THE FOLLOWING PAGES CONTAIN REPRINTS

OF

SECURITIES EXCHANGE ACT RELEASES

CONCERNING

PROPOSED AMENDMENTS

TO

RULE 15c3-1

AND

RULE 15c3-3

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-18418; File No. S7-856]

Net Capital Requirements for Brokers and Dealers; Proposed Rule

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule amendments.

SUMMARY: The Commission is reproposing for comment amendments to the uniform net capital rule which will result, overall, in an increase in the percentage deductions ("haircuts") from the market value of certain debt securities in the proprietary or other accounts of brokers or dealers, including Government securities, municipal securities and nonconvertible debt securities. The Commission is republishing 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; the Commission intends to adopt the proposed haircut schedules themselves and is not soliciting public comment with regard to the appropriateness of specified percentage deductions. The Commission is proposing for comment amendments that will modify the current treatment of municipal securities that have no ready market, change the haircuts for redeemable securities of registered investment companies which invest solely in debt instruments and clarify the treatment of repurchase, reverse-repurchase and matched repurchase agreements under the net capital rule. Finally, the Commission is reproposing for comment amendments that will change the haircuts for preferred stock. In a companion release issued today, the Commission has adopted amendments to the net capital rule that will reduce the capital requirements for many brokers and dealers.

DATE: Comments must be received on or before March 15, 1982.

ADDRESSES: All comments should be submitted in triplicate and addressed to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. All comments should refer to File No. S7-856 and will be available for public inspection at the Commission's Public Reference Room, 1100 L Street, NW., Washington, D.C.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Esq., Division of Market Regulation, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549 at (202) 272-2372.

SUPPLEMENTARY INFORMATION: The uniform net capital rule (the "Rule") requires a broker or dealer to maintain a minimum net capital, the amount of which depends on the nature of its business and its aggregate liabilities if on the basic method of computing net capital (the "basic method") or its customer related receivables if on the alternative method of computing net capital (the "Alternative"). A broker or dealer on the basic method may not allow its aggregate indebtedness to exceed 1500% of its net capital. A broker or dealer electing the Alternative must maintain a 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 (the "Reserve Formula").

In computing net capital, a broker or dealer is required to deduct from net worth certain percentages of the market value of all securities carried in its proprietary or other accounts. These deductions are generally referred to as "haircuts." The amount of the haircuts for debt securities (including short term notes) depends on the nature of the issuer, the time to maturity of the security and, for securities of non-governmental issuers, the ratings of nationally recognized statistical rating services. In general, the haircuts for debt securities were designed to take into account the historical market fluctuations of each type of instrument.

Recent events in the debt market caused the Commission to question the adequacy of the present haircut provisions for debt securities. Interest rates rose to unprecedented heights in the 1979-1980 period, causing precipitous declines in the values of already issued debt instruments. Some brokerage firms dealing primarily in municipal securities were forced to liquidate or withdraw from the market because of the unanticipated sharp changes in interest rates. Moreover, some major brokerage firms reportedly suffered large trading losses in debt securities, as did several large national banks.

In Securities Exchange Act Release No. 17209 (the "Haircut Release"),[1] the Commission proposed for comment amendments to the haircut schedules for Government securities, municipal securities and nonconvertible debt securities. Also, in an effort to make its financial responsibility rules more compatible with sound business practices, the Commission solicited comment on the degree to which the haircut provisions should deal with hedges among various classes of debt instruments. Through the comment process the Commission expected to develop criteria for hedging which would be objective, clear and easily determinable.

As discussed in the Haircut Release, data provided to the Commission tended to confirm doubts as to the adequacy of the present haircut provisions. The data were compiled from records accumulated by brokerage firms in the ordinary course of dealing in debt securities. In general, the data were covered a period of 49 months from February 1976 through February 1980. In the case of Government securities, daily values were provided for 3 month, 6 month, 9 month and 12 month Treasury bills and for selected 2 year, 5 year, 10 year, 20 year and 30 year coupon Treasury bonds. For municipals, weekly prices were extracted from the Bond Buyer Municipal Index. The data showed that the month-end to month-end price movements in most debt securities in the months of January 1977, October 1979, January 1980 and February 1980 were greater than the existing haircuts for the securities. They indicated a need for higher haircuts than the Rule presently provides.

