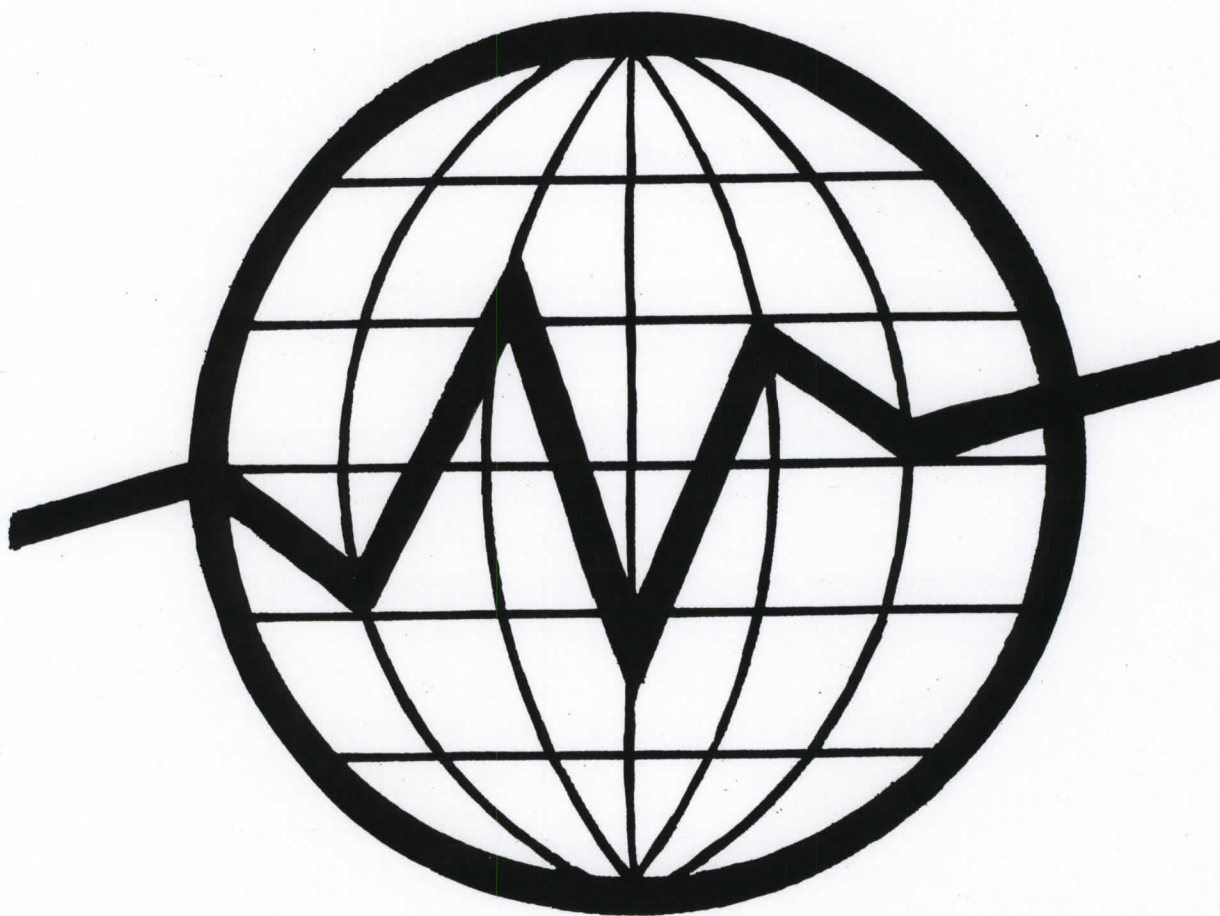


**CAPITAL ADEQUACY  
STANDARDS FOR  
SECURITIES FIRMS**



**INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS**

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of Securities Commissions

Published in the UK for  
the International Organisation  
of Securities Commissions (IOSCO)  
Montreal, Canada.

October 1989

Printed in England by  
Royle City Ltd.

