

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 05-66

June 3, 2005

ABN AMRO INCORPORATED
MEMBER ORGANIZATION

* * *

Failed to apply Net Capital charges on aged, internally unpaired debit items in its fixed income clearance accounts; improperly computed its Customer Reserve Formula, by failing to include aged, internally unpaired credit items relating to its fixed income clearance accounts, improperly coding one or more accounts as “non-customers,” and using an inconsistent methodology to determine the amount of stock borrows/loans to be included; failed to create and maintain accurate books and records relating to its fixed income clearance accounts and stock record; funded its Customer Reserve Bank Account from the Firm’s operating account, which was overdrawn; failed to comply with NYSE interpretation Memo 99-6 Reserve Formula Chart for Proprietary Accounts of Introducing Brokers and Dealers (“PAIB”) by improperly including fails to deliver versus the box and fails to deliver versus fails to receive in its PAIB Reserve Formula computation; created a deficit by improperly delivering fully paid securities out of a control location; miscoded Repos/Reverse Repos on its FOCUS Report; and failed to provide for, establish, and maintain adequate procedures and controls, including a system of follow-up and review of certain of its business activities in order to prevent the foregoing violations and ensure compliance with Exchange Rules and federal securities laws relating to its financial and operations areas. – Consent to censure and fine of \$200,000.

Appearances:

For the Division of Enforcement
Matthew L. Moore, Esq.
Ellen McCarthy, Esq.

For Respondent
John Paul Ketels, Esq.
Steven F. Gatti, Esq.

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A Hearing Panel of the New York Stock Exchange, Inc. (“Exchange”) met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange’s Division of Enforcement (“Enforcement”) and ABN AMRO Incorporated (“Respondent”), an Exchange member organization. Without admitting or denying guilt, Respondent consented to a finding by the Hearing Panel that it violated:

- I. Section 15(c) of the SEA and Rule 15c3-1 thereunder, by failing, on multiple occasions, to apply Net Capital charges on aged, internally unpaired debit items in its fixed income clearance accounts;

- II. Section 15(c) of the SEA and Rule 15c3-3 thereunder, by improperly computing its Customer Reserve Formula, in that, among other things, it failed to include aged, internally unpaired credit items relating to its fixed income clearance accounts, improperly coded one or more accounts as “non-customers,” and used an inconsistent methodology to determine the amount of stock borrows/loans to be included;
- III. Section 17(a) of the SEA and Rules 17a-3 and 17a-4 thereunder, and Exchange Rule 440, by failing to create and maintain accurate books and records relating to its fixed income clearance accounts and stock record;
- IV. Section 15(c) of the SEA and Rule 15c3-3(e)(1)/06 thereunder, by funding its Customer Reserve Bank Account from Respondent’s operating account, which was overdrawn;
- V. Exchange Rule 401 in that Respondent failed to comply with NYSE interpretation Memo 99-6 Reserve Formula Chart for Proprietary Accounts of Introducing Brokers and Dealers (“PAIB”) by improperly including fails to deliver versus the box and fails to deliver versus fails to receive, in its PAIB Reserve Formula computation;
- VI. Section 15(c) of the SEA and Rule 15c3-3(b)(2) thereunder, by creating a deficit by improperly delivering fully paid securities out of a control location;
- VII. Section 17(a) of the SEA and Rule 17a-5 thereunder, by miscoding Repos/Reverse Repos on its FOCUS Report; and
- VIII. Exchange Rule 342, in that Respondent failed to provide for, establish, and maintain adequate procedures and controls, including a system of follow-up and review of certain of its business activities in order to prevent the foregoing violations and ensure compliance with Exchange Rules and federal securities laws relating to its financial and operations areas.

For the sole purpose of settling this disciplinary proceeding, Enforcement and Respondent stipulate to certain facts, the substance of which follows:

Background and Jurisdiction

1. Respondent is an Exchange member organization and a wholly-owned subsidiary of ABN AMRO Holding N.V., which is listed on the Exchange under the symbol “ABN.” Respondent, through its predecessor entities, has been an Exchange member organization since 1965. Respondent is the successor firm to ABN AMRO Securities (USA) Inc. and The Chicago Corporation, both former Exchange member organizations, after the merger of those entities in January 1997. Respondent’s business lines include international equities, the trading of American Depository Receipts (“ADRs”), corporate bond trading, futures trading, underwriting, and securities lending.

