NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
1735 K STREET NORTHWEST · WASHINGTON, D.C. 20006 · (202) 833-7200

February 8, 1982

TO: Members of the National Association of Securities Dealers, Inc.

RE: Guidelines Regarding Communications With The Public About Investment Companies and Variable Contracts

Background

Attached are "Guidelines Regarding Communications With The Public About Investment Companies and Variable Contracts." The guidelines are primarily to assist members in complying with the Association's general rules governing the content of public communications, in view of the withdrawal of the Securities and Exchange Commission's Statement of Policy on investment company sales literature (SEC Release 33-6034, March 8, 1979). The guidelines have been approved by the Association's Board of Governors and were filed with the SEC on December 28, 1981 for immediate effectiveness pursuant to Rule 19b-4(e) under the Securities Exchange Act of 1934, as amended. They were published for public comment on March 10, 1981 (Notice to Members 81-9) and, as explained below, have been modified in part in response to comments received.

Explanation

NASD members and associated persons are subject to high standards of commercial honor in dealing with the public (Article III, Section 1, Rules of Fair Practice) and must conform to principles of fair dealing and good faith in public communications as specified in Article III, Section 35 of the Rules of Fair Practice. Among other things, Section 35 prohibits public communications which contain untrue statements of material facts or which are otherwise false or misleading. Communications concerning investment company securities or variable contracts can be quite complicated or technical, particularly if related to investment results or comparisons. Experience with the SEC's Statement of Policy demonstrated that, because there are numerous methods of presenting such data, a variety of purposes for such presentations, and important differences among investment companies in terms of investment objectives and risk, precise standards which apply to all situations are virtually impossible to develop. Likewise, specific requirements to deal with each different situation or type of security are impractical. Consequently the attached guidelines are cast in terms of general principles which should be applied by members. They do not set forth precise, rigid formulas or requirements. They recognize that most, if not all, standards are subject to legitimate exceptions. Where deemed appropriate, examples of proper (or improper) communications or illustrations may be published or added to the guidelines from time to time.

Members should recognize that these guidelines do not replace the Commission's previous Statement of Policy and they do not purport to interpret any of the federal securities laws or Commission rules. Neither do they displace more specific requirements contained in such rules (e.g. the yield calculation method specified in Rule 434d for money market funds). While the principles of the Association's standards are consistent with those of the Commission (e.g., Rule 156 under the Securities Act of 1933), adherence to these guidelines does not assure an automatic "safe harbor" under any statute or rule. The guidelines are intended to allow maximum creative flexibility and avoid the rigidity of the previous Statement of Policy and it should be recognized that they are broad in scope and take a different approach than did the Statement. Thus, in certain circumstances, the guidelines may lead to greater or lesser emphasis being placed on certain aspects of disclosures. The guidelines are applicable to all sales literature as well as to communications pursuant to Rules 134, 135A, and 434d under the Securities Act of 1933.

Comments Received

A total of five comments were received on the guidelines as proposed, two of which were received after the comment deadline. Three comments were received from members, one from a law firm, and one from a state securities commission.

Two of the commentators suggested that the guidelines include more specific standards concerning comparisons of money market mutual funds with bank investments and the use of certain terminology by money market funds. While the Board is sympathetic with the concerns of these commentators, it was not felt that the approach suggested would be consistent with that of the guidelines, which is to focus on general principles and not specific requirements or prohibitions.

The other three commentators expressed concern that certain sections of the proposed guidelines dealing with performance illustration standards were too rigidly worded and implied requirements. All three pointed as an example to a provision which addressed the period of time covered by performance illustrations. The Board agrees that the language as proposed was unduly rigid and revisions have been made to clarify that, while certain standards are recommended, they are not required and legitimate exceptions to any of the recommended standards are possible.

Other changes of an editorial nature have been made to the language and format of the guidelines during the course of review by the Board and its committees, but such changes do not affect the substance of the guidelines.

Questions regarding these guidelines should be directed to the Association's Advertising Department in Washington, D.C., 1735 K Street, N.W., Washington, D.C. 20006, Telephone No. (202) 833-7270.

Sincerely,

Gordon S. Macklin
President

GUIDELINES REGARDING COMMUNICATIONS WITH THE PUBLIC ABOUT INVESTMENT COMPANIES AND VARIABLE CONTRACTS

1. General Considerations

In judging whether a communication, or a particular element of a communication, may be misleading, several factors should be considered, including, but not limited to:

The Overall Context in Which the Statement or Statements are Made

A statement made in one context may be misleading even though such a statement could be perfectly appropriate in another context. An essential test in this regard is the balance of treatment of risks and potential benefits.

The Audience to Which the Communication is Directed

Different levels of explanation or detail may be necessary depending on the audience to which a communication is directed, and the ability of the member, given the nature of the media used, to restrict the audience appropriately. If the statements made in a communication would be applicable only to a limited audience, or if additional information might be necessary for other audiences, it should be kept in mind that it is not always possible to restrict the readership of a particular communication.

The Overall Clarity of the Communication

A statement or disclosure made in an unclear manner obviously can result in a lack of understanding of the statement, or in a serious misunderstanding. A complex or overly technical explanation may be worse than too little information. Likewise, material disclosure relegated to legends or footnotes realistically may not enhance the reader's understanding of the communication.

2. Special Considerations in Presenting Investment Results

Presentations of investment results require special care to insure that they are not misleading. While it is not possible to prevent every reader of a communication which illustrates investment results from attributing unwarranted predictive value to the data, adequate consideration of certain basic principles can reduce this risk. Among these basic principles are:

Investment Objectives and Policies as Related to Data Provided

Generally speaking, illustrations of investment results should be designed to illustrate the relationship of investment performance to stated investment objectives over meaningful periods. If material changes in objectives, policies, management, or other characteristics have occurred during or since the time period illustrated, these changes should be described.

Appropriateness and Fairness of the Time Periods Illustrated

In general, the appropriate time periods for illustrations of results are those which are of sufficient duration that the relevance of the data to the investment objectives can be determined. Thus yield or performance data may cover a variety of different periods for different types of investments. The selection of a specific time period solely for the purpose of illustrating performance "at its best" is likely to mislead. Illustrations should generally include the last full calendar or fiscal year, or the last twelve months.

Adequacy of Information Concerning the Relevance of Results Illustrated to Probable Future Results

Investment results cannot be predicted or projected and historical illustrations should reflect this. Presentations of investment results should be made in a context that makes clear that within the longer periods illustrated there have been short term fluctuations, often counter to the overall trend of investment results, and that no single period of any length is to be taken as "typical" of what may be expected in future periods. This is a simple principle, and not one which should require a great deal of boiler plate language but rather a simple, straightforward explanation.

The Clarity of a Chart or Table Format

In selection of a format for illustration of investment results in either chart or table form, consideration should be given not only to the completeness and accuracy of the data, but also to the clarity and meaningfulness of the overall presentation. Careful consideration should be given to the overall visual impact of data presented in chart form, since the reader may not go beyond a scanning of the "trend" shown by a chart. It should be recognized that the reader who is confused by having been buried in masses of unclear, although statistically relevant, data may be misled just as badly as the reader who is given too little information.

The Adequacy of Summary Results and the Need for Supporting Data

While a summary of investment results is often necessary in order to make sales literature readable and understandable, it must be recognized that the reader may not look beyond the summary data presented. Consequently, the preparer of such illustrations should take into account that the summary data must be fair in all respects and not likely to mislead, either directly or by distracting the reader from other necessary information. Generally speaking, all summary data covering periods longer than one year should be supported by full year-by-year data over the same or longer periods and should include reference to that supporting data. If supporting data is not included in the same piece of sales literature, members should carefully consider supplying the data in another document.

Inclusion of Relevant Charges and Expenses

Illustrations of income and/or capital results should reflect the results which would have been achieved by the reader for whom the illustration is designed. Actual sales charges, account charges or deductions, and any other relevant expenses which would have been applicable should be taken into account in the illustration, unless such current charges are different, in which case the current charges should be described. Illustrations of gross investment results may be appropriate under certain limited circumstances, but such illustrations should normally be accompanied by an explanation of how such results would be affected by all applicable charges and expenses.

3. Specific Considerations in Presenting Capital Results or Total Return Illustrations

Application of the foregoing principles to illustrations involving capital results, either alone or as part of a "total return" illustration, results in the following specific considerations:

Capital results illustrations, including "total return" data, should generally cover a period long enough to reflect variations in value through different market conditions. A period of ten years, or if shorter, the life of the company or account, is the recommended minimum illustration period, with periods longer than ten years being in five year increments. In illustrations of other periods, particularly shorter periods, members should consider whether to include with such illustration an explanation of the reason for selecting such period and whether data for the recommended ten year or life minimum period should be included with such illustration or in another specifically referenced document, such as a prospectus or shareholder report. Generally, data for full calendar or fiscal years should be reflected. A discussion of the general trends of relevant securities prices during the period may be desirable to lend proper perspective to such illustrations. Illustrations dealing solely with capital results should explain the relative significance of income.

Illustrations of "total return" (i.e. illustrations which reflect the combined results of capital and income) should reflect dollar and/or percentage changes for each year covered by the illustration, as well as for the total period. The illustration should, except for variable contracts, show the breakdown of the income and capital components at least for the total period covered. Where such a breakdown for the total period would not adequately convey the significance of annual variations in the components, consideration should be given to including annual income and capital data. If dividends are assumed to have been reinvested, the illustration should reflect the actual frequency and results of such reinvestments during the period.

Illustrations of performance results in chart form may be misleading because of the scale on which they are displayed. Generally, if an illustration of capital results or of total return is in chart form, a semi-log (ratio) format is recommended.

4. Specific Considerations in Presenting Yield Data or Illustrations

Application of the foregoing general principles to income or yield illustrations results in the following specific considerations.

Any illustration or statement of yield should be accompanied by an explanation of how the yield is computed, along with any additional information necessary to fairly evaluate the yield, including a reference to such risks as may be involved in ownership of the security. Depending on the circumstances, one or more of the following may be appropriate:

- a statement concerning the variability of income;
- a statement of the variability of capital value, e.g., the net asset value at the beginning and end of the previous calendar or fiscal year, or during a recent market advance or decline;
- information about the general characteristics of the portfolio and any material portfolio changes which are anticipated;

Historic yields should be calculated by dividing the company's annual dividends from net investment income by the maximum offering price of the company's shares, using either the average price during the year or the price at the beginning or end of the year.

Current yields should generally be calculated by dividing the company's dividend income for the previous twelve months by the current maximum offering price. However, annualized yields based on periods of less than one year may be appropriate in some cases, e.g., money market funds, funds with less than a full year's history, and funds where the current rate of dividend income varies significantly from the dividends paid in the previous twelve months. Such annualized yield should be based on the company's gross income less actual expenses for the period.

