responsibility for member broker-dealers. The reason for this difference is that Congress felt that, in view of the authority already established in the SEC under section 15(c)(3) to provide safeguards with respect to financial responsibility, "it was unnecessary to mention this power again in connection with the new power of the SEC to provide other qualification standards for nonmembers."110

III. Regulation by the States

At present there are thirty-four states that have enacted blue-sky provisions to assure the financial responsibility and stability of broker-dealers. These states impose upon broker-dealers within their jurisdiction either net capital-to-indebtedness ratio requirements, minimum net capital rules, and/or bonding requirements, all of which apply both as conditions to entry and as continuous operational requirements after entry. Although the blue-sky provisions vary significantly from state to state, six patterns can be derived:

(1) Those states imposing bonding requirements solely. There are fifteen states in this class. They are (with the dollar amount of the bond required): Alaska (up to 10,000 dollars),111 Arizona (up to 25,000 dollars),112 California (5,000 dollars),113 Florida (5,000 dollars),114 Hawaii (5,000 dollars),115 Indiana (25,000 dollars),116 Iowa (5,000 dollars),117 Maine (10,000 dollars),118 Michigan (up to 100,000 dollars),119 Missouri (5,000 dollars),120 Nebraska (discretionary),121 North Dakota (discretionary),122 Oregon (10,000

dollars),\textsuperscript{123} South Dakota (5,000 to 15,000 dollars),\textsuperscript{124} and Vermont (1,000 to 25,000 dollars).\textsuperscript{125}

(2) Those states imposing minimum net capital requirements solely. There are three states in this class. They are (with the respective amounts required): New Hampshire (25,000 dollars),\textsuperscript{126} New York (10,000 dollars),\textsuperscript{127} and Pennsylvania (25,000 dollars).\textsuperscript{128}

(3) Those states imposing minimum net capital and bonding requirements. This class includes seven states: Arkansas (minimum net capital of 12,500 dollars and bond of 5,000 and up to 50,000 dollars),\textsuperscript{129} Colorado (minimum net capital of 10,000 dollars and bond up to 10,000 dollars),\textsuperscript{130} Georgia (minimum net capital of 100,000 dollars and bond of 10,000 dollars),\textsuperscript{131} Kentucky (minimum net capital of 10,000 dollars and bond up to 10,000 dollars),\textsuperscript{132} Oklahoma (minimum net capital of 10,000 dollars and bond of 10,000 dollars),\textsuperscript{133} South Carolina (minimum net capital up to 10,000 dollars and bond of 10,000 dollars),\textsuperscript{134} and Utah (minimum net capital discretionary and bond of 10,000 dollars).\textsuperscript{135}

(4) Those states imposing minimum net capital or bonding requirements. These states require a bond only if net capital is below a prescribed amount. This class includes four states: Alabama (minimum net capital of 25,000 dollars or bond up to 10,000 dollars),\textsuperscript{136} Minnesota (minimum net capital of 15,000 dollars or bond of 15,000 dollars),\textsuperscript{137} New Jersey (minimum net capital of

\textsuperscript{124} S.D. Code § 55.1912 (1960).
\textsuperscript{127} N.Y. Gen. Bus. Law § 352-K.
\textsuperscript{129} 1 Blue Sky L. Rep. 1704.
\textsuperscript{132} Ky. Rev. Stat. §§ 299.300(3)(b), (c) (1962).
25,000 dollars or bond of 25,000 dollars), Ohio (minimum net capital of 10,000 dollars or bond discretionary), and Virginia (minimum net capital of 25,000 dollars or bond of 25,000 dollars).

(5) States imposing bonding and net capital-to-indebtedness ratio requirements. There is only one state in this class: Mississippi (ratio requirement of 20:1 and bond of 5,000 dollars).

(6) Those states imposing net capital-to-indebtedness ratio requirements, minimum capital requirements, and bonding requirements. This class includes three states: Kansas (minimum net capital of 10,000 dollars, ratio requirement of 20:1, and bond of 5,000 dollars), Maryland (minimum net capital of 15,000 dollars, ratio requirement of 20:1, and bond up to 10,000 dollars), and New Mexico (minimum net capital of 5,000 dollars, ratio requirement of 20:1, and bond up to 100,000 dollars).

A. Bonding Requirements

The bonds required by any of the above states, either as the sole requirement or in conjunction with a net capital-to-indebtedness ratio requirement or a minimum net capital requirement, are surety bonds and typically permit an aggrieved person to sue directly on the bond for violation by the bonded broker-dealer of civil liabilities provisions of the applicable blue-sky law. In fact, the bonds are conditioned on strict compliance with the blue-sky laws. The bonds are required before the broker-dealer can register and thus conduct his business within the state, and usually run to the state for the benefit of aggrieved persons. The sureties required on the bond must be approved by the state.