2. On February 15, 2002, the Exchange's Division of Member Firm Regulation ("MFR") issued a "Report on the Examination of the Firm" which contained findings of violations of the federal securities laws and Exchange rules in connection with MFR's examination of Respondent in the Fall of 2001 (the "2001 Examination Report"). MFR referred the 2001 Examination report to Enforcement, which opened a formal investigation of Respondent on April 3, 2002.
3. By letter dated April 25, 2002, Enforcement notified Respondent that it was formally investigating the findings of violations contained in the 2001 Examination Report.
4. Thereafter, MFR issued a "Report on the Examination of Respondent," dated February 11, 2003 in connection with MFR's examination of Respondent in the Fall of 2002 (the "2002 Examination Report"). The 2002 Examination Report was also referred to Enforcement and subsequently combined into Enforcement's formal investigation of Respondent.

Summary of Violative Conduct

5. As set forth below, in connection with the 2001 Examination Report, Respondent: failed, on multiple occasions during the period from approximately May 2001 to approximately November 2001, to apply Net Capital charges on aged, internally unpaired debit items in its fixed income clearance accounts; improperly computed its Customer Reserve Formula, in that, among other things, it failed to include aged internally unpaired credit items relating to its fixed income clearance accounts; funded its Customer Reserve Bank Account from Respondent's operating account, which was overdrawn; improperly included fails to deliver versus the box and fails to deliver versus fails to receive, in its PAIB Reserve Formula computation; and, in one instance, created a deficit by improperly delivering fully paid securities out of a control location. In addition, Respondent failed to provide appropriate supervision to prevent the foregoing violations.
6. As set forth below, in connection with the 2002 Examination Report, Respondent in computing its Customer Reserve Formula, among other things, improperly coded one or more accounts as "non-customers," and used an inconsistent methodology to determine the amount of stock borrows/loans to be included; failed to maintain an accurate stock record; and miscoded Repos/Reverse Repos on its FOCUS Report. In addition, Respondent failed to provide appropriate supervision to prevent the foregoing violations.

The 2001 Examination Report

The Firm's Fixed Income Clearance Accounts

Net Capital

7. A review of Respondent's fixed income clearance accounts with the Bank of New York ("BONY"), Government Securities Clearing Corporation ("GSCC"), Depository Trust

Company (“DTC”), and Centrale de Livraison de Valeurs Mobilières (“CEDEL”) as of August 31, 2001, disclosed a large number of internally unreconciled debit and credit items in the accounts. These clearance accounts were used by Respondent to clear and settle fixed income-related transactions for its proprietary accounts and for the accounts of customers and other broker dealers. A review of the fixed income clearance general ledger accounts from May through August 2001 specifically disclosed aggregate, aged internally unpaired debit and credit balances, which Respondent mistakenly netted for Net Capital computation purposes, as follows:

- As of May 31, 2001, Respondent had approximately \$1.5 and \$1.49 billion in internally unpaired debit and credit balances, respectively.
 - As of June 29, 2001, Respondent had approximately \$1.1 and \$1.2 billion in internally unpaired debit and credit balances, respectively.
 - As of July 31, 2001, Respondent had approximately \$2.6 and \$2.4 billion in internally unpaired debit and credit balances, respectively.
 - As of August 31, 2001, Respondent had 2,100 internally unpaired differences and aggregate debits and credits of approximately \$6.33 and \$6.35 billion, respectively. As of August 31, 2001, approximately \$2.44 billion of these debit items and \$2.37 billion of these credit items were aged greater than seven business days.
8. By September 2001, Respondent had a significant level of internally unpaired differences, which were further aggravated by unforeseen events of September 11, 2001, when BONY experienced considerable operational problems that further impacted Respondent’s daily fixed income clearing operations and the accuracy of settlement activity. After September 11, 2001, the aggregate number of internally unpaired differences in the general ledger clearance accounts further increased. As of September 28, 2001, there were approximately \$46.3 billion and \$43.7 billion, respectively, in aged, internally unpaired aggregate debits and credits in those accounts. During October 2001, the internally unpaired balances in these accounts continued to increase significantly and, as of October 31, 2001, there were approximately 7,360 aged, internally unpaired differences in the accounts, which totaled approximately \$77 billion in debits and \$77.2 billion in credits.
9. Respondent sent notifications of the above deficiencies to the Securities and Exchange Commission (“SEC”), the Exchange, and other regulatory agencies on December 10, 2001 and December 18, 2001, pursuant to the Securities Exchange Act of 1934 (“SEA”) and Rule 17a-11, thereunder. Respondent had not disclosed the aged, internally unpaired differences that existed during May through August 2001 on Financial and Operational Combined Uniform Single Reports (“FOCUS Reports”) filed with the Exchange relating to those time periods. Thereafter, Respondent did not fully disclose the significant increase in internally unpaired differences that occurred after the events of September 11, 2001.