Yields or income should not be characterized as tax sheltered or as free or exempt from income tax where tax liability is merely postponed or deferred. Unless income is free from all income taxes, references to tax exemption should indicate which taxes apply or specify which taxes do not apply. For example, if income from an investment company investing in municipal bonds may be subject to state or local income taxes, this should be stated, or the illustration should otherwise make it clear that income is free from federal income tax.

5. Considerations Regarding Comparisons

Comparisons of investment products or services may be valuable or useful to investors but care must be taken to insure that comparisons are fair and balanced. Comparisons generally should include explanation of the purpose of the comparison and explanation of any material differences between the subjects of the comparison.

Comparisons involving investment companies and variable contracts are often related to yield or performance, but may also relate to structure, fees, tax features and other matters. It is essential that a comparison be as complete as practicable and that no fact be omitted which, if disclosed, would likely alter materially the conclusions reasonably drawn or implied by the comparison. This point is particularly important with respect to selection of time periods for comparison of investment results. Data for each subject of the comparison should also be presented on the same basis, i.e., for the same period in terms of both aggregate and year by year data.

Comparisons with alternative investment or savings vehicles should explain clearly any relevant differences in guarantees, fluctuation of principal and/or return, insurance, tax features, and any other factors necessary to make such comparisons fair and not misleading.

A comparison of investment performance with a market index or average generally should, if appropriate in view of the nature of the comparison, include a clear indication of the purpose of the comparison and the reason or purpose for selection of the index or average, and a description of the index and the fact that it is unmanaged. The extent of the explanation necessary will vary, depending upon the degree of general recognition of the particular index. If there are material differences between the composition of the index and the composition of the portfolio, this should be pointed out. If the comparison is not on a total return basis, the relative impact of differences in income or capital changes, whichever is applicable, should also be explained.

Unless the comparison clearly explains the material relevant differences, a comparison with an index, average, or group of investment companies or accounts should relate to an index, average, or group of investment companies or accounts with investment objectives similar to that of the company compared. Where possible, it is advisable to use an independently prepared and published index, average or group. The smaller or less widely recognized the group or category selected, the greater the importance of explaining the reason for the selection. Since overall investment company industry averages generally include diverse portfolios and objectives, comparisons with such averages should generally not be used.

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NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
1735 K STREET NORTHWEST • WASHINGTON, D.C. 20006 • (202) 833-7200

February 8, 1982

IMPORTANT

PLEASE DIRECT THIS NOTICE
TO ALL
FINANCIAL AND OPERATIONAL
OFFICERS AND PARTNERS

TO: All NASD Members

RE: SEC Adopts and Proposes Significant Amendments to the Net Capital and Customer Protection Rules

SUMMARY

On January 13, 1982, the Securities and Exchange Commission issued four releases announcing the adoption of amendments and a series of proposed amendments to Rule 15c3-1 (the"Net Capital Rule") and Rule 15c3-3 (the "Customer Protection Rule"). The adopted changes, which are explained in Securities Exchange Act Release No. 18417, are to become effective on May 1, 1982. The proposed amendments, described in Securities Exchange Act Releases No. 18418, 18419 and 18420, are also proposed to become effective on May 1, 1982, following the standard comment process. Copies of these releases are reprinted at the conclusion of this notice. These changes, both adopted and proposed, evolve from a number of far-reaching proposals issued by the Securities and Exchange Commission in October of 1980. A brief summary of each of the recently-published releases follows:

- Securities Exchange Act Release No. 18417 - Announces the adoption of a series of amendments to the Net Capital Rule. These include the following:
  - A lowering of the ratio of required capital for firms on the "alternate" method from 4% to 2% of the aggregate debit items from the Reserve Formula;
  - A reduction in "early warning levels" for "alternate" rule calculators from 6% and 7% to 5% of

the aggregate debit items from the Reserve Formula;

— A sliding scale deduction, based on time, for short securities differences;

— The creation of a "revolving subordinated loan agreement" vehicle which will permit more liberalized repayment provisions;

— A continuation of the non-allowable asset treatment for exchange memberships;

— A continuation of the non-allowable asset treatment for "syndicate receivables";

— The use of an "add-back to capital" provision for certain illiquid receivables equal to the dollar amount of an actual tax liability arising from such receivables; and,

— The treatment of free shipments of mutual fund shares as an allowable asset for a period of up to 16 business days following shipment.

- Securities Exchange Act Release No. 18418 — Announces that the Commission is re-proposing for comment a series of amendments to the Net Capital Rule which will result in an overall increase in the haircuts on certain debt securities;

- Securities Exchange Act Release No. 18419 — Announces that the Commission proposes to amend an interpretation to the Customer Protection Rule to permit fails to deliver and fails to receive which allocate to one another to be excluded from the Reserve Formula under that rule. In addition, the SEC is proposing to reduce, in stages, the time period governing the "aging" of fails to deliver and to provide a deduction from net worth related to fails to deliver excluded from the Reserve Formula; and,

- Securities Exchange Act Release No. 18420 -- Announces that the Commission proposes to amend the requirement in the Customer Protection Rule that brokers obtain and maintain possession or control of customers' fully paid and excess margin securities in the case of securities that are borrowed from financial institutions and other persons pursuant to a written agreement that provides, among other things, for the full collateralization of the borrowed securities and the delivery of additional collateral to satisfy differences in excess of 5% of the market value of the

> securities. The Commission also proposes to interpret the Customer Protection Rule to exclude from the Reserve Formula all debit and credit entries relating to such borrowings.

A more detailed discussion of the various elements raised in those releases follows.

DISCUSSION OF THE RELEASES

Securities Exchange Act Release No. 18417

"Ratio" Levels for "Alternate" Firms

At the present time, firms electing to compute their net capital pursuant to paragraph (f) of the Net Capital Rule must maintain net capital equal to the greater of $100,000 or 4% of the aggregate debit items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers (the "Reserve Formula") as prescribed by the Customer Protection Rule (Rule 15c3-3). Firms whose business is limited solely to transactions involving municipal securities need only maintain the greater of $25,000 or 4% of aggregate debits from the Reserve Formula. Effective May 1, 1982, the percentage of aggregate debit items which forms the "ratio," as it were, for firms using the "alternate" method of computation will be reduced to 2% of aggregate debit items from the Reserve Formula. There will be no change in the minimum dollar levels, i.e., $100,000 or $25,000, as the case may be.

With this change in the method of calculating the net capital requirement of "alternate" firms, there is a corresponding reduction in the "early warning," "withdrawal of equity capital" and "repayment of subordinated debt" levels established in various portions of the Net Capital Rule. These levels have been reduced to a figure equal to five percent of aggregate debit items in the Reserve Formula. The overall effect of this change is to reduce the "outer limit," so to speak, of the "alternate" net capital requirement by two percent.

Tax Liabilities Related to Non-Liquid Assets

In today's Net Capital Rule, a broker-dealer is permitted to add back to net worth any receivable that would otherwise be deducted in an amount equal to the amount of any deferred tax liabilities arising from that receivable. However, no add-back treatment is currently available if the offset to the receivable is an actual tax liability. This means that there is what amounts to a double deduction, i.e., both the asset and the actual tax liability are deducted from net worth in determining net capital. The new amendments will remedy this situation by permitting a firm to add back to net worth that portion of actual tax liabilities which relate to receivables that must be deducted from net worth.

Free Shipments of Investment Company Shares

At the present time, receivables arising out of the "free shipment" of mutual fund shares must be deducted from net worth in computing net capital if such receivables are outstanding more than seven business days. In response to an NASD request that the SEC extend this time period, the Commission has, effective May 1, 1982, extended the seven business day period to 16 business days.

Short Securities Count Differences

A firm having a short securities count difference (securities which are owed but cannot be located) must take a charge to net worth equal to 100 percent of the market value of the "short" security position. This charge, under the present rule, is taken if the difference has not been resolved by the seventh business day following discovery. Under the adopted amendments to the Net Capital Rule, this charge will be taken in steps. There are five steps, each comprised of seven business days, measured from the date of discovery of the "short" position. As the time increases from discovery date, the percentage of market value of the "short" position that must be charged to net worth increases until it reaches 100 percent. The steps are as follows:

Short Differences Business Days From Discovery	Charge to Net Worth % of Market Value
0 to 7	0
8 to 14	25%
15 to 21	50%
22 to 28	75%
29 and above	100%

In order to respond appropriately to sudden and unexpected occurrences, the amended rule gives the designated examining authority for a broker-dealer the power to provide limited relief from the charges to net worth for short securities count differences. This flexibility is designed to enhance customer protection and to provide an opportunity to rehabilitate the broker-dealer's operations under the oversight of an independent third party. The designated examining authority may extend the time period prescribed above for up to ten business days if it finds that exceptional circumstances warrant an extension.

Revolving Subordinated Loans

Under the present Net Capital Rule (temporary subordinations excepted), subordinated loans may not be prepayed or repaid, in whole or in part, until one year has elapsed since the loan was approved by a broker-dealer's designated examining authority. This provision was designed to insure the adequacy as well as permanence of capital in the industry. In response to requests by both self-regulatory organizations and broker-dealers, effective May 1, 1982, the Net Capital Rule will allow a firm to repay or prepay a non-temporary subordinated loan at any time without penalty. To accomplish this, Schedule D to the rule is being amended to permit a broker-dealer to repay any borrowings arising out of a revolving subordinated loan, upon approval of the designated examining authority, provided that after giving effect to such prepayment, together with any other scheduled repayments over the succeeding six months, the firm can satisfy certain rigid financial tests relating to its net capital and ratio requirements. These are more difficult tests than those currently contained in the rule relating to repayment and accelerated repayments.

Exchange Memberships and Syndicate Receivables

Stating that it does not believe it would be appropriate to reduce liquidity requirements further, the SEC announced that it will make no change in the net capital treatment of exchange memberships or syndicate receivables (receivables related to investment banking activities). Thus, assets of either type will continue to be classified as non-allowable assets and deducted from net worth in the computation of net capital.

Securities Exchange Act Release No. 18418

This release deals with proposed increases in haircuts on proprietary positions involving certain debt securities, shares in investment companies whose portfolios are comprised exclusively of certain debt securities and preferred stock. The release also clarifies the treatment of repurchase, reverse repurchase and matched repurchase agreements under the Net Capital Rule.

In general, the proposed haircuts on debt securities would significantly increase the charges to net worth in comparison to such charges today. However, the extent of this increase may be mitigated, on a firm by firm basis, due to new "hedging" provisions that permit the netting of many forms of debt securities, as well as futures contracts on government debt securities.