The New York Stock Exchange (the "NYSE"), the National Association of Securities Dealers (the "NASD"), the Securities Industry Association (the "SIA") and several brokers and dealers presented well-reasoned comments which the Commission has integrated into its own proposals. These groups also presented the Commission with extensive new data on debt instruments, updating the previously furnished data.

In view of the complexity of provisions in the proposed amendments that would allow brokers and dealers to elect to recognize hedges among Government securities with different maturities and between Government and nonconvertible debt securities and the possible difficulty of computing appropriate deductions for such securities, the Commission is reproposing those provisions for comment.

The Commission, however, is not soliciting comment with regard to the specific percentage deductions for debt

[1] Securities Exchange Act Release No. 17209 (Oct. 9, 1980), 45 FR 69911 (Oct. 22, 1980).

securities because of its belief that its proposed deductions adequately reflect the increased volatility in the Government securities marketplace.

The Commission is also reproposing for comment haircuts on preferred stock and is proposing for comment haircuts on redeemable securities of registered investment companies which invest solely in debt instruments. Finally, the Commission is proposing for comment amendments to the Rule codifying existing staff interpretations, with some modifications, with respect to the treatment of repurchase, reverse-repurchase and matched repurchase agreements.

I Government Securities

Haircut Schedules

The Rule requires, in the case of a security issued or guaranteed as to principal or interest by the United States or any agency thereof, deductions from net worth equal to a percentage of the net long or short position in each category described in subparagraph (A) of the haircut provisions of the Rule. There is no deduction for securities having less than one year to maturity. The deduction for securities having one year but less than three years to maturity is 1%; that for securities having three years but less than five years to maturity is 2%; that for securities with five years or more to maturity is 3%.

The data submitted to the Commission by the SIA in 1979 indicated that these haircuts were inadequate in measuring the risk in carrying the securities, particularly those securities with less than one year to maturity and those with five years or more to maturity. That data showed that the majority of monthly changes in market value were greater than the existing haircuts and that, for some months, the month-end to month-end price movements were considerably greater than the existing haircuts. For example, in 26 of the 49 months in the survey, Treasury bills maturing in 6 months moved in price between one-tenth of 1% to over 1%. In one month, Treasury bills maturing in nine months moved 1.50% and in February 1980, 1.90%. Finally, in 39 of 49 months, Treasury bills maturing in 12 months moved between .1% and 2.51% (February 1980). In each case, however, the Rule required no haircut.

The data for 2 year coupon bonds, 5 year coupon bonds, 10 year coupon bonds, 20 year coupon bonds and 30 year coupon bonds showed the same discrepancies as securities having 1 year or less to maturity. For example, in 3 different months within a 6 month period, Treasury bonds maturing in 30 years declined substantially: 7.06% in February 1980, 8.82% in January 1980 and 9.16% in October 1979. Yet, the required haircut for these securities is only 3%.

Based largely on these data, the Commission proposed in the Haircut Release to alter the haircuts on Government Securities in Rule 15c3-1(c)(2)(vi)(A) as follows:

(A) In the case of a security issued or guaranteed as to principal or interest by the United States or any agency thereof, the applicable percentages of the market value of the net long or short position as specified below are:

[the present haircut is indicated in brackets]

(1) Less than 3 months to maturity—0% [0];

(2) 3 months but less than 6 months to maturity—⅛ of 1% [0];

(3) 6 months but less than 9 months to maturity—¼ of 1% [0];

(4) 9 months but less than 1 year to maturity—⅜ of 1% [0];

(5) 1 year but less than 3 years to maturity—1½% [1%];

(6) 3 years but less than 5 years to maturity—3% [2%];

(7) 5 years but less than 10 years to maturity—4½% [3%];

(8) 10 years but less than 20 years to maturity—5% [3%]; and

(9) 20 years or more maturity—6% [3%].

While the proposed haircuts were not based on the largest changes in any 30 day period, the Commission believed that they nevertheless represented a more realistic appraisal of the potential movements of Government securities over a 30 day period.