10. SEA Rule 15c3-1, known as the “Net Capital Rule,” requires every broker-dealer to maintain, at all times, a specified minimum level of liquid assets, or net capital, sufficient to permit it to liquidate in an orderly fashion if the net capital requirement is not met.
11. Respondent failed to apply net capital charges for the aged, internally unpaired differences, as required by the Net Capital Rule. Application of net capital charges for such aged, internally unpaired differences as well as for short securities differences in Respondent’s fixed income clearance accounts for the week of August 31, 2001, resulted in adjustments to Respondent’s Unconsolidated Excess Net Capital totaling approximately \$105,664,951 and caused a net capital deficiency of approximately \$27,332,158. Such adjustments further caused a reduction of Respondent’s Consolidated Excess Net Capital, from \$406,662,862 to \$288,240,187. The largest of the adjustments (\$82,863,889) resulted from aged, internally unpaired debit items balances in Respondent’s fixed income clearance accounts.
12. Due to the large number and dollar amounts of the aged, internally unpaired differences in Respondent’s fixed income clearance accounts, other net capital deficiencies may have existed during months immediately prior and subsequent to August 31, 2001.
13. To ensure future net capital compliance while the internally unpaired differences were researched and resolved, Respondent, at the Exchange’s direction, infused additional capital of \$500 million and \$280 million on November 20, 2001, and December 10, 2001, respectively.

Customer Reserve Formula

25. Section 15(c) of the SEA and Rule 15c3-3 thereunder, Exhibit A, sets forth the “Formula for Determination of Reserve Requirement for Brokers and Dealers.”
26. Respondent failed to include aged credit items that were not internally paired-off against related debit items in its Customer Reserve Formula computations. It mistakenly netted such items for computation purposes. Respondent failed to properly compute its Reserve Formula for the week of August 31, 2001, resulting in a hindsight deficiency of \$2,199,061,507. The largest adjustment (\$2,371,609,000) resulted from Respondent’s failure to include aged, internally unpaired credits in its fixed income clearance accounts. Similar adjustments contributed to hindsight deficiencies during the period of September 1, 2001 through November 16, 2001, and the interim periods May 31 and August 31, 2001.
27. In addition, MFR calculated hindsight deficiencies of \$1,461,286,497, \$1,155,702,753, and \$2,341,815,523 for the weeks ending on May 31, June 29, and July 31, 2001 respectively. Respondent sent the required SEA Rule 17a-11 notice of these deficiencies to the SEC and the Exchange on December 10, 2001.

Books and Records

28. Exchange Rule 440, and Section 17(a) of the SEA and Rules 17a-3 and 17a-4 thereunder require, in pertinent part, all member organizations to make and keep current records accurately reflecting all assets and liabilities, income and expenses and capital accounts.
29. As described above, Respondent failed to timely identify and resolve the money and other internally unpaired differences in its fixed income clearance accounts and as a result, failed to create and maintain current and accurate books and records.

Other Violations

Reserve Deposit Made From Overdrawn Account

30. SEA Rule 15c3-3(e)(1)/06 states in relevant part:

Checks deposited or funds wired to a Reserve Bank Account that create overdrafts or increase existing overdrafts in other bank accounts do not qualify as bona fide deposits. Consequently, a broker-dealer cannot meet its deposit requirements by utilizing such overdrawn funds. In order for a deposit to be considered bona-fide, the bank account from which the funds were wired must have had funds on deposit per the books of the broker-dealer in excess of the wired amount at the time the wire was sent. SEA Rule 15c3-3, NYSE Interpretation Handbook at page 545

31. Respondent used its operating account to fund its Reserve Account pursuant to the August 17 and 24, 2001, Customer Reserve Formula computations. However, the operating account was overdrawn when the funds were wired, thus rendering the transfers invalid and resulting in hindsight deficiencies on those dates. Respondent sent the required SEA Rule 17a-11 notice of these deficiencies to the SEC, the Exchange, and other regulatory agencies on October 24, 2001.