While revised "haircut" schedules are contained in the release, the Commission made it clear that it is not soliciting comment on the appropriateness of the specific percentage amounts. According to the Commission, it has republished " . . . all of the haircut schedules for these securities for the exclusive purpose of facilitating comment concerning the ability of brokers or dealers to deal with the complex procedures and increased haircut categories introduced in the proposed amendments which recognize hedging of certain debt securities as a method of reducing haircut requirements on those securities."

U.S. Government Securities

Haircuts on U.S. Government and Agency securities are being significantly increased. However, the haircut schedule would permit brokers and dealers to recognize the reduction in market risks inherent in many hedging strategies via the netting and cross-netting of various categories of positions. The complexity of determining the aggregate haircut on positions comprised of U.S. Government securities is, in turn, being significantly increased.

Under the current rule, U.S. Government and Agency securities are not haircut if they have a maturity of less than one year. Under the new schedule, only those U.S. Government and Agency securities with less than three months to maturity would not receive a haircut. For U.S. Government and Agency securities having a maturity of more than one year, the present rule prescribes haircuts ranging from 1% for issues having a one to three year maturity to 3% for issues having a maturity of five years or more. Under the new schedule, there are both more categories (12 in all) and increased haircuts (ranging to 6%).

Municipal Securities

No change is proposed in the haircut level for municipal notes, viz., securities which, when issued, have a maturity date of 731 days (two years) or less. The haircuts are also unchanged for municipal bonds having a maturity date of less than two years from the date of a net capital computation. However, for municipal securities having a maturity of two years or more, the haircut percentages are being significantly increased — from 3% to 5% for municipal securities with two but less than five years to maturity and from 5% to 7% for municipal securities with five or more years to maturity.

Investment Company Shares

The Commission proposes to lower significantly the haircut percentage applicable to shares in investment companies which invest solely in cash or debt instruments of the following kinds:

(1) securities issued or guaranteed as to principal and interest by the United States Government or an agency thereof;

(2) municipal securities;

(3) securities issued or unconditionally guaranteed by the Canadian Government;

(4) commercial paper rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations; and,

(5) bankers acceptances and certificates of deposit issued by any bank as defined in Section 3(a)(6) of the Securities Exchange Act of 1934.

Length of Time to Maturity	Haircut %
One year or less to maturity	2%
More than one year to maturity	7%
More than one year to maturity and, in addition to the above, the portfolio of the investment company includes high quality non-convertible debt securities	9%

Non-Convertible Debt Securities

The haircuts proposed for this category of securities are also being increased significantly. Each of the percentage deductions for the six categories is being increased. The current scale of charges ranges from 1% to 7%. Under the new schedule, these charges will range from 2% to 9%. The actual impact on a given firm will be dependent upon the extent to which long and short positions in non-convertible debt securities are hedged by long and short positions in U.S. Government and Agency securities. Use of the hedging strategies for non-convertible securities would still require haircuts be taken on the non-convertible debt although they would be somewhat reduced from those applied to unhedged positions. However, the deduction that would otherwise be required on the U.S. Government or Agency securities need not be taken when used to hedge positions in non-convertible debt securities.

Preferred Stock

For non-convertible preferred stocks rated in one of the four highest categories by at least two of the nationally recognized statistical rating organizations, the haircut charges are being reduced from 20% to 10%. All other preferred stocks would be treated as if a common stock and thus subject to a 30% haircut for those computing under the basic method or 15% for those computing under the alternative method.

Futures

The Commission proposes, under certain circumstances, to allow a broker-dealer to exclude long and short positions in government securities hedged by a futures contract from a haircut category. As with non-convertible debt, however, while the government securities position will not be haircut, the futures contract will be haircut as may be required by Appendix B to the Net Capital Rule.

Repurchase, Reverse Repurchase and Matched Repurchase Agreements

The release clarifies the treatment of repurchase, reverse repurchase and matched repurchase agreements under the Net Capital Rule. If adopted, the amendments would codify the exclusion of those securities sold subject to repurchase as a component of matched repurchase agreements from the applicable haircut provisions of the rule. The proposed amendments would also codify the treatment currently accorded reverse repurchase agreements (individually and as components of matched repurchase agreements) and would require a deduction equal only to a percentage of any deficiency in the market value of the securities collateralizing the loan.

The proposed amendments would also permit the offset of any required deduction with respect to a reverse repurchase agreement by any margin or other deposits held by the broker or dealer on account for the same entity with whom the firm has the reverse repurchase agreement. The proposed amendments, however, would alter the percentage deduction required with respect to reverse repurchase agreements, increase the number of maturity categories to six, and require that brokers and dealers deduct the entire deficiency in the event that the market value of the securities falls to below 50% of the contract price for resale under the agreement.

Securities Exchange Act Release No. 18419

In this release, the Commission details its proposal to amend an interpretation to its Customer Protection Rule so that fails to deliver and fails to receive which allocate to one another would be excluded from the Reserve Formula under that rule. This would have the effect of lowering the capital requirements for brokers and dealers who use the alternative method of computing net capital. In addition, the Commission is proposing to amend the Net Capital Rule to reduce in stages the time period before a deduction must be taken for fails to deliver and to provide a deduction for those fails to deliver which would be excluded from the Reserve Formula in accordance with the amended interpretation. The rule as amended would authorize the designated examining authority for a broker or dealer to extend the aging period for fails to deliver under prescribed circumstances.

Amendments to Interpretation to Customer Protection Rule

Broker-dealers would be permitted to net fails to deliver and fails to receive when computing the Reserve Formula prescribed by the Customer Protection Rule. This will significantly reduce the amount of aggregate debit items in the Reserve Formula which, ipso facto, will reduce the capital requirement of firms which compute net capital in accordance with the "alternative" method.

However, the proposed rule changes would require a firm which computes capital in accordance with the "alternate" method to take a charge to net worth equal to one percent of the aggregate dollar value of fails to deliver excluded from the Reserve Formula. It is to be noted that this one percent charge is applicable only to firms using the "alternate" method. The so-called "basic method" calculators would not be required to take this charge.

Aged Fails to Deliver

The Commission has also proposed to amend the time period after which a fail-to-deliver becomes "aged" and therefore subject to a charge to net worth. Currently, a deduction to net worth is applied whenever a fail-to-deliver is outstanding 11 business days or longer (21 business days or longer in the case of municipal securities). The Commission is now proposing that the time period for aging a fail-to-deliver be cut gradually from 11 business days or longer to five business days or longer (or from 21 business days or longer to 15 business days or longer in the case of municipal securities). This change would be implemented in stages. That is, during the period May 1, 1982, through September 1, 1982, the deduction would apply only to fails to deliver that are outstanding seven business days (17 business days in the case of municipal securities). Thereafter, the five and 15 day time periods would apply. Also, the Commission would permit a firm's designated examining authority to grant extensions of up to five business days during which an "aged fail" charge need not be taken.

Securities Exchange Act Release No. 18420

In this release, the Commission proposes, subject to certain specified conditions, to permit a firm to borrow fully paid and/or excess margin securities from financial institutions and other customers. This would be done by amending that portion of the Customer Protection Rule that requires firms to obtain possession or control of customers' fully-paid or excess margin securities. The amendment would not require that customers' fully-paid or excess margin securities be reduced to possession or control if they have been borrowed in accordance with the conditions detailed in the release. Similarly, the dollar amount of securities so borrowed would be exempted from inclusion in the Reserve Formula.

Of significance to members is the disparity between this provision of the release and the recently proposed amendments of the Federal Reserve Board ("FRB") which also relate to the borrowing of stock.

By way of background, the FRB recently proposed to amend Section 220.6(h) of Regulation T to the end of permitting a broker-dealer to use cash, U.S. Government securities or irrevocable letters of credit as the required deposit when securities are borrowed.

The Commission points out in this release that its proposed amendments to the Customer Protection Rule would not permit the use of letters of credit in lieu of cash or government securities as collateral for such loans. The Commission has, however, invited comment on the question by asking whether the use of letters of credit as collateral for borrowed securities would be consistent with the current financial responsibility requirements under federal securities laws and, in particular, whether alternative restrictions concerning the use of any cash generated by relending the borrowed securities may be appropriate in circumstances in which unsecured letters of credit are used to collateralize a loan of securities.

* * *

The above discussion briefly addresses the principal issues upon which the Commission has taken action or is soliciting comment. As noted previously, copies of the four relevant releases are reprinted in their entirety as part of this Notice. For a more complete explanation of the changes being implemented or proposed by the Commission, members are advised to review these releases carefully. To aid in such review, a comparison of the current requirements to both the adopted and proposed changes to the Net Capital and Customer Protection Rules follow immediately.

In connection with the above, the Association strongly recommends that members and other interested parties provide the Commission with their written comments on the proposed changes. In order for such comments to receive consideration by the SEC, they should be received by the Commission on or before March 15, 1982, the closing date of the comment period. Comments to the SEC should be marked with the relevant file number or numbers, which are as follows:

- Release No. 34-18417 - File No. S7-855
- Release No. 34-18418 - File No. S7-856
- Release No. 34-18419 - File No. S7-922
- Release No. 34-18420 - File No. S7-923

Comments on these proposals are to be directed to:

George A. Fitzsimmons, Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

To assist the Association's Capital and Margin Committee, which will meet shortly to review the proposed amendments, the Association will be appreciative of receiving copies of any correspondence sent by members to the Commission on this subject. These duplicate copies can be directed to:

Capital Proposal
Department of Policy Research
National Association of Securities Dealers, Inc.
1735 K Street, N.W., 8th Floor
Washington, D.C. 20006

Finally, questions concerning this notice or the Commission's adopted or proposed amendments to the Net Capital Rule or the Customer Protection Rule can be directed to either John J. Cox at (202) 833-7320 or Elizabeth A. Wollin at (202) 833-7356.