It should be noted that these bonds differ from the fidelity bonds required by rule 319 of the NYSE in that the fidelity bond

139 Ohio Reg. DS-4, 2 BLUE SKY L. REP. ¶ 38664, promulgated under OHIO CODE ANN. § 1707.20 (1964).
142 Kan. Regs. 81-17-1, D, 3A and 3B, 1 BLUE SKY L. REP. ¶ 19703, promulgated under KAN. GEN. STAT. ANN. §§ 17-1254(c), 1270(f) (1961).
143 Md. CODE ANN. art. 32A, §§ 16(d), (e) (Cum. Supp. 1964).
145 E.g., ARIZ. REV. STAT. ANN. § 44-1943 (1956).
146 E.g., CAL. CORP. CODE § 25703.
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does not confer a right of action directly on the customer, whereas the surety bonds required by state blue-sky laws do. However, there is a limitation on this right, as most blue-sky laws demand that the action be brought within two years from the time the act complained of occurred.

All of the states requiring bonds provide that deposits of cash or securities will be accepted in lieu of such bonds. Also, most of the states that require bonds do so regardless of a broker-dealer's net capital. But a few states demand a bond only in the event that a broker-dealer's net capital, as defined in the statute or by appropriate regulation, is less than a given amount. Furthermore, the bonds required are usually for a determined amount; but a few states leave the amount of the bond to the discretion of their commissioner of securities laws, who is to base his decision on such factors as the financial condition of the broker-dealer or the volume of business and number of salesmen employed. However, even though the bond required may be for a determined amount, the amount may vary within a prescribed range, depending on the number of salesmen a broker-dealer has.

Clearly, the surety bonds required by a majority of the states assure the financial responsibility of the broker-dealer at least to the extent of the face value of the bond, because they allow only broker-dealers with a substantial amount of money to pay for the bonds (and who are able to get sureties) to enter into the business. Furthermore, they prevent a broker-dealer from being judgment proof when suit is brought for any violation of the civil liabilities sections of the respective blue-sky laws.

B. Minimum Net Capital Requirements

The minimum net capital requirements, which are imposed either as the sole requirement or in conjunction with a net capital-to-indebtedness ratio requirement or a bonding requirement, appear in varying forms with respect to the dollar amounts required. A

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147 See NYSE Rule 319, 2 NYSE Guide ¶ 2319.
152 E.g., S.D. Code § 55.1912 (1960).
154 1 Blue Sky L. Rep. ¶ 1704.
majority of the blue-sky laws prescribe 10,000 dollars or 15,000 dollars as the necessary level of minimum net capital. Georgia requires the highest level of minimum net capital—100,000 dollars. A few states provide for more than one level of minimum net capital.

Most states fail to define the term "minimum net capital" ("minimum capital" in the words of several blue-sky laws), thus creating the presumption that minimum net capital simply means a level of cash that is required to be maintained by the broker-dealer. However, a few states have defined the phrase either by using their own terminology or by using the same terms that define "net capital" under the SEC's rule 15c3-1. The few states that define minimum net capital do so by regulations or rules rather than by the enabling statute itself. Such a method is essential in light of the technical nature of minimum net capital rules.

C. Net Capital-to-Indebtedness Ratio Requirement

The four states imposing a net capital-to-indebtedness ratio requirement in conjunction with minimum net capital and/or bonding provisions all prescribe a 20:1 ratio. The terms "net capital" and "aggregate indebtedness" are defined in the statutes of the respective states by using the terminology of rule 15c3-1.

D. Relief for Violation of Blue-Sky Provisions

The forms of relief available for violation of the above provisions are fairly uniform throughout the states and roughly parallel those found under the Exchange Act of 1934. First is suspension or revocation of registration, second is injunctive relief. Fine and/or imprisonment is a third possible form of relief, one not

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156 For example, in New Mexico a broker-dealer must have a minimum of 10,000 dollars upon registration, but once registered, only 5,000 dollars. N.M. Order 61-421B, 2 BLUE SKY L. REP. ¶ 34613, promulgated under N.M. STAT. ANN. § 48-18-20.2 (Supp. 1963).
159 Kansas, Maryland, Mississippi, and New Mexico. See notes 141-44 supra and accompanying text.
161 E.g., KY. REV. STAT. § 292.470 (1962).
available under federal securities law. However, the majority of the states require that the broker-dealer had knowledge of the provision or rule before there can be any fine or imprisonment for its violation.

Most blue-sky laws provide for periodic examinations of broker-dealers' records and financial statements. Thus, violations can be readily detected.