PAIB Reserve Formula Computation

32. In addition to regular customer accounts held by a clearing broker on behalf of an introducing broker, an introducing broker may maintain a proprietary trading account or a Proprietary Account of an Introducing Broker (“PAIB”), with the clearing broker. The SEC permits an introducing broker to include PAIB assets in its net capital computation under SEA Rule 15c3-1 only if the introducing broker and the clearing broker enter into a “PAIB Agreement.” SEC No Action Letter Re: Proprietary Accounts of Introducing Brokers and Dealers, 1998 SEC No-Act. LEXIS 1059 (Nov. 10, 1998) (requirements effective on June 1, 1999) [hereinafter, SEC No Action Letter]; Net Capital Requirements on Introducing Brokers’ Proprietary Accounts Assets Held by Clearing Brokers, NYSE Interp. Memo 98-10 (Dec. 10, 1998).

33. Under the PAIB Agreement, a clearing broker must compute the PAIB assets (“PAIB Reserve Formula Computation”) for all of its introducing brokers, in accordance with SEA Rule 15c3-3, with certain modifications. Reserve Formula Allocation Chart for PAIB, NYSE Interp. Memo 99-6 (May 27, 1999). In addition, the clearing broker must establish and maintain a separate PAIB “Special Reserve Account for the Exclusive Benefit of Customers” (“PAIB Reserve Account”) and maintain a balance in that account equal to the amount by which total credits exceeds total debits, as computed under the PAIB Reserve Formula. Respondent, as a clearing broker, maintained a PAIB Reserve Account as required by the SEC No Action Letter, cited *supra*.
34. Respondent improperly computed its PAIB Reserve Formula for the week of August 31, 2001. The adjustments determined by MFR reduced Respondent’s excess debits by \$14,346,910, from \$26,018,414 to \$11,671,504, and resulted from fails to deliver versus the box and fails to deliver versus fails to receive, which were improperly included.

Physical Possession or Control of Securities

35. Pursuant to SEA Rule 15c3-3(b)(2), broker-dealers must take timely steps in good faith to establish prompt physical possession or control of all fully-paid and excess margin securities carried for the accounts of customers.
36. A review of three securities in deficit as of September 24, 2001, disclosed that, in one instance, Respondent created a deficit by delivering fully-paid securities out of a control location. The deficit was created when Respondent overrode segregation instructions issued to DTC to effect a free delivery.

The 2002 Examination Report

Customer Reserve Formula

37. MFR determined that Respondent improperly computed its Customer Reserve Formula for the week of September 30, 2002, which resulted in an understatement of the Reserve Formula deposit requirement in the amount of \$77,586,274. The adjustments are set forth below.

Misclassification of Accounts

38. After reviewing a sample of accounts on Respondent’s ADP system, MFR determined that eight accounts were improperly coded as “non-customers.” The largest two of the accounts were non-proprietary accounts of Respondent’s affiliated broker-dealers and had credit balances totaling \$36,012,528 that were excluded from the Customer Reserve Formula. Also, two accounts with credits totaling \$506,680, classified as “non-customers” were actually prime brokerage accounts and should not have been excluded from the Customer Reserve Formula. In addition, two PAIB accounts were

erroneously classified as customer accounts, and as a result, customer credits were understated by \$38,197,321 and customer debits were overstated by \$224,667.

39. After a review of accounts on Respondent's "ICI" system, MFR determined that Respondent's classification of accounts as "customer," under Rule 15c3-3, was inconsistent with Respondent's coding of such accounts in the system. A review of 11 accounts classified as "customer" for Reserve Formula purposes disclosed that five were coded as broker-dealer accounts in the ICI system. Also, seven of the 11 accounts classified as customer accounts were accounts of broker-dealers. As a result, customer debits and credits were overstated by \$5,398,854 and \$30,388 respectively.