# **CAPITAL ADEQUACY STANDARDS FOR SECURITIES FIRMS**

Report of  
The Technical Committee of the  
International Organisation of Securities  
Commissions

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**INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS**

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# I. PREFACE

The Technical Committee of the International Organisation of Securities Commissions ('IOSCO'), comprised of representatives of securities regulators of 12 countries<sup>1</sup> held its first meeting in July 1987. At this meeting, six working groups were established to study various aspects of the international securities markets. One group, Working Group Number 3 under the Chairmanship of Mr Jeffrey R Knight of the International Stock Exchange, with representatives from France, Japan, the United Kingdom, and the United States, was set up to study the issues related to capital adequacy for securities firms from a world-wide perspective.

The Working Group surveyed the capital requirements in the 12 countries which are members of the IOSCO Technical Committee. Based upon (1) a detailed consideration of the risks faced by securities firms, (2) information obtained by members of the Working Group, and (3) The deliberations at the meetings of the Working Group, the Working Group reached a number of conclusions about the capital requirements that securities firms should meet.

Those conclusions are contained in this paper, which was presented to the Technical Committee at its meeting in Montreal, Canada on June 20-21, 1989. At that meeting, the Technical Committee adopted this paper and approved it for presentation to the 14th Annual Conference of IOSCO in Venice, Italy on September 18-21, 1989.

1. The 12 countries are Australia, Canada, France, West Germany, Hong Kong, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

## II. CONCLUSIONS OF THE TECHNICAL COMMITTEE

The Technical Committee has reached the following conclusions:

1. There is a need for a common conceptual framework regarding the capital requirements for securities firms.
2. The framework should contain the following elements:

A. Liquidity and solvency should be covered by a standard that provides for a firm to have sufficient liquid assets to meet its obligations given the risks a firm faces.

B. Marking of marketable securities and commodities positions to market is necessary to prevent firms from storing up losses and also to give a true picture of a firm's position.

C. Risk-based requirements<sup>2</sup> should cover all the risks to a firm and, in particular, should contain:

- i. a base requirement reflecting the scale of a firm's activities to capture non-measurable risks.
- ii. position risk requirements (for both on and off balance sheet items) reflecting the price volatility of individual securities with provisions for concentrated positions and allowances for risk reduction measures such as hedging.
- iii. settlement risk requirements reflecting the risk of non-performance in a timely manner.

The capital held by each firm must exceed the sum of the risk-based requirements.

2. The Technical Committee believes that minimum requirements should not be regarded as a substitute for risk-based requirements.

3. In some systems, it is necessary that the definition of capital should reflect the fluctuating nature of the risk-based requirements. Some regulatory systems allow certain types of financings such as subordinated loans to serve as capital in addition to owner's equity. It is, however, recognised that there should be limits on the amount of these financings relative to owner's equity. Some systems do not make allowances for such financings. The Technical Committee recognises that at present the definition of capital varies between systems to reflect their differing regulatory structures.

4. Differential minimum capital requirements, based on the type of business being conducted by the firm, should be established so that firms wishing to enter the securities business demonstrate a level of commitment to the business. Capital requirements should not be set so high as to adversely affect competition in the marketplace.

5. Capital requirements should be reinforced by adequate recordkeeping, reporting, and examination programs.

### III. BACKGROUND

The remainder of this paper examines the need for capital requirements (capital adequacy standards) for securities firms, the risks which need to be covered, and the various ways in which requirements can be structured.

It discusses the important need for capital adequacy standards for securities firms taking positions as principal, carrying client (customer) accounts, and/or holding client property<sup>3</sup>. It sets forth a three-part conceptual framework against which capital adequacy standards for these firms can be measured. The framework would consist of the following:

1. A capital adequacy test that reflects liquidity, solvency, and the risks (market, settlements, and other) faced by a securities firm;
2. A regulatory structure for the maintenance of a securities firm's books and records; and
3. A framework of regular reporting to, and examination by, a supervisory authority.