Hedges

The present Rule assesses deductions only on the net long or net short positions in the fixed categories of subparagraph (A), thereby recognizing certain limited hedges. In some cases, however, the Rule may not appropriately deal with hedges. For example, the Rule requires no haircut where a broker or dealer is long a Government security 1 month to maturity and short a Government security 11 months to maturity but requires a haircut of 1% on the short position where the broker or dealer is long a security 11 months to maturity and short a security 13 months to maturity. Furthermore, the Rule requires no haircut on the following position: A long Government security, 5 years to maturity, offset by a short Government security, 30 years to maturity. Yet, the data demonstrates that the historical market fluctuations of these two securities are not similar.

In the Haircut Release, the Commission solicited comment on the degree to which the Rule should deal with hedges and proposed to alter the hedging provisions to allow long or short positions to be netted as follows:

(*i*) Long or short positions with maturity dates within 1 year may be netted against long or short positions with maturity dates within 15 months, but only when such maturity dates are within 3 months of one another;

(*ii*) Long or short positions with maturity dates of between 1 and 5 years (except as in (*i*) above) may be netted against long or short positions with maturity dates of between 1 and 6 years, but only when such maturity dates are within 1 year of one another;

(*iii*) Long or short positions with maturity dates of 5 years or more (except as in *ii* above) may be netted against long or short positions with maturity dates of 5 years or more, but only when such maturity dates are within 5 years of one another.

Industry Response

The commentators generally supported the Commission's efforts to revise the haircut schedule to reflect adequately the increased volatility of Government securities over the spectrum of maturities. Some commentators suggested reductions for certain maturities while others suggested increases. Many supported the Commission's efforts to inject greater flexibility into the haircut provisions by recognizing offsetting hedges. Others indicated a preference for computational simplicity, even at the cost of more rigid haircut categories and less flexibility to reduce applicable haircuts.

Although not discussed in this release, these comments have been reviewed extensively by the Commission and incorporated, as appropriate, in the amendments that the Commission is republishing for comment. Because the Commission believes that the SIA's proposal concerning haircuts for Government securities provides an appropriate framework for determining deductions in a manner that attempts to reflect sound industry business practices in the Government securities marketplace, the discussion that follows will focus initially on the SIA's proposal. That proposal has been modified, however, to take into account data regarding monthly price fluctuations (instead of data regarding weekly price fluctuations from which the SIA derived

its initial haircut schedules),[2] and comments from other interested persons. At this point, interested persons may wish to examine the text of the proposed rule amendments concerning haircuts on Government securities as they appear at the conclusion of this release.

The SIA submitted a proposal for revising the haircut schedules that the Commission believes would permit brokers and dealers to recognize the reduction in market risks inherent in many hedging strategies. The SIA prepared a statistical analysis of the price fluctuations of 13 separate securities issues over a 39-month period ending in March 1980. This analysis included 9 types of Treasury bills and bonds, 8% Government National Mortgage Association bonds (commonly referred to as "GNMA's"), 20-year corporate bonds having the highest rating by nationally recognized ratings services, 3-month Treasury bill futures contracts and Treasury bond futures contracts. On the basis of this statistical analysis, the SIA derived the following haircut schedule:

Category 1

(1) Less than 3 months to maturity—0%;

(2) 3 months but less than 6 months to maturity—¼ of 1%;

(3) 6 months but less than 9 months to maturity—⅜ of 1%;

(4) 9 months but less than 1 year to maturity—½ of 1%;

(5) 1 year but less than 15 months to maturity—⅝ of 1%;

(6) 15 months but less than 18 months to maturity—¾ of 1%;

(7) 18 months but less than 2 years to maturity—⅞ of 1%;

(8) 2 years but less than 2½ years to maturity—1%;

(9) 2½ years but less than 3 years to maturity—1¼%;

Category 2

(10) 3 years but less than 5 years to maturity—1¾%;

(11) 5 years but less than 7 years to maturity—2%;

(12) 7 years but less than 10 years to maturity—2¼%.

Category 3

(13) 10 years but less than 20 years to maturity 2½%;

(14) 20 years or more to maturity—3%.