Sincerely,

Gordon S. Macklin
President

Attachments

COMPARISON OF CURRENT REQUIREMENTS TO ADOPTED AND PROPOSED REQUIREMENTS

Rule 15c3-1 (The "Net Capital Rule")

Adopted Changes

PROVISION	PRESENT TREATMENT	ADOPTED CHANGE
Minimum net capital requirement for "alternate" rule calculators	$100,000	No change
Percentage of aggregate debit items that serves as "ratio" requirement for "alternate" rule calculators	4%	2%
Adjustments to net worth for actual tax liability on a non-allowable asset	No adjustment permitted	Add to net worth the amount of an actual tax liability directly related to a non-allowable asset
Free shipments of investment company shares	The amount is counted as an allowable asset for a period of 7 business days following shipment	The amount is counted as an allowable asset for a period of 16 business days following shipment
Charges to net worth for short securities differences	100% of the market value of short securities difference is deducted on the seventh business day following discovery of the difference	Deduct the following percentages of market value for short securities differences % of Charge — Business Days After Discovery 25% — 7 50% — 14 75% — 21 100% — 28
Ability of Examining Authority to waive a short securities difference haircut	Not permitted	Permitted in exceptional circumstances for a period not to exceed 10 business days
Limitation on withdrawal of equity capital and restrictions on repayment of subordinated debt	None permitted if net capital would fall below 7% of aggregate debit items from the Reserve Formula	None permitted if net capital would fall below 5% of aggregate debit items from the Reserve Formula

PROVISION	PRESENT TREATMENT	ADOPTED CHANGE
Early warning level for "alternate" firms (Rule 17a-11)	6% of aggregate debit items	5% of aggregate debit items
Prepayment of subordinated loans prior to their having been in effect for 12 months - so called revolving subordinated loans	Not permitted	Permitted with approval of the Examining Authority and if certain conditions are met. The conditions imposed are higher than for payment or repayment of subordinated loans which have been in effect for at least 12 months
Exchange membership	Not treated as liquid or allowable assets	No change
Syndicate receivables	Not treated as liquid or allowable assets	No change

Rule 15c3-1 (the "Net Capital Rule")

Proposed Changes

PROVISION	PRESENT TREATMENT	PROPOSED AMENDMENT
Deductions from net worth for aged fails to deliver/ fails to receive	Deduct from the contract price of fails to deliver outstanding 11 business days or more (21 business days for municipals) the haircut applicable to the underlying security	Deduct from the contract price of fails to deliver outstanding 7 business days or longer (17 business days for municipals) the haircut applicable to the underlying security. In September 1982, the time will be further reduced to 5 business days (15 business days for municipal securities).
Haircuts on reverse repurchase agreements	Not covered by the rule; SEC position prescribed by interpretation	A percentage deduction (as noted below) applied to the difference between the contract price of the reverse repurchase agreement and the current market price of the security subject to the reverse repurchase agreement measured to the date of maturity of the reverse repurchase agreement from the capital computation date

PROVISION	PRESENT TREATMENT	PROPOSED AMENDMENT
		7 days or less 0% 8 days to 14 days 5% 15 days to 30 days 10% 31 days to 60 days 25% 61 days to 90 days 50% 91 days or more 100% If the current market value of the security subject to the reverse repurchase agreement is less than 50% of the contract price for resale under that agreement, then regardless of the days to maturity of that contract, the charge to capital is 100% of the difference between market price and contract price. Deductions of this type may be reduced by the amount of margin or other deposits held by the firm on the particular contract or by the excess current market value of securities over the contract price of other reverse repurchase agreements which the firm has with the entity.
Deduction from net worth based on reverse repurchase agreement deductions which exceed 5% of capital before haircuts	Not covered in present rule	Deduct from capital the difference between the current market value of securities and the contract price of reverse repurchase agreements having 90 calendar days or less to maturity which is greater than 5% of capital before haircuts.
Haircuts on matched repurchase agreements	Not covered in present rule	No deduction on the repurchase leg if the appropriate charge, if any, is made on the reverse repurchase leg.

PROVISION	PRESENT TREATMENT	PROPOSED AMENDMENT
Haircuts on Government Securities		
Category 1		
Less than 3 months to maturity	0%	0%
3 months but less than 6 months	0%	1/2 of 1%
6 months but less than 9 months	0%	3/4 of 1%
9 months but less than 12 months	0%	1%
Category 2		
1 year but less than 2 years	1%	1 1/2%
2 years but less than 3 years	1%	2%
Category 3		
3 years but less than 5 years	2%	3%
5 years but less than 10 years	3%	4%
Category 4		
10 years but less than 15 years	3%	4 1/2%
15 years but less than 20 years	3%	5%
20 years but less than 25 years	3%	5 1/2%
25 years or more	3%	6%
Hedging of positions in U.S. Government and Agency securities	Haircut taken on net of long or short per category	Haircut for each category is the net of the aggregate long or short deduction for each subcategory plus 50% of the deduction on the lesser of the two. Also, position offsets and futures contracts can be used to reduce haircuts
"Easy Mechanics" haircut choice for U.S. Government and Agency securities	Not permitted	Permitted

PROVISION	PRESENT TREATMENT	PROPOSED AMENDMENT
Haircuts on municipal notes, i.e., a scheduled maturity at date of issue of 731 days (2 yrs) or less	No change proposed	No change proposed
<u>Haircuts on municipal bonds - i.e., all others municipal notes</u>		
Less than 1 year to maturity	1%	1%
1 year but less than 2 years	2%	2%
2 years but less than 5 years	3%	5%
5 years or more	5%	7%
<u>Haircuts on mutual funds</u>		
Money market funds with no investment exceeding 1 year to maturity	5%	2%
Other money market funds	5%	7%
Mutual funds - which invest in money market instruments and non-convertible debt securities	30%	9%
<u>Haircuts on Non-Convertible Debt</u>		
Less than 1 year to maturity	1%	2%
1 year but less than 2 years	2%	3%
2 year but less than 3 years	3%	5%
3 years but less than 4 years	4%	6%
4 years but less than 5 years	5%	7%
5 years or more	7%	9%

PROVISION	PRESENT TREATMENT	PROPOSED AMENDMENT
Hedging positions in non-convertible debt positions with in U.S. Government and Agency securities	Not permitted	Permitted - However, when non-convertible debt securities are hedged, the value of the long and short positions are to be haircut at a somewhat lower haircut percentage than that which would otherwise apply to such securities.
Haircuts on cumulative, non-convertible preferred stock ranking prior to all other preferreds of the same issuer and rated in one of the four highest categories by at least 2 recognized rating organizations	20%	10%
All other preferred stock	20%	30%

Rule 15c3-3 (the "Customer Protection Rule")

Proposed Changes

Charge to net worth for fails to deliver "netted" from the Reserve Formula	None - Netting not permitted	1% of the amount of such fails to deliver — "alternate firms" only
Exclusion of fails to deliver which match, by issuer and quantity of security, to fails to receive	Not generally permitted - allowed to certain "trading" firms by interpretive letter	Permitted
Borrowing of customer fully paid and excess margin securities	Not generally permitted due to possession and control requirements	Permitted under certain conditions, one of which is that cash or government securities must be given to lender. Cash must be in the form of a cashier's or certified check. Only T bills and T bonds may be used. If securities are used, current market value must be

PROVISION	PRESENT TREATMENT	PROPOSED AMENDMENT
		brought up to 100% coverage whenever the market value of the security borrowed exceeds 105% of the market value of the collateral. This provision would limit the benefits that would otherwise accrue to brokers and dealers as a result of a proposed amendment to Regulation T of the Federal Reserve Board. The FRB amendment would allow a firm to borrow securities and give cash, government securities or an irrevocable letter of credit to the lender. The proposed Customer Protection Rule amendment would, in effect, negate the use of letters of credit, as the requirements of that rule, in almost all instances, would force the "borrower" to maintain possession and control of securities borrowed from customers thereby precluding the lending of such to others.
"Wein" interpretive letter	Now in effect	Withdrawn — no longer effective

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-18417; File No. S7-855]

Net Capital Requirements for Brokers and Dealers; Amended Rules

AGENCY: Securities and Exchange Commission.

ACTION: Adoption of amendments to net capital rule.

SUMMARY: The Commission is amending portions of the net capital rule. The amendments will lower the required minimum percentage of net capital to aggregate debit items under the alternative method of computing net capital. The amendments will also affect the computation of net capital under either the basic method or the alternative method.

EFFECTIVE DATE: May 1, 1982.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Division of Market Regulation (202) 272-2372, 500 N. Capitol Street, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: In October 1980, the Commission proposed for comment a number of far-reaching amendments to its net capital rule for brokers and dealers ("the Concept Release").[1] Those amendments would have substantially reduced the amount of liquid capital required to be maintained by those firms which have elected the alternative method of computing net capital. In a companion release, the Commission proposed for comment new haircut schedules for debt securities. [2] In the Concept Release, the Commission also solicited comment on a broad range of questions regarding the financial responsibility standards for brokers and dealers in its reexamination of the scope, adequancy and necessity of those rules. The Commission received thoughtful and helpful comments from self-regulatory organizations, industry groups and from several brokers and dealers. In light of these comments, the Commission has determined to modify its initial proposal and to adopt the amendments described below. The Commission has also issued three associated releases which deal with subsidiary questions relating to the net capital rule.

[1] Securities Exchange Act Release No. 17208 (Oct. 9, 1980), 45 FR 69915 (Oct. 22, 1980).

[2] Securities Exchange Act Release No. 17209 (Oct. 9, 1980), 45 FR 69911 (Oct). 22, 1980) ("the Haircut Release").

I.

Capital standards based upon liquidity for brokers and dealers have been in effect since at least 1934 when the Securities Exchange Act was adopted. Section 8(b) of the original Act made it unlawful for a member of a national securities exchange to allow "in the ordinary course of business as a broker" its aggregate indebtedness to all other persons to exceed such percentage of the net capital employed in the business (but not exceeding in any case 2000%) as the Commission may by rules prescribe as necessary or appropriate. The primary purposes of this section was to prevent a broker from operating on a "shoestring."[3] Because of inherent limitations in the wording of Section 8(b), it never was more than a general standard of conduct for the securities business.

In 1938, Congress enacted Section 15(c)(3) of the Securities Exchange Act which authorized the Commission to adopt financial responsibility standards for brokers and dealers. In 1942, the Commission adopted Rule X-15C3-1 which incorporated the aggregate indebtedness standards of Section 8(b). The rule exempted from coverage members of national securities exchanges whose rules and practices imposed minimum capital requirements more comprehensive than those of the Commission. In succeeding years, the Commission was generally satisfied with the financial responsibility program. During the years 1967-1970, however, the securities industry underwent an unprecedented financial and operational crisis. That crisis is extensively detailed in the Commission's Study of Unsafe and Unsound Practice of Brokers and Dealers [4] which the Commission was called upon to prepare for the Congress under Section 11(h) of the Securities Investor Protection Act of 1970. Referring to the operational crisis of the late 1960's, the Study exposed the structural weaknesses of an industry which could not withstand "the stresses and strains placed upon it by events of virtual hurricane force."[5] Out of this period emerged a number of legislative and administrative proposals designed to prevent recurrence of the resulting problems.

The first major development was the passage of the Securities Investor Protection Act of 1970 which was designed to give investors who dealt with brokers and dealers additional protections for their funds and securities, in the event of the insolvency of a broker or dealer. Therein Congress provided additional authority to the Commission to adopt rules relating to the acceptance of custody and use of customer securities and the carrying and use of customers' deposits and credit balances. Pursuant to this authority, the Commission adopted Rule 15c3-3 which requires a broker or dealer to have and maintain possession or control of all fully-paid and excess margin securities carried by it for the account of customers and to use customers' funds or customers related funds only in "safe" areas of its business of its business related to financing customer transactions and to deposit in a separate bank account any such funds not so used.