While this paper recognises that the segregation of client property is an important aspect of prudential supervision and investor protection, it is not covered herein as it is not strictly within the ambit of capital adequacy standards. Annex A briefly describes the client segregation approaches in some countries. Clients in some national markets are protected in the event of the failure of a particular securities firm through a compensation or insurance scheme. However, the existence of a customer insurance arrangement would still leave market participants concerned about their exposure to

3. Securities firms engage in a wide variety of other activities such as: (1) managing or participating in underwriting of public offerings of securities; (2) arranging for private placements of securities issues; (3) assisting and participating in mergers and acquisitions of companies; (4) lending and borrowing securities; (5) engaging in repurchase and reverse repurchase transactions; and (6) engaging in foreign currency and interest rate swap transactions. However, in some countries, certain financial activities may not be covered by the securities laws. For example, in one country, the securities laws are not applicable to firms dealing solely in foreign currency or interest rate swaps. Thus, these activities may be carried on in that country in unregulated affiliates of a securities firm. However, if these activities are carried on in the regulated securities firm, the capital adequacy standard of that country would apply. This paper does not deal with capital requirements for firms engaged solely in providing investment advice or managing investments.



their customers or counterparties for uncompleted transactions entered into with a failed securities firm. Without adequate financial responsibility safeguards, compensation arrangements would become extremely costly<sup>4</sup>. To be effective, a compensation or insurance scheme should operate in tandem with strong financial responsibility requirements.

This paper also recognises that there are a wide variety of firms in securities markets worldwide, but in terms of regulation, there are two principal categories:

1. Securities firms, whose predominant activity is acting as agent or principal in securities or derivative products, and
2. Banks, whose securities activities generally are only one part of their total activities and have generally been a minor part of those activities.

This paper primarily focuses on the former, but many of the risks for a bank involved in the securities business would be similar. There are fundamental differences between the regulatory approach of many securities firm regulators and that of bank regulators. The differences are discussed briefly in Annex B.

The equity market crash in October 1987, focused attention on the growing interdependency of the world's securities markets. It highlighted the potential capital exposure of securities firms to developments in those markets and the need for all markets to have an adequate regulatory structure for the prudential supervision of securities firms. This, along with the increasing international competitiveness of the securities industry, has focused attention on different capital

<sup>4</sup>. Clearing house guarantee arrangements would also become extremely expensive in the absence of an adequate financial responsibility framework.

approaches in international markets. From the viewpoint of firms operating in those markets, it would be helpful to have requirements which are similar in approach. Accordingly, there is a need for some degree of convergence in the conceptual framework underlying the capital requirements imposed by different countries.

## IV. CAPITAL ADEQUACY TEST

### A. Need for Capital Standard

Capital adequacy standards foster confidence in the financial markets and should be designed to achieve an environment in which a securities firm could wind down its business without loss to its customers or the customers of other broker-dealers and without disrupting the orderly functioning of the financial markets. Capital standards should be designed to provide supervisory authorities with time to intervene to accomplish this objective. They should allow a firm to absorb losses. They also should provide a reasonable, yet finite, limitation on excessive expansion by securities firms to minimise the possibility of customer losses and disruption of the markets.

The efficient functioning of the financial markets requires members of the financial community to have confidence in each other's stability and ability to transact business responsibly. This, in turn, requires each member of the financial community to have, among other things, adequate capital. In the absence of a supervisory authority setting objective capital adequacy standards, investors, other securities firms, and financial institutions would be reluctant to deal with securities firms. In an unregulated environment, the financial failure of a firm would call into question the solvency of other securities firms and could cause serious disruption of the markets. For example, broker-dealers often need financing from banks and institutions to carry or clear securities transactions. Any significant interruptions in the availability of bank financing, or any other source of financing, could significantly affect the broker-dealer community and the operation of the markets. If, because of doubts about the adequacy of the capital of foreign firms dealing through branches, market participants or investors in any market felt that they could deal safely only with indigenous firms, the further development and growth of international markets would be considerably impeded.

## B. Risks Addressed by Capital Adequacy Standard

Finally, those entering the securities business should have a sense of commitment and obligation to their business in order to help promote responsible and reliable operations. One of the ways of demonstrating this is through adequate capital.