The categories are based on traditional definitions of what constitutes long, intermediate and short-term debt instruments. The division of the sub-categories was determined by an analysis of the statistical data indicating which positions had the strongest relationships to other positions. As proposed for comment in this release, however, the categories and sub-categories have been modified to take into account monthly rather than weekly data and to reflect the historical relationship among securities with different lengths to maturity without unnecessarily increasing the number of sub-categories.

The SIA proposed that the haircut for each category should be determined by brokers and dealers using the following seven step process:

Step 1: For each category, compute the net long or short positions for each sub-category.

Step 2: Apply the appropriate haircut to each of the net long or short positions.

Step 3: Aggregate the haircuts for all the net short positions.

Step 4: Aggregate the haircuts for all the net long positions.

Step 5: Take the smaller of the result of step 3 or step 4 and multiply by 65%.

Step 6: Net the aggregate long haircuts and short haircuts computed in Steps 3 and 4.

Step 7: Total the results of Step 5 and Step 6 to arrive at the haircut for the category.

The computation process includes the "weighting" of subcategory haircuts in determining the overall haircut for the category and is regarded by the SIA as providing a regulatory requirement that corresponds to the limitation of economic risk arising from hedging techniques. Permitting only a partial offset of haircuts among subcategories within each category, according to the SIA, is necessary to account for the increasing fluctuation in prices and yields as the difference in dates to maturity of the long and short positions increase. At the same time, however, permitting a partial offset of haircuts among sub-categories recognizes that the market risks of holding both positions are historically less than the total deduction that would be required with respect to each position if the haircut schedule did not permit hedging of securities in different sub-categories. Thus, for example, a long position consisting of $1 million of three month Treasury bills does not entirely offset a short position consisting of $1 million of six month Treasury bills.

The SIA's hedging formula also prescribes a safety factor that is a percentage of the lesser of the aggregate net long or net short positions within each category. By including the safety factor in the haircut computation for each category, the computation takes into consideration the degree to which the various security positions act as hedges for each other. Since the haircuts for the sub-categories reflect only the manner in which the market value of the individual security positions within a particular sub-category fluctuates, the safety factor adds a measure of how the market value of the sub-categories vary with each other.[3] The SIA determined that the safety factor for a haircut schedule based on an analysis of 30 day price fluctuations would be 48% rather than the 65% originally recommended. For ease of computation and to provide an added measure of safety in the case of portfolios with an undue concentration in a particular sub-category, the Commission has increased the safety factor to 50%.

Because fixed categories would impose arbitrary restrictions forbidding the recognition of otherwise bona-fide risk-limiting hedges, the Commission has included in the proposed amendments a provision whereby a broker or dealer can elect to recognize some cross-category hedges. Under that provision, an electing broker or dealer could exclude the market value of a long or short security from one category and a security from another category provided that such securities have maturity dates: (1) Between 9 months

[2] The SIA chose to examine volatility on a weekly basis using readily available data supplied by the Federal Reserve Bank of New York. This data described the 1980 average value of daily transactions and the average turnover for Government securities. The data indicated that dealers, on the average, turn over their inventory every 1.5 days. The use of weekly volatility data instead of monthly volatility data as the basis for determining haircuts appears to be inappropriate. While the SIA's data reflect the experience of 35 Government securities dealers, it is substantially distinct from that of other registered brokers and dealers; *e.g.*, only one-third of these Government securities dealers are registered brokers or dealers. Historically, the haircut schedules have been based on a 30-day period. This 30-day time period represents the accepted industry accounting cycle and, under the recordkeeping rules, is the frequency within which brokers and dealers are required to make and preserve a full net capital computation, even though the Rule requires continuous compliance. Thus, the Commission believes that haircuts on Government securities under the Rule should be based on an average holding period of 30 days and should anticipate adverse market fluctuations occurring over a 30-day period. Accordingly, the Commission asked the SIA to prepare a statistical analysis of the 30-day price fluctuations. From this analysis, the Commission extracted the proposed haircut schedule as published in this release. The SIA's analysis indicated that larger haircuts were warranted for the very short maturities but that the haircut schedule as published in the Haircut Release was appropriate for the other maturities.