E. An SEC Ruling

In 1963, the SEC advised broker-dealers in New York that a violation of a New York statute that specified a minimum net capital requirement would be considered a violation of the anti-fraud provisions. The ruling goes beyond the scope of state regulation because the majority of states do not provide for civil liability for violating capital requirements. Thus, a result unintended by the states may result from the operation of their laws. Whether the ruling will be enforced is unknown, but it will undoubtedly serve as a warning to those in the business.

F. North Carolina

North Carolina does not specifically provide for bonding, minimum capital, or net capital-to-indebtredness ratio requirements. The only provision expressly dealing with the financial responsibility of broker-dealers provides that the Secretary of State may cancel the registration of a broker-dealer if the broker-dealer is insolvent or in danger of insolvency. However, it requires registration with the SEC as a prerequisite for registration in the state. This requirement subjects broker-dealers in North Carolina to rule 15c3-1 and thus assures financial responsibility of broker-dealers, at least by present federal standards.

G. Uniform Securities Act

The Uniform Securities Act contains two provisions directed toward the financial responsibility of broker-dealers. The first is section 202(d), which provides: "The [Administrator] may by rule require a minimum capital for registered broker-dealers."
No net capital to aggregate indebtedness ratio is provided for. However, the Official Comment to section 202(d) states that any state that adopts the act and wants to prescribe such a ratio may do so by adding at the end of section 202(d): "or prescribe a ratio between net capital and aggregate indebtedness." Any definition of the terms "minimum capital" or "ratio between net capital and aggregate indebtedness" is left to section 412(a), which provides: "The [Administrator] may from time to time make . . . such rules . . . as are necessary to carry out the provisions of this act . . . ." Such a relegation of the definition of these terms to administrative rules or regulations is essential in view of their technical nature.

The second provision, section 202(e), relates to the posting of surety bonds by broker-dealers:

The [Administrator] may by rule require registered broker-dealers, to post surety bonds in amounts up to 10,000 dollars, and may determine their conditions. Any appropriate deposit of cash or securities shall be accepted in lieu of any bond so required. No bond may be required of any registrant whose net capital, which may be defined by rule, exceeds 25,000 dollars. Every bond shall provide for suit thereon by any person who has a cause of action under section 410 [section dealing with civil liabilities under the act], and if the [Administrator] by rule or order requires, by any person who has a cause of action not arising under this act. Every bond shall provide that no suit may be maintained to enforce any liability on the bond unless brought within two years after . . . the act upon which it is based.

The Official Comment to section 202(e) states that the administrator has no discretion whether to accept a deposit of cash or securities in lieu of a bond but that he has discretion to ascertain if the amount of the deposit and the type of securities deposited are proper. Many of the previously discussed blue-sky provisions relating to the requirements of posting bond are similar to section 202(e).

IV. CONCLUSION

Among 215 new broker-dealers registering with the SEC in a six month period in 1956, twenty-seven per cent had net capital of

\[\text{Loss & Cowett, Blue Sky Law 265 (1958).}\]
\[\text{Uniform Securities Act § 412(a).}\]
\[\text{Uniform Securities Act § 202(e).}\]
\[\text{Loss & Cowett, op. cit. supra note 168, at 266.}\]
less than 1,000 dollars. Hence, the present pattern of federal regulation of the financial responsibility of broker-dealers is inadequate. More than a net capital-to-aggregate indebtedness ratio is needed; a minimum net capital rule should be adopted. As recently as November 22, 1964, the SEC announced that such a rule is to be formally proposed within a short time. Therefore, barring successful opposition to its adoption, a minimum net capital requirement will soon exist, and adequate protection of the investing public will be further assured.

With the adoption of a minimum net capital rule by the NASD, the regulation of the financial responsibility of broker-dealers by the self-regulatory bodies will likewise become adequate; the pattern of regulation by the stock exchanges is already sufficient.

While adoption of the pertinent provisions of the Uniform Securities Act is recommended, it appears unlikely that many states will provide this further assurance of financial responsibility in the near future. However, any concern over the lack of sufficient assurances by the states is mitigated by the extensive regulation by federal and self-regulatory bodies.

BARRY A. OSMUN

Conflicts—Most Significant Relationship Rule

Decedent, a domiciliary of Pennsylvania, purchased a ticket in Pennsylvania from an air line, a Delaware corporation with principal offices in Illinois, for a flight from Pennsylvania to Arizona. The plane crashed while landing at a scheduled stop in Colorado, causing the decedent's immediate death. The executor of his estate brought an action against the air line in Pennsylvania for breach of contract of carriage, seeking recovery under Pennsylvania's law of damages which allowed recovery for decedent's probable earnings during the period of his life expectancy. The lower court sustained the contract action, but denied recovery under Pennsylvania's law of damages, holding that the law of the

\[^{272}\text{Special Study, pt. 1, at 85.}\]
\[^{273}\text{N.Y. Times, Nov. 23, 1964, p. 59, col. 5.}\]