A capital adequacy test should address the risks faced by securities firms. Some of these risks and how they can be measured for capital purposes are set forth below.

### 1. Position Risk

Securities firms that trade as principal usually hold securities with a view to selling them in the near future at a profit. In other words, they are not in the business of holding securities as long term investments; their object is to run a "trading book". Consequently, they must be in a position to withstand losses, whether realised or not, which result from their trading activities. Position risk (market risk) has various forms. There is the basic risk that the price of securities that the firm holds might fall or that the price of securities that comprise a short securities position of the firm might rise. Also, the risk of non-payment of principal and interest in debt issues must be considered.

There is also the risk associated with a position in a security that is large in relation to the total market for that security. In attempting to liquidate the position, the firm might experience a significant decline in the price of the security (or a significant increase if it is buying to cover a short position). Furthermore, the risk that a firm experiences when it holds a large position in one issue or a number of different issues of a single issuer relative to its capital must be taken into account. Risk stemming from other activities, such as foreign currency forward and interest rate swap transactions and other off-balance sheet transactions, also must be addressed.

In order to measure the potential market risk, one needs to gauge how much the price of a security might rise or fall in value. This requires a review of a number of factors. A supervisory authority should take into account the historical fluctuations in the market price of each type of issue. Other factors that might be taken into account include the nature of the issuer, the liquidity of the market for a security, and the ratings of recognised rating services which categorise debt securities as investment or non-investment grade.

The assessment of potential market risk should also take account of concentrated positions in one issue or in a number of issues of a single issuer as well as providing allowances which recognise the extent to which firms engage in the techniques which reduce the risks of other positions. The allowances provided should take into account and encourage firms to adopt risk reducing strategies. For example, some countries give consideration to offsetting long and short securities positions and hedged options and futures positions. Another country provides allowances for diversified equities portfolios.

All of the above factors, together with the supervisor's experience and judgement about the financial markets, should be considered by the supervisory authority in reaching its decision regarding the levels of capital necessary to accommodate a given level of position risk.

## **2. Settlement/Counterparty Risk**

The settlement risks faced by a firm depend in large part on the nature of the clearance and settlement systems in the various markets. In every system, firms will be exposed to the risk that their clients will renege on a transaction and also, in some systems, to the risk that other market participants will renege. Some systems remove a large part of the risk between market participants through, for example, the

simultaneous exchange of money and securities via book-entry transfer and/or the guarantee of settlement by the clearing house. However, if there is a clearing house guarantee, firms would still be collectively exposed where the risk of a member's default to the clearing house is, to some degree, shared by all clearing house members.

Another factor that varies from market to market is the extent to which settlement risks accumulate (ie., the build-up of delivery obligations resulting from the failure of a securities firm to deliver securities on an agreed settlement date to a counterparty). In some markets, contracts remain valid until settled, but settlement of outstanding contracts can be accelerated. A firm can buy-in<sup>5</sup> securities that another firm has failed to deliver by the settlement date in order to enable settlement to take place. On the other hand, in other markets, unilateral cancellation of a contract is permitted against the non-delivering firm after the settlement due date.

Clearly, requirements to cover settlement risks must reflect the nature of the risks in a particular market. Some of the risks that could be faced vis-a-vis clients or other market participants are as follows:

*a. Price Movements*

If a firm purchased securities and then sold them (with neither transaction having settled) and the price increased, it would be exposed to the risk that the original seller could default. Assume, for example, that securities firm A sells to securities firm B, who in turn sells to securities firm C. If the price of the security rises and firm A fails to deliver the security and

5. In a buy-in transaction, the firm failing to deliver has to pay the price difference. In practical terms, however, buy-ins will not work unless a market exists in which a particular security can be purchased at a fair price. For example, the market for a particular security may be so thin that a fair buy-in price cannot be established.

becomes insolvent, firm B must purchase the securities in the market at the higher price, without the ability to recover from insolvent firm A, because firm B is still liable to firm C. The risk in such a transaction, and indeed any transaction, is that a firm would have to meet the money difference between the contract price of a securities transaction and the subsequent market price if the counterparty did not settle. The price difference is measurable at any time.