[3] The safety factor was derived by analyzing the covariance coefficients of each security position to formulate the safety factor in terms of a percentage of the lesser of the aggregate haircut on the long positions or the aggregate haircut on the short positions within a given category.

and 15 months and within 3 months of one another; (2) between 2 years and 4 years and within 1 year of one another; or (3) between 8 years and 12 years and within 2 years of one another. The electing broker or dealer, however, would be required to include the net market value of the two securities in the category for the security with the longer date to maturity.

Futures Contracts

The Commission proposes to amend the Government securities haircut provisions to permit brokers and dealers to exclude long or short positions in Government securities that are hedged by certain futures contracts.[4] To qualify, the futures contract must be traded on a regulated market and must provide for the delivery of a Government security with a maturity date that would be within a specified range of the maturity date of the long or short Government securities position the broker or dealer seeks to exclude.

Brokers and dealers electing to exclude certain Government securities positions hedged by futures contracts, however, would be required to take the appropriate deduction from net worth in accordance with the requirements of existing Appendix B to the Rule.

Simplified Computation for Brokers and Dealers

The NYSE, the NASD and others expressed concern about the complexity of a haircut rule that would permit substantial hedging. The Commission's revised amendments will require greater precision and more work in determining applicable hedges. Brokers and dealers will be required to classify Government securities in their portfolios according to more distinct maturity dates and, if they wish to use the special hedging provisions, will be required to compare maturity dates. The Commission is concerned that the benefits of the proposals—reduction in required capital and capital requirements that are more compatible with economic reality—for some firms may be outweighed by the added computation costs.

The NYSE suggested that an additional section be added to the SIA's proposal that, as an alternative to the computation of haircuts under the SIA proposal, would allow a broker or dealer to deem all long and short positions as falling into the category of the position with the longest term to maturity and, without any netting of long and short positions, would require the deduction of the applicable percentage of the market value of both long and short positions. Although this alternative would not permit reductions in haircuts for hedging, it would simplify the computation for those brokers or dealers that do not have extensive Government securities inventories.

Accordingly, the Commission proposes, as an alternative to the principal haircut procedure, a simplified procedure for computing applicable haircuts that should satisfy the concerns of commentators that the Rule continue to provide a simple and direct method for computing required deductions from net capital. This procedure would require an electing broker or dealer to apply the percentage deduction provided in the schedule to the value of each net long or short position in Government securities in the 12 subcategories, and would prohibit any hedging between sub-categories or adjacent categories. By netting long and short positions within sub-categories, however, the Rule would continue to permit some risk-taking hedges by electing brokers and dealers.

II. Municipal Securities

Under the current Rule, haircuts for municipal securities are divided into two categories. The first category prescribes haircuts for short term municipal notes having a maturity of 731 days or less and which are issued at par value and pay interest at maturity, or which are issued at a discount and which are not traded flat or in default as to principal or interest.[5] The second category prescribes haircuts for any other municipal security which is not traded flat or in default as to principal or interest. This second category has four subcategories which presently require haircuts ranging from 1% for securities with less than one year to maturity to 5% for securities with five years or more to maturity.

In the Haircut Release, the Commission proposed to increase the haircut for municipal securities in the second category with more than two years to maturity.[6] The Commission also solicited comment on what criteria should be used to determine the market value of municipal securities for net capital purposes where the securities are the subject of quotations only by the computing broker or dealer. Finally, the Commission requested comment on whether the haircut provisions for municipal securities should distinguish between "rated" and "unrated" securities to differentiate between investment grade and more speculative issues.

Haircut Schedules

Data developed in the course of the rulemaking process revealed that the existing haircuts for municipal securities were not adequate to cover price fluctuations in the municipal bond market during the past years.[7] Accordingly, the Commission proposed to increase the haircuts for municipal bonds having at least two but less than five years to maturity from 3% to 5% and for municipal bonds having five or more years to maturity from 5% to 7%.

In response to the proposal, the Public Securities Association (the "PSA"), disputed the appropriateness of increasing the haircuts for certain long term municipal securities. The PSA stated its belief that the current haircut schedules for municipal securities were adequate to protect investors and that the increased haircuts proposed by the Commission would have an adverse impact on the municipal bond market. The PSA, however, did not submit any data to demonstrate the validity of these beliefs. Rather, it noted that in response to market volatility firms take independent action to reduce market risks.

