

approximately 400 broker-dealers subject to the rule that carry a total of approximately 103 million public customer accounts.⁴

When we adopted Rule 17a-5(c) on June 30, 1972,⁵ our goal was for broker-dealers to "directly" send a customer essential information so that a customer could "judge whether his broker or dealer is financially sound."⁶ We adopted the Rule in response to the failures of many broker-dealers holding customer funds and securities in the period between 1968 and 1971. When first adopted, Rule 17a-5(c) required a broker-dealer to send its balance sheet to its customers five times a year. We later reduced this to two times a year.⁷

In a letter of February 26, 2001, the staff of the Commission's Division of Market Regulation ("Division") provided no-action relief to allow a broker-dealer to send its balance sheet with its next mailing of quarterly customer account statements after the expiration of the time limits prescribed by Rule 17a-5(c), provided that the broker-dealer also sent certain updated

into cash) in excess of liabilities to promptly satisfy the firm's liabilities, including those to customers. A broker-dealer that fails to meet the minimum net capital requirements must cease conducting a securities business.

⁴ These numbers are based on reports broker-dealers are required to file with the Commission on Form X-17a-5, "Financial and Operational Combined Uniform Single Report" (commonly referred to as FOCUS Reports).

⁵ We adopted Rule 17a-5(c) pursuant to Exchange Act sections 17(a), 10(b), 15(c)(1), (2) and (3), and 23(a). In 1975, Congress passed the Securities Acts Amendments, Pub. L. No. 94-29, 89 Stat. 97, which gave the Commission explicit authority, pursuant to Exchange Act section 17(e), over the accounting practices of broker-dealers. Section 17(e) provides:

(1)(A) Every registered broker or dealer shall annually file with the Commission a balance sheet and income statement certified by a registered public accounting firm, prepared on a calendar or fiscal year basis, and such other financial statements (which shall, as the Commission specifies, be certified) and information concerning its financial condition as the Commission, by rule may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(B) Every registered broker and dealer shall annually send to its customers its certified balance sheet and such other financial statements and information concerning its financial condition as the Commission, by rule, may prescribe pursuant to subsection (a) of this section.

(C) The Commission, by rule or order, may conditionally or unconditionally exempt any registered broker or dealer, or class of such brokers or dealers, from any provision of this paragraph if the Commission determines that such exemption is consistent with the public interest and the protection of investors.

(2) The Commission, by rule, as it deems necessary or appropriate in the public interest or for the protection of investors, may prescribe the form and content of financial statements filed pursuant to this title and the accounting principles and accounting standards used in their preparation.

⁶ Exchange Act Release No. 9658 (June 30, 1972).

⁷ Exchange Act Release No. 11187 (Jan. 17, 1975).

net capital information.⁸ Further, the Commission has provided that, with the consent of the customer, a broker-dealer may send its balance sheet electronically.⁹

II. Pilot Program Granting Exemptive Relief

In July 1998, the Securities Industry Association ("SIA")¹⁰ requested additional relief on behalf of broker-dealers due to the cost of sending a full balance sheet to each customer.¹¹ Full balance sheets for large broker-dealers may be six or more pages long, primarily due to the footnote disclosures required by GAAP.

In response to the request for relief, we issued a conditional exemptive order establishing a two-year pilot program ending December 31, 2001 that permitted a broker-dealer that elected to take advantage of the exemption to send only a "financial disclosure statement" to its customers containing summary information regarding its net capital when it otherwise would have had to send its customers its full balance sheet, as long as it also provided customers with a toll-free number to call for a free copy of its full balance sheet and made its full balance sheet available to customers on its Internet Web site.¹² The exemptive order required that the financial disclosure statement include certain of the broker-dealer's net capital information as of the balance sheet date and information on how to obtain the broker-dealer's full balance sheet, at no cost to customers, by accessing the broker-dealer's Internet Web site or by calling a toll-free telephone number to promptly obtain the customer's choice of either a paper copy or an electronic copy. The no-action relief allowing a broker-dealer to send its financial information with its next mailing of quarterly customer account statements after the expiration of the Rule 17a-5(c) time limits as long as it also sent certain updated net capital information also applied to broker-dealers taking advantage of the exemption. These broker-dealers would therefore send customers net capital information as of the balance sheet date, as required by the exemptive order, and updated net

capital information, as required by the no-action relief.

A broker-dealer taking advantage of the exemption and the no-action relief could send its financial disclosure statement with the updated net capital information to its customers and publish its balance sheet on its Web site at the time of its next mailing of quarterly customer account statements after the expiration of the Rule 17a-5(c) time limits. For example, a broker-dealer with a fiscal year end of November 30 is required by Rule 17a-5(c) to send an audited balance sheet to customers by March 15 (105 days after November 30). The broker-dealer would use a calendar year for its mailings of quarterly customer account statements. If the broker-dealer sends its first quarterly customer account statements at the beginning of April, the no-action relief allows it to send its audited balance sheet with certain updated net capital information to its customers with those first quarterly account statements. If the broker-dealer takes advantage of the exemption and the no-action relief, it could send its financial disclosure statement and updated net capital information to its customers with the first quarterly account statements at the beginning of April and publish its November 30 audited balance sheet on its Web site at the same time.

The pilot program was designed to reduce the cost to broker-dealers of complying with Rule 17a-5(c) while making it as easy as possible for customers to get the information they need to evaluate the financial soundness of a broker-dealer that may be holding their cash and securities. Participation in the pilot program was voluntary, and broker-dealers that participated in the pilot program were the firms that were likely to benefit most from taking advantage of the exemption.

In December 2001, we extended the pilot program for one year, until December 31, 2002.¹³ As of July 2002, 29 broker-dealers holding a total of about 40 million customer accounts participated in the pilot program. In November 2002, we extended the pilot program to June 30, 2003.¹⁴ As of June 2003, 3 additional broker-dealers holding a total of approximately 300,000 customer accounts were taking advantage of the exemption.

⁸ Letter of February 26, 2001 from Michael Macchiaroli, Associate Director, to Cheryl M. Kallem, Chairperson, Securities Industry Association (2001 SEC No-Act. LEXIS 523).

⁹ Exchange Act Release No. 37182 (May 15, 1996).

¹⁰ The 600 member firms of the SIA include investment banks, broker-dealers, and mutual fund companies.

¹¹ Letter of July 17, 1998 from Mark Holloway, Chairman, SIA Capital Committee to Michael A. Macchiaroli, Associate Director.

¹² Exchange Act Release No. 42222 (Dec. 10, 1999).

¹³ Exchange Act Release No. 45179 (Dec. 20, 2001), 66 FR 67341 (Dec. 28, 2001).

¹⁴ Exchange Act Release No. 46921 (Nov. 26, 2002), 67 FR 72005 (Dec. 3, 2002).