*b. Unsecured Claims and Free Deliveries*

If a firm purchased securities from a counterparty and paid for the securities prior to the counterparty's delivery of the securities, it would have an unsecured claim. The firm would be exposed to the risk of loss if the counterparty failed to deliver the securities. Likewise, if the firm delivers securities and has not been paid, it would be exposed to risk of loss. The risk is clearly increased if the total unsecured claims or those with respect to one counterparty are large relative to a firm's capital.

*c. Funding Costs*

Even if the counterparty does not renege, the firm might incur additional funding or borrowing costs when delivery is delayed. A firm that bought and then sold securities could feel obliged because of business considerations to make delivery on the sale even though the firm from whom it purchased had not made delivery. To do so, the firm might have to purchase or borrow securities in the market a day or two before it makes delivery on the sale. The firm would have to absorb the funding costs for carrying those positions.

Timing differences in settlement create other funding costs and risks. For example, where a firm has paid a counterparty upon receipt of securities, the firm may be unable to settle with the client until the next day or the following day. The firm would have to fund the

transaction either by borrowing funds or using other funds in its possession. In either case, the firm will incur a cost either in terms of interest expense or the opportunity cost of uninvested funds. These costs, again depending on the system, can be large<sup>6</sup>.

Cross border exposures are also a very important consideration. A firm might have to settle in the market in country A today, but either stock or money might not be available in country B for two to three days. Major differences in settlement cycles increase the problems caused by cross border trading. A move towards standard settlement cycles would be a helpful development in reducing these types of risks.

The exposure attributable to settlement related problems can be identified. In systems where contracts remain unsettled over long periods, time can be used as a rough proxy for the likelihood of default (ie, the older outstanding contracts are likely to be at greater risk).

Effective requirements for settlement risks should be designed not only to address risk but also to encourage firms to settle promptly and to facilitate more efficient clearance and settlement systems. More efficient clearance and settlement systems would reduce the risks to the financial system as a whole.

#### *d. International Initiatives in the Area of Clearance and Settlement*

The Technical Committee notes the recent recommendations which the Group of Thirty<sup>7</sup> has made regarding the structure for clearance and settlement systems on a world-wide basis.

6. If there were doubts about a firm's capital and the funds were not made available by lenders, the firm could experience difficulty.

7. See Group of Thirty Report on Clearance and Settlement in the World's Securities Markets.



These proposals provide a blueprint for potential changes in clearing and settling securities transactions which could have a major effect in reducing settlement risks in the world's securities markets. In particular, settling trades on a continuous rolling basis (ie, settling trades on all business days of the week) and standardised and reduced periods for comparison and settlement would reduce settlement risks. The development of effective, automated book-entry, central securities depositories and the institution of delivery versus payment systems would also be a major step which would have a positive impact on risk exposure. Thus, the implementation of the Group of Thirty recommendations could reduce the amount of capital firms might otherwise be required to maintain to cover their exposure to settlement risks.

Furthermore, the International Federation of Stock Exchanges is expected to publish soon a study containing recommendations as to the ways in which cross border settlement procedures can be improved in order to reduce both the costs and the risks involved. This work is expected to be in a form which will be complementary to the Group of Thirty recommendations.

Finally, the Technical Committee of IOSCO will be considering suggested initiatives for improving clearance and settlement in the world's securities markets.

### **3. Other Risks**

Firms face a myriad of other risks in the securities business. One such risk is execution errors that result from misunderstandings or negligence. For example, errors may result from mis-interpretation (1) of instructions received from a client, (2) between the front office and the back office, or (3) in communicating instructions to third parties. Other common errors include the purchase or sale of an

incorrect amount of securities, a sale intended as a purchase (or vice versa), and delays in executing a client order. Some of the costs created are of an administrative nature, but there are also the costs of having to make good any transaction by buying or selling securities at the current market price and absorbing any loss incurred as a result of adverse price movements (ie, the price difference). The risk can be assessed by trying to examine the prevalence of these mistakes. This risk generally tends to increase in periods of heavy volume.