In the meantime the Commission also adopted Rule 17a-13 which requires quarterly counts of securities by brokers and dealers in their possession or control, in order to establish a minimum standard as to the location of securities for brokers and dealers. The Commission also improved its early-warning system to require a broker or dealer to report immediately any net capital violation or the lack of current books and records. The Commission, in addition, revised its reporting provisions to provide for more detailed surveillance of brokers and dealers and to coordinate effectively the examination programs of the Commission and the self-regulatory organizations.

Finally, the Commission, responding to Congressional concern, substantially reformed its net capital rule. The Commission eliminated the exemption in its prior net capital rule for all members of national securities exchanges and made virtually all registered brokers and dealers subject to the Commission's capital requirements.[6] The reformed rule continued the basic liquidity concept under which the securities industry had operated for many years. That concept requires a firm to have and maintain designated minimum amounts of liquid assets in relation to its aggregate indebtedness. In addition, the Commission introduced an alternative method to measure the capital adequacy of brokers and dealers. The alternative method linked the capital requirement of a broker or dealer

[3] *See, for example,* House Hearings on H.R. 7852 and 8720, 73rd Cong., 2nd Sess. (1934) at 87.

[4] *See* Securities and Exchange Commission, *Study of Unsafe and Unsound Practices of Brokers and Dealers,* H. Doc. No. 92-231, 92nd Cong., 1st Sess. (1971) [hereinafter cited as "Unsafe and Unsound Study"].

[5] *Id.* at 11.

[6] Section 15(c)(3) of the Act was amended by the Securities Acts Amendments of 1975 to require the Commission, by September 1, 1975, to establish minimum financial responsibility requirements for all brokers and dealers.

to its customer related business as measured by the requirement of Rule 15c3-3. These reforms were significant steps in the Commission's continuing efforts to structure its rules to provide adequate protection for customers' assets while recognizing the industry's need for flexibility in efficiently allocating capital resources.

The Commission's present net capital rule requires that a broker's or dealer's "aggregate indebtedness" never be more than 1500% of its "net capital," as those terms are defined in the rule. Net capital essentially means the net worth of a broker or dealer reduced by prescribed percentages of the market value of securities owned by the broker or dealer ("haircuts") and reduced by other assets not readily convertible into cash, but including certain subordinated debt, i.e., net liquid assets. Aggregate indebtedness inlcudes all the money liabilities of a broker or dealer, except certain specifically described items. In essence, the rule requires a broker or dealer to cover each dollar of its liabilities with not less than one dollar and six and two-thirds cents of liquid assets.

The alternative method of computing net capital requires a broker or dealer to maintain minimum net capital equal to the greater of $100,000 or 4% of aggregate debit items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers under Rule 15c3-3 ("Reserve Formula"), 17 CFR 240.15c3-3a. The debit items in the Reserve Formula represent monies owed the broker or dealer in relation to customer transactions. The alternative method is founded on the concept that if the debit items in the Reserve Formula can be liquidated at or near their contract values, these assets, along with any cash required to be on deposit under the net capital rule, will be sufficient to satisfy all customer-related liabilities (which are represented as credit items in the Reserve Formula). As an additional safeguard, election of the alternative method requires a firm to reduce by 3% its aggregate debit items to provide, in essence, a bad debt reserve of firm capital to assure adequate resources to pay customer claims. Election of the alternative also requires that operational charges (stock record differences and suspense account items) be reflected in the Reserve Formula after seven business days, rather than after 30 business days, as permitted for those firms which have not elected the alternative method. These limitations, whether under the basic or the alternative method, allow a firm to increase its customer commitments only insofar as its net capital can support the increases.

Tables three through six of the Commission's Concept Release provide a financial profile of firms electing the alternative and basic methods of computing net capital. Most brokers and dealers utilize the basic method for complying with the net capital rule. As Tables three and four indicate, 139 of the 374 NYSE member firms conducting a public business as of December 31, 1979 were using the alternative method for the computation of net capital. These 139 firms accounted for 68% of the aggregate assets, 76% of the aggregate equity capital, and 81% of the aggregate revenues of the 374 NYSE firms conducting a public business. Of the classified NYSE member firms, all ten national full line firms elected the alternative capital approach, while 57 regional firms (48% of NYSE member firms classified as regional) utilized this method.[7]

Only 44 of the 2,066 brokers and dealers that conducted a public business as of December 31, 1979, and who were not members of the NYSE used the alternative method for computing net capital (*See* Tables five and six in the Concept Release). These 44 firms were, on average, substantially larger than the 2,022 firms using the basic method.

In this release, the Commission is adopting changes to the net capital rule which will affect not only the alternative method but also the basic method. Under the amendments, the net capital rule will still require, for the protection of customers, a cushion of liquid assets beyond the "net" amount of liquid assets needed to offset a broker's or dealer's liabilities.

The amendments will lower the ratio of required net capital to aggregate debit items. The amendments will also change the existing early warning levels. Finally, the amendments will modify the present treatment of certain items in the computation of net capital which will be applicable to firms using either the basic or alternative method. Other proposed amendments discussed in the companion releases will affect the treatment of certain debit items in the Reserve Formula, excluding those items from the computation of aggregate debit items, thereby further lowering the minimum net capital requirement under the alternative method.

The most significant issue before the Commission is whether the required ratio of net capital to aggregate debit items should be lowered from the present 4%. The Securities Industry Association (the "SIA") has recommended that the percentage be reduced to 2%. As a corollary, the SIA urges the Commission to lower the existing early warning levels, reasoning that otherwise there would be no effective lowering of the net capital required since prudent firms strive to stay above the early warning thresholds.

A. Lowering of the Percentage

Initially, the SIA proposed that the ratio of net capital applicable to item 10 debits be lowered from 4% to 2%. The "item 10 debits" are the debit balances in customers' cash and margin accounts or, more simply, the amount of money which customers owe the broker or dealer. The Commission proposed for comment a reduction to 3% and only as to the balances in margin accounts, not in cash accounts. The limitation as to margin accounts were premised on the theory that these accounts were adequately secured if in compliance with the maintenance margin rules of the appropriate self-regulatory organization.

The SIA in its comments to the Commission's proposal now recommends that the Commission reduce the minimum net capital requirement under the alternative method from 4% to 2% on all Reserve Formula debit items. It states that for the firms it observed it would require an inordinate operational effort to apply varying percentages to different debit items for purposes of computing net capital under the alternative method. In addition, for most firms, these remaining debits represent only a small portion of the total debits.

The Commission agrees with the SIA that any reduction in the required ratio should apply to all of the debit items. It is not, however, because the other debits are insignificant in amount. As to one large retail firm, those non-item 10 debits amounted to $207,000,000 or about 20% of its total debit items. Rather, for the sake of more simple calculations and manageability by all firms large and small, it is reasonable to extend the reduction to all debit items.

The main question before the Commission is whether the present ratio of net capital to aggregate debit items imposes an unwarranted requirement of liquid assets. This question is not easily

[7] National full line firms conduct a general securities business and have a nationwide branch office network. Regional firms, on the other hand, confine their activities to a more limited geographic area. For further information on classified NYSE member firms, *See* Chapter three Securities and Exchange Commission, *Staff Report on the Securities Industry in 1979*, September 1980

answered. As the Commission said in its original proposal:

Initially, it must be noted that there is not necessarily any direct correlation between the 4% figure presently in the Rule and the amount of liquid capital required to protect customers. That figure was selected based on judgments inferred from the then-existing system.

Essentially, the SIA's arguments in support of its recommendations are two fold:

A. The debit items in the formula are by and large collectable.

B. The pivotal development has been the emergence of Rule 15c3–3, the Customer Protection Rule, as the centerpiece of the Commission's financial responsibility program.

Neither point, however, is entirely conclusive in determining whether the liquidity requirements of the net capital rule should be lowered.

Collectability of Debits

The SIA states that statistics it has obtained indicate that even a 2% minimum net capital requirement would be more than adequate to account for the risk posed by item 10 debits.

The purpose of the net capital rule, however, is to ensure the ability of the broker or dealer promptly to pay its liabilities, particularly to customers. It requires the broker or dealer to be liquid at all times. When the Commission originally designed the Rule 15c3–3 formula it assumed that the debit items were fully collectable. It would have been inappropriate to allow the use of customer funds (the credits) to finance transactions which would result in uncollectable receivables. Thus, tying the net capital cushion to the collectability of these receivables mixes two concepts whose objectives are not entirely consistent. The capital cushion was designed to guard against the insolvency of a firm which could result from other losses.

The net capital rule establishes a minimum standard upon which customers and the industry can rely. Moreover, the liquidity cushion acts as a deterrent to the recurrence of those particular problems pointed out in the Unsafe and Unsound Study by dampening the degree of leverage a broker or dealer may achieve through its use of customers' assets.

Rule 15c3–3

The SIA also contends that the net capital rule is of lessened importance with the "success" of Rule 15c3–3. It states:

To leave the uniform Rule substantially unchanged would be to disregard both the full extent of the protections afforded customers by Rule 15c3–3 and the Commission's own aim of placing less reliance on the uniform Rule after gaining operational experience with Rule 15c3–3. At this advanced date, that experience indicates that Rule 15c3–3 has succeeded to the point that it has been ready for some time to shoulder more of the Commission's financial responsibility regulation mandate.

The Commission has often expressed its desire to consider alternatives to the liquidity concept in the net capital rule. However, the present Rule 15c3–3, by itself, is not an adequate financial responsibility test. There are serious theoretical and practical limitations to its substitution for the net capital rule. First, as to the possession and control requirements of Rule 15c3–3, there are pronounced delays between the time when a decision is made that a security must be in possession or control and the time it must actually be in possession or control. As to the formula, the computation is made only once a week and there is a ten-day period between one computation and the next required deposit. Beyond that, however, examinations by the Commission and self-regulatory organizations have found substantial and continuing violations of Rule 15c3–3 and an apparent lack of understanding of the rule among some brokers and dealers some eight years after the rule's adoption.

Finally, it should be noted that many of the firms that have been liquidated under SIPC proceedings did not make the required deposits as they approached financial difficulty.

While limitations of the regulatory framework suggest caution, there are other factors which have led the Commission to believe that a lowering of the minimum percentage requirement from 4% to 2% is appropriate. Since 1975, the year the present net capital rule was adopted, brokers and dealers have exhibited a willingness to commit their capital to back-office improvements. Brokers and dealers have improved their ability to handle, without bookkeeping or other operational difficulties, heavy trading volume. Their inability to do this in the 1968–1970 period was an important factor in the demise of many brokers and dealers. Moreover, most brokers and dealers that compute net capital using the alternative method clear significant portions of their business through clearing agencies which reduces their exposure to losses and increases their efficiency. In addition to these operational improvements, the Commission and self regulatory organization surveillance programs have been upgraded and the NYSE and the NASD have indicated that they intend to improve their surveillance techniques further.

