BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 29, 1970

To Chairman Burns

Subject: Composition of "capital" of brokerage firms.

From John D. Stoffels

Brokerage firm capital consists largely of initial contributions and reinvested earnings. In addition to this standard capital component, however, there are two specialized forms of capital.

-- Subordinated accounts: A customer or partner agrees to subordinate the equity in his personal account with the firm to the creditors of the firm. The customer or partner is free to trade in the account, but is restricted from withdrawing cash or securities as long as the agreement continues in force.

-- Secured demand notes contributed as capital: The brokerage firm holds an IOU from a third party for a given amount of money, callable on demand. The note is secured with stock of a comparable value, which the broker holds in his vault. If the broker calls the note and the party can't or won't come forward with cash, the broker may sell the security collateral to raise the cash. (A number of problems arose with this type of "capital" during 1969 and 1970, when notes were called, payment was not forthcoming, and the market value of securities collateralizing the notes had dropped sharply below the face amount of the note. In many cases stocks of questionable value--even unregistered letter stock--were held as demand note collateral.)

Superimposed on the capital accounts of the firm are certain restrictions on the valuation of firm assets used in arriving at total capital. Generally, the firm must discount the market value of its own investments in stock and may not include the value of assets of uncertain liquidity.

For many years, NYSE member firms have been exempted from the SEC's capital rules on the basis that the NYSE's own rules were at least as stringent. A recent investigation of the capital rules of the exchange by the SEC brought to light the fact that, especially during 1969, the exchange made a number of changes in its requirements which, in effect, caused their rules to become less stringent than those of the SEC. The SEC report (confidential) indicates that the exchange justified its loosening interpretations on the basis that tighter interpretations would have caused many firms to be in violation of the rules during 1969. The SEC report points out that these less stringent requirements not only disguised capital deficiencies during 1969 and 1970, but very likely established a climate that permitted capital problems in the industry to become even more acute than otherwise would have been the case.

Since the SEC's study of capital surveillance, the Commission has urged the exchange to tighten its rules, and some progress has already been made in this direction. The exchange now proposes to increase the discounts that must be applied to firm investments in securities and will in future presumably apply the "liquidity principle" more strictly in determining the eligibility of assets to be counted for capital. In addition, new guidelines with respect to subordinated and other capital contributions require that these must be left "at the risk of the business" for a period no less than one year.