Other basic risks faced by securities firms are reduced revenues, increased expenses, increases in back office paperwork, and fraud. For example, an unexpected decrease in a firm's transaction volume may result in reduced income to the firm while expenses remain constant or increase. On the other hand, an unexpected growth in the firm's business may result in increased back office paperwork. This could strain a securities firm's capabilities causing recordkeeping and settlement problems. These are generally unmeasurable risks that need to be captured in a cushion of capital based on a firm's scale of activities.

## C. Approaches to Capital Adequacy

### 1. Liquidity and Solvency

A capital adequacy structure for securities firms should cover both securities and non-securities activities and should cover liquidity and solvency. Lack of liquidity can cause difficulties for a firm because it might not be able to meet its liabilities as they fall due. Furthermore, given the risks in the activities of securities firms, significant losses can occur quickly causing difficulties for a firm. Therefore, some regulatory structures provide that a firm at all times should be able to meet all liabilities including all claims by customers and counterparties.

The Technical Committee acknowledges the existence of two different methods of addressing

liquidity. In the larger markets, the standard, after the proposals recently announced by Japan, will be a net liquid assets test for securities firms. The objective of this test is that a firm should be able to wind down quickly its activities and repay all of its liabilities including the claims of other securities houses and customers. Under this requirement, which is a combined test of liquidity and solvency, a firm at all times must have liquid assets which exceed its total liabilities by a sufficient margin to cover the risks to the firm's net worth. Securities and commodities positions are marked to market daily which prevents the securities firm from storing up losses which could lead ultimately to its failure or bankruptcy<sup>8</sup>.

A key feature of the net liquid assets approach is that all intangible, non-marketable, and illiquid assets, such as goodwill and property, are deducted from capital<sup>9</sup>. Most unsecured receivables are treated as illiquid assets and, therefore, are also deducted from capital.

An alternative approach to the net liquid assets test is to treat liquidity as an additional risk faced by the firm. This has led some countries to set a ratio of liquid assets to short-term liabilities as part of a number of ratios linking the capital of the firm to the risks faced. For example, a firm could be required to hold liquid assets which exceeded the total of all liabilities with a maturity of less than one year. This would ensure that the firm had adequate day to day liquidity while it remained in business, but it would not provide that the firm could meet all claims by customers and market counterparties. Countries that use this approach have separate solvency requirements. These solvency requirements are designed to provide

8. If a firm incurs substantial losses, it might have to take action such as liquidating some positions or increasing its capital in order to remain in compliance with a net liquid assets test.

9. Some regulators make some allowance for property which secures a loan.

that a firm has sufficient capital to cover the risks to its net worth. It is also important in this approach that securities and commodities positions are marked to market daily so that losses are not stored up.

## **2. Risk-Based Requirements**

It is essential that firms have sufficient capital to cover fluctuating risks such as position and settlement risks<sup>10</sup> plus a cushion to cover risks that are not measurable<sup>11</sup>. One approach would be to require firms to have such a high capital base that this alone would provide adequate capital to cover these risks. This approach has the disadvantage that, in general, firms would have to hold capital substantially in excess of the risks that they were facing. Capital in excess of these risks would have to be held to provide that a firm had the necessary capital to allow for extreme positions which might be taken both in terms of the size of particular positions and the price volatility of the securities. Furthermore, unless there were strict limits on the size of positions taken, there would also be the danger that with a sudden change in market conditions a firm's capital base could be endangered.

In view of the disadvantages of the above approach, the Technical Committee strongly favours the adoption of risk-based requirements with a cushion of capital to cover unmeasurable risks. The advantage of a risk based approach is that it provides that firms hold a level of capital appropriate to the amount of risk. Thus, the capital requirements are neither too severe, which would increase costs for the firms and

10. Of course, the level of risk associated with the conduct of an investment business (such as position risk and settlement risk) can vary depending upon the nature of the securities market and related clearance and settlement systems. Securities regulators would, of course, take these differences into account in establishing the risk-based standards.