Perhaps of equal importance is that the early warning rules of the Commission and the self-regulatory organizations will be set significantly above the 2% minimum now adopted. Based on these factors and the protections of Rule 15c3–3, as well as the Commission concern that there should be no unwarranted capital requirements to protect investors, the Commission in its judgment believes that a reduction from 4% to 2% is appropriate. The reduction will enable firms to reallocate capital without creating undue risks to investors.

B. Early Warning Levels

Although the net capital rule presently requires a broker or dealer to maintain net capital equal to only 4% of aggregate debit items, the rule contains other provisions restricting certain aspects of the broker's or dealer's business, if its net capital falls below 7% of aggregate debit items.[8] In addition, Rule 17a–11 requires a broker or dealer to file prescribed reports with the Commission if its net capital falls below 6% of aggregate debit items.

Since prudent brokers or dealers maintain sufficient net capital to avoid falling below these early warning levels, it would provide no relief for those firms if the Commission lowered the basic requirement of 4% without adjusting these early warning levels. In the Concept Release, the Commission proposed that these levels be replaced with amounts equal to 175% and 150%, respectively, of the amount of minimum net capital required. The NYSE has advised the Commission that it proposes to lower its own early warning test set forth in the Rule 325(b) to 5% of aggregate debit items if the minimum level under the alternative method is lowered to 2%. This appears to be a reasonable accommodation which the Commission believes should be incorporated into its own early warning system. The 3% cushion should be sufficient to provide advance warning of a possible impending failure of a broker or dealer and adequate time to initiate corrective action. Thus, the capital lock-in provisions of Rule 15c3–1(e), the restrictions in Appendix D and the early warning reporting requirements of Rule 17a–11 will be amended to be set at levels of 5% of aggregate debit items.

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[8] Some restrictions become effective only when the firm's net capital falls below 6% of aggregate debit items.

III

Minimum Reguirement

Election of the alternative method, as discussed above, requires that a broker of dealer maintain net capital of at least $100,000. In the Concept Release, the Commission announced its intention to consider lowering the minimum from $100,000 to $25,000. This reduction, the Commission noted, would result in equivalent minimum net capital requirements for non-introducing brokers and dealers that carry customer accounts, whether they comply with the aggregate indebtedness test (the basic method) or the aggregate debit items test (the alternative method). The Commission noted that consideration should be given to lowering the minimum in stages, and proposed for comment a new minimum of $75,000 for brokers and dealers electing the alternative method. Further, the Commission stated that, if the reduction was adopted, it would monitor the impact through FOCUS data and the review of SIPC liquidations and periodic on-site examinations of brokers and dealers.

Upon further review, the Commission has determined not to lower the minimum at this time for brokers and dealers electing the alternative method. The Commission notes that the $100,000 requirement has been substantially eroded by inflation.[9] The minimum level of required net capital was set originally because the alternative method's percentage requirements are based on customer-related receivables rather than liabilities. Thus, it was feared that a firm could expand its liabilities without limitation, thereby jeopardizing its solvency. The Commission sees no reason to alter its views on this matter.

IV

Short Securities Differences

Paragraph (c)(2)(v) of the uniform net capital rule requires brokers and dealers to deduct from net worth in computing net capital the market value of all short securities differences [10] that are unresolved for seven business days after discovery and the market value of long securities differences [11] where such securities have been sold by the broker or dealer before they are adequately resolved (less any reserves established therefor). Generally, the broker or dealer discovers these differences by performing a "box-count" and reconciling the results of the "box-count" with its books and records as required by Rule 17a–13.

Paragraph (c)(2)(v) of the net capital rule was promulgated in response to the industry's poor performance in the resolution of short securities differences during the "Paperwork Crisis" of 1968–70.[12] It was designed to provide an incentive to brokers and dealers to resolve short securities differences within a short time after discovery before the differences became impossible to trace. Potentially, if the securities are not located, the broker or dealer will be obligated to buy the missing securities in the open market to make delivery.

The Commission has determined that requiring a 100% deduction for unresolved short securities differences after seven business days is no longer warranted, although it should not be inferred that maintenance of current and accurate records and of adequate internal controls is being de-emphasized. As has recently been demonstrated, a broker or dealer can still encounter the same kind of recordkeeping problems that undermined many brokers and dealers from 1968 to 1970. It appears to the Commission from data submitted [13] that short securities differences are largely resolved over a period of time, although the data received relate to firms which have not failed. The scaling of deductions for short securities differences reflects more accurately the experience of brokers and dealers and, at the same time, adequately provides the necessary safeguards and incentives.

Furthermore, the early deduction may inhibit corrective action by a broker or dealer suffering severe and sudden operational problems. A broker or dealer faced with such a situation may be compelled to assign its personnel to research particular short securities differences in order to avoid potential capital charges rather than assign its personnel perhaps more productively to correct the underlying problems which gave rise to the operational problems.

While the NYSE recommended a different scaling than now adopted,[14] the Commission has determined to adopt a scaling that is compatible with the requirements of Rule 15c3–3(h) which generally requires broker-dealers to "buy-in" all unresolved short securities differences by at least the 45th calendar day after the discovery date. Forty-five calendar days is equivalent to approximately 30 business days. Under the scale proposed by the NYSE, if the broker or dealer is in compliance with Rule 15c3–3(h), the full capital charge would not be meaningful because the broker or dealer would have been required to buy in the short securities difference by the 28th business day or long before the 45th business day, the day on which a 100% deduction would be required under the NYSE scale. Consistent with Rule 15c3–3(h), the outer limits of the Commission's scale will be set at 28 business days. Since 28 business days is equal to approximately 40 calendar days, a broker or dealer would be required to have liquid assets equal to the short securities differences five days prior to the 45th calendar day, the day by which the broker or dealer would be required to "buy-in" short securities differences under Rule 15c3–3(h). The time periods specified in the scale (7, 14, 21 and 28 business days), will still provide a substantial incentive to brokers and dealers to review and eliminate their short securities differences. Finally, it appears prudent and less confusing to provide for equal increases of deductions from the market values of short securities differences at each successive level of the scale.[15]

In response to the need for flexibility to respond to sudden and unexpected occurrences, the amended rule provides

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[9] The present value of $100,000 is about $65,000, as compared to 1975.

[10] "Short securities differences" occur where the securities record of a broker or dealer shows an obligation for a particular number of securities but which it is unable to locate.

[11] "Long securities differences" refer to situations where the "box-count" reveals securities in the broker's or dealer's possession or control, the owner of which is unknown.

[12] *See* Unsafe and Unsound Study at 100–104.

[13] The results of the study indicated that short securities differences and other unresolved items as reported by brokers and dealers in quarterly FOCUS filings from December 1979 through December 1980 ranged between $13.9 million and $100.7 million. Losses actually sustained during this period, however, were reported to be only $599 thousand.

[14] The NYSE proposed the following schedule:

Differences [1]	Number of business days after discovery
20 percent	10
40 percent	20
50 percent	30
100 percent	45

[1] Percentage of market value of short securities differences.

[15] The adopted scale is as follows:

Differences [1]	Number of business days after discovery
25 percent	7
50 percent	14
75 percent	21
100 percent	28

[1] Percentage of market value of short securities differences.

that, under appropriate circumstances, the examining authority for a broker or dealer can provide limited relief from the requirements of the rule. This flexibility would afford customer protection and also provide an opportunity to rehabilitate the broker's or dealer's operations under the oversight of an independent third party.[16] The self-regulatory organization of course is expected to notify the Commission if it grants an extension without which the broker or dealer in whose favor the extension was granted would have been compelled to send telegraphic notice to the Commission pursuant to Section 17a-11 because not in compliance with the net capital rule.[17]

V

Subordinated Loans

Appendix D to Rule 15c3-1 sets forth the minimum and non-exclusive requirements for satisfactory subordination agreements. Among other things, no prepayment or any payment of a payment obligation may be made (except under the strictly defined limitations of paragraph (c)(5) of Appendix D) before the expiration of one year from the effective date of the subordination agreement. This provision was designed to insure the adequacy as well as the permanence of capital in the industry.

Over the years, it has been suggested by both the self-regulatory organizations and brokers and dealers that firms meeting certain criteria be permitted to make use of "Revolving Subordinated Loan Agreements." Under the terms of such agreements, brokers and dealers are permitted to make subordinated borrowings which can be repaid at any time without penalty. The agreements would conform in all other respects to the requirements of Appendix D.

With limitations, the suggestion appears not to contravene the net capital rule's objectives. The NYSE has suggested criteria which appear to be appropriate. Accordingly, Appendix D to Rule 15c3-1 will be amended to permit any broker or dealer to prepay any borrowings arising out of a Revolving Subordinated Loan Agreement which could be prepaid at any time upon approval by the designated examining authority so long as:

1. The intended prepayment, along with other intended repayments and scheduled repayments of capital during the succeeding six months would not result in a capital ratio greater than 900% (if the broker or dealer is on the basic method) or a net capital percentage less than 6% of aggregate debit items (if the broker or dealer has elected the alternative method), or net capital less than 200% of the minimum dollar requirement (under either method); and
2. Pre-tax losses during the latest three month period equaled less than 15%[18] of current excess net capital.[19]

VI

Liquidity Concept

There are several additional proposals advocated by the SIA which would substantially lower the net capital requirements and which the Commission believes are not consistent with the liquidity concept of the net capital rule and therefore should not be wholly adopted, at least at this time.[20]

A. Exchange Memberships

The SIA has recommended that the current value of a firm's exchange seat, less appropriate haircuts, be includable in a firm's net capital. Under the present rule, the value of an exchange membership is considered a non-liquid asset which must be deducted from a firm's net worth. The SIA in its initial report argued that exchange memberships should be included in net capital because they are easily marketable.

The Commission, in its Concept Release, asked for additional comment on this recommendation noting that "though in most cases they may be readily sold at some price, because of the priorities set forth in exchange rules, it is not certain what amount of the proceeds would benefit customers."

In responding generally, the SIA noted the success of Rule 15c3-3 as the centerpiece of the Commission's financial responsibility program and then stated,

> This in turn indicates that the liquidity concept, and with it the notion that assets are properly allowable only to the extent that they will unconditionally inure to the benefit of customers upon liquidation, can be deemphasized. Rather, the question becomes to what extent a particular asset contributes to a level of financial viability sufficient to assure the completion of transactions among professionals (footnote omitted). In this light, the priority rules governing the disposition of the proceeds from the sale of exchange memberships are, if anything, a factor in favor of their allowance for purposes of the Rule.

