

Financial Services Newsletter

Broker-Dealers with Operating Leases: SEC No-Action Relief

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In anticipation of Accounting Standards Update (ASU) No. 2016-02, **Leases** (Topic 842) becoming effective, now is a good time to discuss the potential impact of this new guidance from the Financial Accounting Standards Board (FASB) on accounting for operating leases for broker-dealers. For public entities, the effective date is for fiscal years after December 15, 2018 and, for all other entities, for fiscal years after December 15, 2019.

Under the new standard, lessees with operating leases that have a term greater than 12 months would be required to recognize these leases on their statement of financial condition. The lease liability is to be measured at the present value of the lease payments with a related “right-of-use asset.”

Broker-Dealers: Net Capital Computations

Under the new standard, broker-dealers with operating leases greater than 12 months would likely have a significant effect on their net capital computations. Under Rule 15c3-1 of the Securities and Exchange Act of 1934 (SEA), the “right-of-use asset” would be a non-allowable asset for net capital purposes. In addition, the related liability would contribute to aggregate indebtedness. Further, the new standard would also have a negative effect on the aggregate indebtedness to net capital ratio.

Depending on the circumstances, capital contributions may be needed prior to the ASU effective date in order for broker-dealers to avoid the risk of a potential net capital deficiency.

Impact on Broker-Dealers

In a letter dated May 31, 2016, the Securities Industry and Financial Markets Association (SIFMA) expressed its concerns to the Division of Trading and Markets (the Division) of the Securities and Exchange Commission (SEC) with respect to the new ASU. The SIFMA pointed out what they, and others in the broker-dealer sector, considered unintended consequences for broker-dealers computing net capital pursuant to SEA Rule 15c3-1 after implementation of the new lease guidance.

Specifically, the SIFMA requested that the SEC’s staff issue an interpretation stating that the “right-of-use asset” arising from such leases be considered an allowable asset for net capital purposes to the extent of the amount of the corresponding lease liability.

In addition, the SIFMA pointed out the results of its preliminary survey of 22 broker-dealers with diverse business models where they assessed the impact of the ASU on regulatory capital. The initial results showed an estimated impact on collective regulatory capital of \$9.8 billion with a disproportionate impact on regional, smaller and introducing broker-dealers as well as those with multiple retail locations.

SEC’s Response

The Division issued a no-action letter dated November 8, 2016, addressing the SIFMA’s concerns on the lease ASU’s impact on broker-dealers. The Division has withdrawn this letter and has issued a new letter, dated October 23, 2018 in its place.

Net-Capital Computations under SEA Rule 15c3-1

Specifically, the no-action letter stated that the Division would not recommend enforcement action if a broker-dealer computing net capital adds back an operating lease asset to the extent of the associated operating lease liability.

The new letter removed the provision that if the value of the operating lease liability exceeds the value of the associated operating lease asset, the amount by which the liability's value exceeds the associated lease asset must be deducted for net capital purposes, as such excess would already be included in aggregate indebtedness.

The SEC stated that a broker-dealer cannot add back an operating lease asset to offset an operating lease liability unless the asset and the liability arise from the same operating lease; nor can a broker-dealer add back combined or aggregated operating lease assets to offset combined or aggregated operating lease liabilities.

Aggregate Indebtedness Calculation and Ratio

As it relates to the aggregate indebtedness calculation and ratio, the SEC no-action letter stated that the Division would not recommend enforcement action if a broker-dealer determining its minimum net capital requirement using the AI standard does not include in its aggregate indebtedness an operating lease liability to the extent of the associated operating lease asset.

If the value of the operating lease liability exceeds the associated operating lease asset, the amount by which the lease liability exceeds the lease asset must be included in the broker-dealer's aggregate indebtedness.

A broker-dealer cannot add back an operating lease asset to offset an operating lease liability unless the asset and the liability arise from the same operating lease; nor can a broker-dealer add back combined or aggregated operating lease assets to offset combined or aggregated operating lease liabilities.

Recommendation

Broker-dealers with operating leases greater than 12 months — particularly introducing broker-dealers and those with multiple locations — should carefully review and assess with their financial and operations principals and/or other professionals their operating leases and how the new lease ASU will impact their computations of net capital and aggregate indebtedness. Certainly, the SEC no-action letter will provide broker-dealers with relief from the unintended consequences that the new lease standard would have on their regulatory capital computations. For a copy of the No-Action letter, please [click here](#).

Contact Us

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