11. Different ways can be used to provide for this cushion. For example, one country ties the required cushion to a firm's volume of business measured by criteria such as customer receivables, total liabilities (other than subordinated liabilities), or position risk. Other countries tie it to a proportion of firm expenditures (eg. one quarter of a firm's annual expenditures).

affect their efficiency, nor too slack, which would enable firms to run excessive risks relative to their capital and leave the markets vulnerable to the failure of participants. By making allowance for techniques such as hedging, this method also has the benefit of encouraging firms to engage in risk reduction techniques which further help to reduce risk in the markets.

### **3. Minimum Requirements**

It is appropriate to require firms wishing to enter the industry to demonstrate a level of commitment by requiring them to meet certain minimum capital requirements. The Technical Committee's view is that these minimum requirements should not be uniform for all firms. Some countries believe that substantial minimum capital requirements are necessary to enhance confidence in the financial safety of the markets. However, since a principal effect of a minimum requirement is that it acts as a barrier to entry, too high a requirement could adversely effect competition in the marketplace. To address this concern, the Technical Committee believes that differential minimum capital requirements should be based on the type of business being conducted by the firm. In general, higher minimum capital requirements should be imposed on firms which hold customer funds and securities or engage in trading activities for the firm's account.

### **4. Definition of Capital**

The Technical Committee notes that different approaches to the definition of capital are used in different regulatory regimes. A number of the countries which currently have capital requirements which are closely tied to the risks associated with a securities firm's business allow firms to use both short-term and long-term subordinated loans<sup>12</sup> in addition to

12. Short-term and long-term subordinated loans are permitted as capital under certain conditions. Subordinated loans are subordinated to the claims of all present and future creditors, including customers.

owner's equity, as capital to cover these risks. Some of these countries also make some allowances for bank guarantees as a substitute for capital. This enables a firm to meet its fluctuating risks, and if a firm were to fail, the subordinated loans or funds called for under the guarantees would be used to meet the claims on the firm by customers or counterparties. Subordinated loans are permanent capital in the sense that repayment to the lender is not allowed if it would result in a firm's capital falling below a threshold set above its required capital. In all regulatory systems, though, the degree to which these forms of capital or substitutes for capital can be used is limited relative to owner's equity. Some systems, however, do not make allowances for subordinated loans or guarantees. The Technical Committee recognises that at present the definition of capital varies between systems to reflect their differing regulatory structures.

## V. RECORDKEEPING REQUIREMENTS

The areas of recordkeeping and reporting requirements raise the issues of accounting principles and practices as well as auditing standards. In that connection, the Technical Committee notes that some countries use trade date accounting, some use settlement date accounting, and others use a mixture of these approaches. Although trade date accounting more accurately reflects risk, one possible resolution would be to permit securities firms to account on a trade date or settlement date basis unless there is a material difference, in which event the firm must use trade date accounting. The Technical Committee will need to consider these issues.

Rules designed to establish capital adequacy standards are effective only to the extent that the securities firms' records are adequate, accurate, and current. Recordkeeping requirements should be designed to ensure that standardised categories of information are maintained by securities firms in their business records in a readily accessible format. This facilitates examination by supervisory authorities to assure that the securities firms are conducting their activities in compliance with the regulations and through which unlawful activities are detected.

Some of the records that should be required are records reflecting:

1. all purchases and sales of securities;
2. customer and firm account information;
3. all receipts and disbursements of cash and other debits and credits;
4. all receipts and deliveries of securities;
5. all assets, liabilities, income, expenses, and capital accounts;
6. location and ownership of customer and firm securities; and
7. trial balances and net capital computations.

## VI. REPORTING & EXAMINATION STRUCTURE

An effective capital adequacy structure should also include reporting requirements, which should be designed to provide supervisory authorities with information regarding the financial and operational health of securities firms and financial and operational problems being experienced by firms.