The SIA submitted historical data which focuses on the fluctuation in value of exchange memberships, rather than their ready liquidity. The SIA concluded that this data demonstrated that it was unnecessary to deduct the entire value of an exchange membership in terms of the purposes of the net capital rule and that their present treatment under the net the net capital rule was both overcautious and presented particular difficulties for those smaller firms which commit a high portion of their net worth to exchange memberships recommendation to specify a 33⅓% haircut on exchange memberships.

Historically, the value of exchange memberships have not been included in a firm's net capital. The Securities Exchange Act, as originally enacted provided in Section 8(b) that firms must exclude only two items from net capital—fixed assets and *the value of exchange memberships*. This exclusion has continued into the present net capital rule. Further, two major exchanges did not allow member firms to include the value of memberships under their own rules concerning the computation of net capital.[21]

To allow the inclusion of exchange memberships in a firm's net capital would deemphasize the net capital rule's liquidity concept, the essential characteristic of the rule. Because of the substantial reduction in the required percentage of net capital for firms electing the alternative method, already discussed, the Commission does not believe that it would be appropriate to reduce the liquidity requirements further.

B. Receivables

Consistent with the concept of liquidity, Rule 15c3-1(c)(2)(iv) requires a broker or dealer in computing net capital to deduct from net worth "assets

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[16] No proposal was made concerning long securities differences, and the Commission is unaware of any reason to change that provision.

[17] It should be noted that the provisions of Rule 17a-13 are not being amended.

[18] The NYSE recommended that 5% should be the criteria.

[19] The appropriate SRO must of course assure itself that the borrowings and repayments are being made for legitimate business purposes.

[20] In the Concept Release, the Commission solicited public comment on the SIA's recommendation that, for purposes of the Reserve Formula, a firm short position that allocates to a customer debit should be treated in the same manner as a firm long position that allocates to a customer credit. Currently, where a firm short position allocates to a customer debit both sides must be included in the Reserve Formula, whereas if a firm long position allocates to a customer credit, both sides are excluded from the Reserve Formula. The Commission stated the exposure inherent in a short sale to customers—that the broker or dealer selling short to a customer may be required to borrow securities in order to meet its delivery requirement under Rule 15c3-3. No comments have been received to negate this objection and the Commission knows of none. Accordingly, the interpretation will not be changed.

[21] *See* NYSE Rule 325 (June 1, 1975) and Chicago Board of Options Exchange Rule 13.3 (1973).

which cannot be readily converted into cash." Included in this category are most unsecured receivables, 100% of which must be deducted from net worth. Certain unsecured receivables, however, need be deducted only after a period of time specified in the net capital rule.

The SIA has recommended that underwriting receivables and investment banking receivables (otherwise known as "syndicate receivables") be given treatment similar to that accorded commissions receivable from other brokers and dealers under the net capital rule. In addition, the SIA has recommended that other unsecured receivables be allowed as liquid assets to the extent that they generate tax accruals.

The Commission has determined to allow inclusion of the receivables but only to the extent they generate tax liabilities which have not been paid.

While the data supplied by the SIA appears to demonstrate the high collectability of underwriting and investment banking receivables, their ultimate collectibility does not alone warrant amending the net capital rule to threat such unsecured receivables as allowable assets.

From the standpoint of liquidity, the question is first whether an asset is readily convertible into cash; this is an all important consideration since the purpose of the rule is to ensure that a broker or dealer has on hand at all times sufficient liquid assets to satisfy customer claims promptly.

As the Commission stated in the Concept Release,

> With certain limited exceptions, unsecured receivables have not been treated as readily convertible into cash because they may not be readily collectable on the initiative of the broker or dealer. If the broker's or dealer's debtor disputes the claim, or simply does not pay, court action and its attendant delays may be the only recourse.

The SIA's data have not demonstrated otherwise.

Although most unsecured receivables are not deemed by the net capital rule to be readily convertible into cash, the rule is somewhat inconsistent in recognizing other unsecured receivables as readily convertible into cash. This results largely from the fact that, in adopting the uniform net capital rule, the Commission annexed provisions from the various net capital rules of the self-regulatory organizations which accepted these unsecured receivables as liquid. Whatever the cause for these exceptions to an otherwise clear policy, the Commission does not view it as a reason to extend the exceptions any further.

Tax Offsets

The current treatment of receivables and corresponding accrued tax liabilities under the net capital rule subjects brokers and dealers to what appears to be a "double deduction." The rule does not allow a broker or dealer to add back actual tax liabilities (in contrast to deferred tax liabilities) to net worth even if the tax liability relates to a receivable which must be deducted from net worth in computing net capital. The Commission did not allow such offsets because current tax liabilities must be paid by the broker or dealer regardless of whether the asset to which the tax relates has been converted into cash.

In retrospect, the Commission believes that this treatment, while justified on a strict liquidity basis, seems unnecessary to protect the solvency of a broker or dealer. Accordingly, a broker or dealer will not be required to deduct from net worth receivables to the extent such receivables are offset by corresponding tax liabilities. Such tax liabilities, however, would have to be reflected as a liability and included in computing the broker's or dealer's aggregate indebtedness.

C. Free Shipments

Currently, Rule 15c3–1(c)(2)(iv)(B) provides that receivables arising out of "free shipments" of mutual fund shares need be deducted from net worth in computing net capital only if such receivables are outstanding more than seven business days. The NASD has requested that the Commission extend the time period during which receivables arising out of free shipments of mutual fund shares are considered "good assets" in computing net capital to 30 calendar days. In support of its proposal, the NASD points out that investment company share liquidations present little risk in view of Section 22(e) of the Investment Company Act of 1940 which provides that the proceeds of a mutual fund redemption must be paid within seven days of the tender of such securities. Moreover, the NASD believes that the seven business day processing period for mutual fund redemptions currently provided for in the rule is unrealistic and ignores current business practices. According to a study conducted by the NASD, on the average, a mutual fund redemption is settled in 18.9 calendar days.

It appears to the Commission that a period of 16 business days to allow for mutual fund redemption is appropriate. This period is based upon a study of the NASD data. Sixteen business days (or approximately 22 calendar days) exceeded the average number of days it took to "settle" mutual fund redemptions (18.9 according to the NASD) by approximately three days. Accordingly, Rule 15c3–1(c)(2)(iv)(B) will be amended to require a deduction from net worth for receivables arising out of free shipments of mutual fund shares after 16 business days rather than 7 business days as currently provided for in the rule.

Statutory Basis and Competitive Considerations

Pursuant to the Securities Exchange Act of 1934 and particularly Sections 15(c)(3), 17(a), and 23(a) thereof, 15 U.S.C. 78*o*(c)(3), 78*q*(a) and 78*w*(a), the Commission is amending § 240.15c3–1 and § 240.17a–11 in Chapter II of Title 17 of the Code of Federal Regulations in the manner set forth below. The Commission believes that any burden imposed upon competition by the amendments is necessary in furtherance of the purposes of the Act, and particularly to implement the Commission's continuing mandate under Section 15(c)(3) thereof, to provide minimum safeguards with respect to the financial responsibility of brokers and dealers.

Text of Amendments

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

In accordance with the foregoing, 17 CFR Part 240 is amended as follows:

1. In § 240.15c3–1, paragraph (a) is revised; (c)(2)(i)(E) added; (c)(2)(iv)(B) and (v), (e) and (f)(1)(i) and (2) revised and paragraph (g) removed to read as follows:

§ 240.15c3–1 Net capital requirements for brokers and dealers.

(a) No broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 1500 percentum of his net capital, except as otherwise limited by the provisions of paragraph (a)(1) of this section, or, in the case of a broker or dealer electing to operate pursuant to paragraph (f) of this section, no broker or dealer shall permit his net capital to be less than 2 percent of aggregate debit items as computed in accordance with § 240.15c3–3a of this chapter, or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater, except as otherwise limited by paragraph (f) of this section, and every broker or dealer shall have the net capital necessary to comply with the following conditions, except as otherwise provided for in paragraph (f) of this section.

* * * * *

(c) * * *
(2) * * *
(i) * * *

(E) Adding to net worth any actual tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section.

* * * * *

(iv) * * *

(B) *Certain unsecured and partly secured receivables.* All unsecured advances and loans; deficits in customers' and non-customers' unsecured and partly secured notes; deficits in special omnibus accounts maintained in compliance with the requirements of 12 CFR 220.4(b) of Regulation T under the Securities Exchange Act of 1934, or similar accounts carried on behalf of another broker or dealer, after application of calls for margin, marks to the market or other required deposits which are outstanding 5 business days or less; deficits in customers' and non-customers' unsecured and partly secured accounts after application of calls for margin, marks to the market or other required deposits which are outstanding 5 business days or less, except deficits in cash accounts as defined in 12 CFR 220.4(c) of Regulation T under the Securities Exchange Act of 1934 for which not more than one extention respecting a specified securities transaction has been requested and granted, and deducting for securities carried in any of such accounts the percentages specified in paragraphs (c)(2)(vi) or (f) of this section or Appendix A (17 CFR 240.15c3-1a); the market value of stock loaned in excess of the value of any collateral received therefor; receivables arising out of free shipments of securities (other than mutual fund redemptions) in excess of $5.000 per shipment and all free shipments (other than mutual fund redemptions) outstanding more than 7 business days, and mutual fund redemptions outstanding more than 16 business days; any collateral deficiencies in secured demand notes as defined in Appendix D (17 CFR 240.15c3-1d);

* * * * *

(v)(A) Deducting the market value of all short securities differences (which shall include securities positions reflected on the securities record which are not susceptible to either count or confirmation) unresolved after discovery in accordance with the following schedule:

Differences [1]	Numbers of business days after discovery
25 percent	7
50 percent	14
75 percent	21
100 percent	28

[1] Percentage of market value of short securities differences.

(B) Deducting the market value of any long securities differences, where such securities have been sold by the broker or dealer before they are adequately resolved, less any reserves established therefor;

(C) The designated examining authority for a broker or dealer may extend the periods in (A) above for up to 10 business days if it finds that exceptional circumstances warrant an extension.

* * * * *

(e) *Limitation on withdrawal of equity capital.* No equity capital of the broker or dealer or a subsidiary or affiliate consolidated pursuant to Appendix C (17 CFR 240.15c3-1c) whether in the form of capital contributions by partners (excluding securities in the securities accounts of partners and balances in limited partners' capital accounts in excess of their stated capital contributions), par or stated value of capital stock, paid-in capital in excess of par, retained earnings or other capital accounts, may be withdrawn by action of a stockholder or partner, or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, sole proprietor or employee if, after giving effect thereto and to any other such withdrawals, advances, or loans and any Payments of Payment Obligations (as defined in Appendix D (17 CFR 240.15c3-1d) under satisfactory subordination agreements which are scheduled to occur within six months following such withdrawal, advance or loan, either aggregate indebtedness of any of the consolidated entities exceeds 1000 percentum of its net capital or its net capital would fail to equal 120 percentum of the minimum dollar amount required thereby or would be less than 5 percent of aggregate debit items computed in accordance with 17 CFR 240.15c3-3a, or, if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater or in the case of any broker or dealer included within such consolidation if the total outstanding principal amounts of satisfactory subordination agreements of the broker or dealer (other than such agreements which qualify as equity under paragraph (d) of this section) would exceed 70 percent of the debt-equity total as defined in paragraph (d). *Provided,* That this provision shall not preclude a broker or dealer from making required tax payments or preclude the payment to partners of reasonable compensation.