Stock Borrow/Loans

40. Respondent was inconsistent in its methodology for determining the amount of stock borrows/loans to be included in the Customer Reserve Formula. Respondent used the market value of "Stock Loan vs. Customer Long" per its ADP allocation as a credit in the formula. However, Respondent included the contract value of securities borrows in three general ledger accounts used for customer-related borrows as its "Stock Borrow vs. Customer Short" equivalent in the Reserve Formula. The adjustment of "Stock Loan vs. Customer Long" to contract value resulted in a decrease in customer credits by \$122,911.
41. A review of the Securities Borrowed in three accounts used for customer-related borrows disclosed that those accounts included certain non-customer related items (e.g., stock borrows vs. the box and non-purpose borrows) and, as a result, were not representative of the contract value of "Stock Borrowed vs. Customer Short." Respondent failed to adjust the Stock Borrows in the Reserve Formula by these non-customer-related items. As a result, the amount of "Stock Borrow vs. Customer Short" included in the computation was overstated by \$175,529,860.

Other Items

42. A review of Respondent's ADP Allocation disclosed that Respondent failed to exclude "PAIB Long vs. Customer Short" in the amount of \$5,011,683 and "Non-Customer Long vs. Customer Short" in the amount of \$132,055,800. As a result, Respondent overstated total credits by \$137,067,483.
43. A review of three securities borrowed that allocated versus the box and were included in the Reserve Formula disclosed that, in one security, Respondent reflected 5,900,000 shares borrowed versus the box for less than one day. However, only 5,000,000 shares were actually in the box for less than one day. As a result, Respondent overstated debits by \$841,500.
44. Respondent failed to include rebates payable to customers in the amount of \$50,243 as credits in the Reserve Formula. In addition, Respondent failed to include \$24,457

of outstanding checks payable to customers of correspondents (where Respondent extends check-writing privileges) as a credit in the Reserve Formula.

Books and Records

45. A Review of Respondent's ICI stock record as of September 30, 2002, disclosed aged stock record breaks with DTC and Centrale de Livraison de Valeurs Mobilieres ("CEDEL") in 57 securities. Although Respondent identified these differences, it had not adjusted its ICI stock record to reflect the securities in their actual location and eliminate the breaks.

FOCUS Report

46. Section 17(a) of the SEA and Rule 17a-5 thereunder requires periodic filings with the Exchange of a FOCUS Report.
47. MFR's review disclosed that \$827,656,000 of Reverse Repos were miscoded as Securities Borrows, \$246,829,000 of Securities Borrows were miscoded as Reverse Repos, \$33,015,000 of Securities Loaned were miscoded as Repos, and \$6,540,000 of Repos were miscoded as Securities Loans on Respondent's systems. This resulted in a \$580,827,000 overstatement of Securities Borrows and understatement of Reverse Repos, and a \$26,475,000 overstatement of Repos and understatement of Securities Loans on Respondent's FOCUS Report.

Supervision

48. Exchange Rule 342 requires member organizations to provide for, establish, and maintain adequate supervisory procedures and controls, including a system of follow-up and review of business activities, in order to ensure compliance with Exchange Rules and the federal securities laws.
49. Respondent did not have adequate supervisory systems in place to detect and prevent all the violations set forth above, including the unpaired debit and credit items, customer reserve hindsight deficiencies, and books and records violations.

Other Factors Considered

50. The increase in the number of aged, internally unpaired credit and debit items during the period from approximately May 2001 to approximately November 2001 was impacted, in part, by the move of Respondent's fixed income operations from Chicago to New York during the Summer of 2001, and was made worse by the industry-wide systemic failures in clearing facilities as a result of the events of September 11, 2001.
51. The internally unpaired items related to fixed income-related transactions were fully resolved and settled with Respondent's counter-parties. As a result, none of the

deficiencies cited herein resulted in any loss or financial harm to Respondent customers.

52. Respondent has taken certain remedial steps following the 2001 and 2002 Examination Reports, including, but not limited to:
- (a) adopting MFR's interpretation of the aged, internally unpaired debit and credit balances, and including them in the applicable calculations on a gross basis;
 - (b) committing significant internal resources to research and pair-off the remaining internal reconciliation differences;
 - (c) infusing significant additional capital to ensure full compliance with applicable rules, and filing the appropriate hindsight notifications;
 - (d) engaging an outside consultant to provide an independent evaluation of Respondent's fixed income operations, and making a number of organizational and operational changes designed to enhance Respondent's fixed income operations and compliance with the Exchange Rules and federal securities laws set forth above; and
 - (e) significantly reducing the size of its correspondent fixed income business.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found Respondent guilty as set forth above by unanimous vote.

PENALTY

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Respondent of a censure and a fine of \$200,000.

For the Hearing Panel

Peggy Kuo – Chief Hearing Officer
Panelists:
Paul W. Brandow
William J. Burke, III