Securities firms should be required to file periodic reports with their supervisory authority so that the supervisory authority is aware of the firms' financial and operational condition. For example, monthly or more frequent reports could be required to be filed by a firm indicating its compliance with net capital requirements, profit or loss for the period, and firm positions. Detailed financial statements and capital adequacy computations should be filed on a reasonably frequent basis. The frequency and detail of the reports should depend on the type of business the firm conducts. Additionally, many countries require securities firms to obtain on an annual basis an audited financial report.

Securities firms should also be required to give supervisory authorities warning of financial or operational problems. For example, if a securities firm's capital falls below a "warning level" set by the supervisory authority, if it fails to have the required level of capital, or if it has books and records which are not current or accurate, prompt notice should be required to be given to a supervisory authority.

Finally, firms should be examined routinely and when possible problems exist by the supervisory authority for compliance with financial responsibility and recordkeeping requirements.



## Annex A Segregation of Client Money and Securities

This annex briefly describes the approaches used in some countries to protect client property in the custody or control of securities firms.

To protect customer securities, some countries require securities firms to have possession or control of all fully paid and excess margin securities<sup>13</sup> of customers. The customer securities are required to be free of all claims or liens. The securities firms are required to make a regular determination to ensure that they have possession or control of customer securities.

The approach taken with respect to cash is important. Firms should not be allowed to use customer funds to finance their own activities. A number of approaches can be used. One country requires customer cash balances to be deposited immediately in a special bank account that must be maintained for the exclusive benefit of customers. Another country permits the use of customer cash balances to finance customer credit transactions. This approach is designed to separate a firm's brokerage activities from its other activities and also to prevent customer cash balances from being used to finance firm trading and underwriting activities and to pay for furniture, fixtures, equipment, and ordinary expenses. This approach would require the securities firm to make a periodic computation (in accordance with a formula) to determine how much money it is holding which is either customer money or money obtained from use of customer securities ("credits"). From that amount, the securities firm subtracts the amount of money which it is owed by customers or by other securities firms relating to customer transactions ("debits"). If the credits exceed the debits, the securities firm is required to deposit the excess in a special bank account. If the debits exceed the credits, no deposit is necessary.

13. Excess margin securities are a portion of securities bought by customers on credit which are in excess of the amount of securities which the securities firm may pledge with a bank to finance the customer's credit purchase.

## Annex B Differences between the Approach of Banking Supervisors and Securities Regulators

This annex briefly examines the differences between the requirements which are needed for securities firms with the requirements which have traditionally been applied to banks.

### **Securities Regulators**

Securities firms generally take positions as short-term traders and have to be able to meet losses as they occur. This leads to an emphasis on

1. marking securities and commodities positions to market to reflect current value, thus including any losses incurred even though no transaction recognising that loss has taken place, and
2. position risk requirements which provide a margin of safety against potential losses which can be incurred as a result of market fluctuations.

The capital of securities firms must be adequate to deal with specific risks encountered (ie, position, settlement, and other basic risks). Securities firms holding large positions are more vulnerable to sudden market movements than diversified banks because a large portion of their net worth can be lost quickly. This has led securities regulators to place considerable emphasis on liquidity and to treat illiquid assets conservatively.

Because of the fluctuations in the risk-based requirements, the securities regulators in some countries have adopted a more flexible approach to allowable capital than is the case for the banking supervisors. For example, some countries' securities regulators allow short-term subordinated loans or bank guarantees to serve as a substitute for capital.

### **Banking Regulators**

The banking regulators take a much longer-term view of their firms. The assumption is that banks hold the majority of their assets to

maturity and, therefore, that credit risk is the important and predominant risk. This also means that those assets do not have to be marked to market. Banking regulators, who are interested in whether a firm can meet claims as they fall due on a long-term basis, look at the maturity mismatch of a bank's book and perhaps require a proportion of a bank's assets be in liquid form.

With respect to securities positions, bank regulators generally focus on the credit risk in the relevant securities. In addition, some bank regulators impose limitations on securities positions in relation to owner's equity. Bank regulators currently are exploring a risk-based capital approach for banks' securities positions.

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Working Group No. 3  
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