(f) * * *

(1)(i) A broker or dealer who is not exempt from the provisions of 17 CFR 240.15c3-3 under the Securities Exchange Act of 1934 pursuant to paragraph (k)(1) or (k)(2)(i) may elect not to be subject to the limitations of paragraph (a) of this section respecting aggregate indebtedness as defined in paragraph (c)(1) of this section and certain deductions provided for in paragraph (c)(2) of this section. *Provided,* That in order to qualify to operate under this paragraph (f), such broker or dealer shall at all times maintain net capital equal to the greater of $100,000 ($25,000 in the case of a broker or dealer effecting transactions solely in municipal securities) or 2 percent of aggregate debit items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3-3, 17 CFR 240.15c3-3a), or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater, and shall notify the Examining Authority for such broker or dealer and the Regional Office of the Commission in which the broker or dealer has its principal place of business, in writing, of its election to operate under this provision. Once a broker or dealer has determined to operate pursuant to the provisions of this paragraph (f), he shall continue to do so unless a change is approved upon application to the Commission.

(2) In the case of a broker or dealer who has consolidated a subsidiary pursuant to Appendix C (17 CFR 240.15c3-1c), such broker's or dealer's minimum net capital requirements shall be the sum of the greater of $100,000 or 2 percent of the parent broker's or dealer's aggregate debit items computed in accordance with 17 CFR 240.15c3-3a, or, if the parent is registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if

greater, and the total of each consolidated broker or dealer subsidiary's minimum net capital requirements. The minimum net capital requirements of a subsidiary electing to operate pursuant to paragraph (f) of this section shall be the greater of $100,000 or 2 percent of its aggregate debit items computed in accordance with 17 CFR 240.15c3–3a, or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated by the subsidiary pursuant to the Commodity Exchange Act and the regulations thereunder, if greater. Where the subsidiary which has been consolidated has not elected to operate pursuant to paragraph (f) of this section, its minimum net capital requirement is the greater of its requirements under paragraph (a) of this section or 6⅔ percent of its aggregate indebtedness.

* * * * *

2. In § 240.15c3–1d, paragraphs (b)(6)(iii), (7), (8)(i), (10)(ii)(B) and (c) (2) and (5) are revised to read as follows:

§ 240.15c-1d Satisfactory subordination agreements (appendix D to 17 CFR 240.15c3–1).

* * * * *

(b) * * *

(6) * * *

(iii) The secured demand note agreement may also provide that, in lieu of the procedures specified in the provisions required by paragraph (b)(6)(ii) of this section, the lender with the prior written consent of the broker or dealer and the Examining Authority for the broker or dealer may reduce the unpaid principal amount of the secured demand note. *Provided,* That after giving effect to such reduction the aggregate indebtedness of the broker or dealer would not exceed 1,000 percentum of its net capital or, in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3–1, net capital would not be less than 5 percent of aggregate debit items computed in accordance with 17 CFR 240.15c3–3a, or, if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater. *Provided, further,* That no single secured demand note shall be permitted to be reduced by more than 15 percent of its original principal amount and after such reduction no excess collateral may be withdrawn. No Examining Authority shall consent to a reduction of the principal amount of a secured demand note if, after giving effect to such reduction, net capital would be less than 120 percent of the minimum dollar amount required by 17 CFR 240.15c3–1.

(7) *Permissive Prepayments.* A broker or dealer at its option but not at the option of the lender, may, if the subordination agreement so provides, make a Payment of all or any portion of the Payment Obligation thereunder prior to the scheduled maturity date of such Payment Obligation (hereinafter referred to as a "Prepayment"), but in no event may any Prepayment be made before the expiration of one year from the date such subordination agreement became effective: *Provided, however,* That the foregoing restriction shall not apply to temporary subordination agreements which comply with the provisions of paragraph (c)(5) of this Appendix D. No Prepayment shall be made, if, after giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements then outstanding the maturity or accelerate maturities of which are scheduled to fall due within six months after the date such Prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such Prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 1000 percentum of its net capital or its net capital would be less than 120 percentum of the minimum dollar amount required by 17 CFR 240.15c3–1 or, in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3–1, its net capital would be less than 5 percent of its aggregate debit items computed in accordance with 17 CFR 240.15c3–3a, or if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, or its net capital would be less than 120 percent of the minimum dollar amount required by paragraph (f) of 17 CFR 240.15c3–1. Notwithstanding the above, no Prepayment shall occur without the prior written approval of the Examining Authority for such broker or dealer.

(8) *Suspended Repayment.* (i) The Payment Obligation of the broker or dealer in respect of any subordination agreement shall be suspended and shall not mature if, after giving effect to Payment of such Payment Obligation (and to all Payments of Payment Obligations of such broker or dealer under any other subordination agreement(s) then outstanding which are scheduled to mature on or before such Payment Obligation) either (A) the aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital or, in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3–1, its net capital would be less than 5 percent of aggregate debit items computed in accordance with 17 CFR 240.15c3–3a or, if registered as a futures commission merchant, 6 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, or (B) its net capital would be less than 120 percent of the minimum dollar amount required by 17 CFR 240.15c3–1 including paragraph (f), if applicable. *Provided,* That the subordination agreement may provide that if the Payment Obligation of the broker or dealer thereunder does not mature and is suspended as a result of the requirement of this paragraph (b)(8) for a period of not less than 6 months, the broker or dealer shall thereupon commence the rapid and orderly liquidation of its business but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of 17 CFR 240.15c3–1 and 240.15c3–1d.

* * * * *

(10) * * *

(ii) * * *

(B) The aggregate indebtedness of the broker or dealer exceeding 1500% of its net capital or, in the case of a broker or dealer which has elected to operate under paragraph (f) of 17 CFR 240.15c3–1, its net capital computed in accordance therewith is less than 2% of its aggregate debit items computed in accordance with 17 CFR 240.15c3–3a or, if registered as a futures commission merchant, 4% of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, throughout a period of 15 consecutive business days, commencing on the day the broker or dealer first determines and notifies the Examining Authority for the broker or dealer, or the Examining Authority or the Commission first determines and notifies the broker or dealer of such fact:

* * * * *

(c) * * *

(2) *Notice of Maturity or Accelerated Maturity.* Every broker or dealer shall immediately notify the Examining Authority for such broker or dealer if, after giving effect to all Payments of Payment Obligations under subordination agreements then outstanding which are then due or mature within the following six months without reference to any projected profit

or loss of the broker or dealer, either the aggregate indebtedness of the broker or dealer would exceed 1200% of its net capital or its net capital would be less than 120% of the minimum dollar amount required by 17 CFR 240.15c3-1, or, in the case of a broker or dealer who is operating pursuant to paragraph (f) of 17 CFR 240.15c3-1, its net capital would be less than 5% of aggregate debit items computed in accordance with 17 CFR 240.15c3-3a, or if registered as a futures commission merchant, 6% of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, or less than 120% of the minimum dollar amount required by paragraph (f) of 17 CFR 240.15c3-1.

* * * * *

(5) *Temporary Subordinations.* (i) For the purpose of enabling a broker or dealer to participate as an underwriter of securities or other extraordinary activities in compliance with the net capital requirements of 17 CFR 240.15c3-1, a broker or dealer shall be permitted, on no more than three occasions in any 12 month period, to enter into a subordination agreement on a temporary basis which has a stated term of no more than 45 days from the date such subordination agreement became effective. This temporary relief shall not apply to a broker or dealer if, at such time, it is subject to any of the reporting provisions of 17 CFR 240.17a-11 under the Securities Exchange Act of 1934, irrespective of its compliance with such provisions or if immediately prior to entering into such subordination agreement either (A) the aggregate indebtedness of the broker or dealer exceeds 1000 per centum of its net capital or its net capital is less than 120% of the minimum dollar amount required by 17 CFR 240.15c3-1, or (B) in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3-1, its net capital is less than 5% of aggregate debits computed in accordance with 17 CFR 240.15c3-3a or, if registered as a futures commission merchant, 7% of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, or less than 120% of the minimum dollar amount required by paragraph (f) of this section, or (C) the amount of its then outstanding subordination agreements exceeds the limits specified in paragraph (d) of 17 CFR 240.15c3-1. Such temporary subordination agreement shall be subject to all the other provisions of this Appendix.

(ii) A broker or dealer shall be permitted to enter into a revolving subordination agreement which provides for prepayment within less than one year of any or all of the Payment Obligations at the option of the broker or dealer upon the prior written approval of the Examining Authority for the broker or dealer. The Examining Authority shall not approve any Prepayment unless:

(A) If, after giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements than outstanding the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such Prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such Prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 900 percentum of its net capital or its net capital would be less than 200 percentum of the minimum dollar amount required by 17 CFR 240.15c3-1 or, in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3-1, its net capital would be less than 6% of its aggregate debit items computed in accordance with 17 CFR 240.15c3-3a or if registered as a futures commission merchant, 7% of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, or its net capital would be less than 200% of the minimum dollar amount required by paragraph (f) of 17 CFR 240.15c3-1 and

(B) Pre-tax losses during the latest three-month period equaled less than 15% of current excess net capital.

* * * * *

3. In § 240.17a-11, paragraph (b)(2) is revised to read as follows:

§ 240.17a-11 Supplemental current financial and operational reports to be made by certain brokers and dealers.

* * * * *

(b) * * *

(2) If a computation made by a broker or dealer pursuant to § 240.15c3-1(f) shows, at any point during the month, that his net capital is less then 5 percent of aggregate debit items computed in accordance with § 240.15c3-3 Exhibit A: Formula for the Determination of Reserve Requirements, or that his total net capital is less than 120 per centum of the minimum net capital required of him, such broker or dealer shall file a report on Part II or Part IIA of Form X-17A-5 (§ 249.617 of this chapter) as determined in accordance with the standards set forth in §§ 240.17a-5(a)(2)(ii) and (a)(2)(iii), within 15 days after the end of each month thereafter until three successive months shall have elapsed during which his net capital is not less than 5 percent of aggregate debit items computed in accordance with § 240.15c3-3 Exhibit A, and his total net capital does not fall below 120 per centum of the minimum net capital required of him.

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By the Commission.

George A. Fitzsimmons,

Secretary.

January 13, 1982.

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