The SIA, while conceding that recent volatility in the market for municipal bonds justified an increase in the haircuts for such securities, recommended increases more modest than those proposed by the Commission. More specifically, the SIA proposed that the haircut for municipal bonds with at least 2 but less than 5 years to maturity be increased from 3% to 3.5%, that a separate haircut category be created for municipal bonds with at least 5 but less than 10 years to maturity and that the haircut be 5% and, finally, that the haircut for municipal bonds with at least 10 years to maturity be increased from

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[4] Exchange listed options on debt securities will be factored into a formula as the options begin trading. A separate haircut schedule as to GNMA options has already been approved. *See* letter from the Division of Market Regulation to the Chicago Board Options Exchange, Inc. dated Sept. 29, 1981. The Commission solicits comment and analysis on the impact of this development.

[5] This category contains seven subcategories prescribing haircuts ranging from 0% for those securities having less than 30 days to maturity to 1% for those securities having maturities from 456 to 731 days.

[6] The Commission did not propose new haircut schedules for municipal securities in the first category or municipal securities in the second category with less than two years to maturity due to lack of sufficient data. It solicited comment on this matter but received none.

[7] This data was compiled by brokerage firms dealing in debt securities (including municipal bonds) over a 49 month period from February of 1976 through February of 1980. Weekly prices were extracted from the Bond Buyer Municipal Index. The data showed that municipal bond prices moved 8.58% in October 1979 and 11.05% in February 1980.

5% to 5.5%. The SIA's proposed haircuts were based on data compiled on the relative price movements of 30 municipal bonds.

Unprecedented increases in interest rates in recent years have caused precipitous declines in the market values of municipal securities already issued. According to a study recently conducted by the Commission staff, 34 municipal securities dealers (banks and registered brokers and dealers) ceased doing business in the past year. Although in some cases financial difficulties could be attributed to fraud or some other impropriety, it appears that many firms went out of business either because of sharp declines in the value of their inventories or simply because the market for municipal bonds had "dried-up."

The Commission is concerned that volatility in the municipal bond market will not abate in the near future. Recent events, such as reduction in maximum personal federal income tax rates indicate continued uncertainty in the municipal securities marketplace. Interested persons are invited to submit objective data and to discuss the impact of the proposed amendments on the municipal securities marketplace.[8]

Market Value of Municipal Securities

Rule 15c3–1(c)(2)(vii) requires that a broker or dealer in computing net capital deduct 100% of the carrying value of securities in the proprietary or other accounts of the broker or dealer for which there is no "ready market." Subparagraph (c)(11)(i) of the Rule provides that a "ready market" includes a recognized established securities market in which there exists independent bona fide offers to buy and sell.

At the time the Rule was adopted, the Commission, recognizing that the structure of the municipal markets did not resemble the corporate securities markets on which the marketability provisions of the Rule were premised, decided to suspend, by interpretation, the application of Rule 15c3–1(c)(2)(viii) to municipal securities pending forthcoming development of appropriate marketability criteria. In the Haircut Release, the Commission requested comment regarding the appropriate criteria to determine the market value of municipal securities for net capital purposes where the securities are the subject of quotations only by the computing broker or dealer.

[8] Companion releases may provide some measure of relief for those brokers or dealers which use the alternative method of computing net capital.

Since 1977, the NASD has been recommending that the Commission adopt the concept of "presumed marketability" for pricing municipal securities. This concept is based on the premise that, although a particular municipal security is not actively traded on a recognized established securities market, all such securities have value, are marketable and can be sold. Conversely, the PSA recommended maintenance of the "status quo" and objected to the alternative marketability criteria developed and proposed by the NASD. According to the PSA, the present practice of not applying the ready market provisions to municipal securities has worked relatively well.

The interim period during which applications of the marketability provisions to municipal securities has been suspended has lasted almost seven years. It has not worked well because it has been difficult, if not impossible, for anyone to value the positions of a firm holding such securities. The Commission believes that the "presumed marketability" test suggested by the NASD is responsive to the structure of the municipal marketplace and is a reasonable alternative to the continued suspension of Rule 15c3–1(c)(2)(vii) to municipal securities. Accordingly, the Commission proposes to rescind the interpretation embodied in Securities Exchange Act Release No. 11854[9] suspending the application of the marketability provisions to municipal securities and to adopt the following:

> If a municipal security has no ready market, a broker or dealer shall value it at cost for a period of 30 calendar days following settlement date.[10] In the absence of further valid price or transaction data, a firm shall mark down the value of each position by 5% of the cost per month until the value has declined to 50% of its originally assigned value. Thereafter, the position shall be valued at zero and considered a non-marketable security for net capital purposes.

Ratings for Municipal Securities

In the Haircut Release, the Commission solicited comment concerning whether the haircut provisions should distinguish between "rated" and "unrated" municipal securities to differentiate between investment grade and more speculative issues. Currently, under Rule 15c31(c)(2)(vi)(E) and (F), commercial paper, and nonconvertible debt securities receive more favorable capital treatment if they are rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations.

[9] Securities Exchange Act Release No. 11854 (Nov. 20, 1975), 40 FR 57786 (Dec. 12, 1975).

[10] The NASD originally recommended that municipal dealers be allowed to value their inventories at cost for a period of 60 calendar days following settlement date. Upon examination, however, the Commission determined that 60 calendar days was too long and proposed that the period should be 30 calendar days.

While the Commission believes that ratings for municipal securities may ultimately be appropriate for distinguishing between investment grade and speculative issues, it does not at this time have sufficient information to formulate an appropriate provision. Thus, for the time being, the Commission proposes that there be no distinction between rated and unrated municipal securities for purposes of haircutting municipal securities under the Rule.

III. Nonconvertible Debt Securities

Haircuts

Rule 15c3–1(c)(2)(vi)(F) requires, in the case of nonconvertible debt securities having a fixed interest rate and fixed maturity date and which are rated in one of the four highest rating categories by at least two of the nationally recognized statisitical rating organizations, haircuts ranging from 1% for those securities with less than one year to maturity to 7% for securities with five years or more to maturity.

In the Haircut Release, the Commission solicited comment regarding the appropriate haircuts for nonconvertible debt securities with less than five years to maturity. On the basis of available data, the Commission proposed to increase the haircut on long term nonconvertible debt securities (securities with more than five years to maturity) from 7% to 9%.

The Commission received few comments regarding the proposed amendment. The NYSE proposed that, in lieu of providing separate categories, a broker or dealer be allowed to lump all long and short positions into the category of the position with the longest term to maturity and deduct the applicable percentage of the market value of the greater of the long or short position. The Commission believes that such an approach, although simplifying computation of haircuts, would not adequately reflect the volatility of particular securities. Furthermore, the NYSE's proposal would require a broker or dealer to set aside an unduly and unnecessarily large sum of capital, since it would require the broker or dealer to take an unnecessarily large haircut on shorter term nonconvertible debt securities.

The NASD suggested that the Commission reduce the number of

categories in the haircut schedule from six to four and change the applicable percentages to coincide with those for municipal securities. Absent further data, however, the Commission does not believe that a reduction in the number of categories is warranted or that nonconvertible debt securities have the same volatility as their respective counterparts in the municipal securities categories.

The Commission believes that, in order to represent more accurately the volatility of nonconvertible debt securities, it is appropriate to raise the percentage haircuts in the schedule of maturity categories.

Hedges

In the Haircut Release, the Commission solicited comment on the degree to which the haircut provisions should deal with hedges among different securities. The Commission invited interested persons to submit data with regard to hedging among securities of different issuers. The Commission indicated that it may be possible to establish hedging criteria that are objective, clear, and easily determinable for reducing any required haircuts.

Most commentators supported, as a matter of principle, a reduction in haircuts under the Rule for hedged securities positions. Commentators noted that requiring haircuts on both the long and short components of a hedged position penalizes brokers and dealers for avoiding market risks.

Debt obligations of the United States Government, because of the virtual absence of credit risk, are widely used by brokers and dealers to price debt securities issued by corporations and other entities. The historic price relationship between debt obligations of the United States Government and other debt instruments, particularly noncovertible debt securities, appears to continue in the secondary market. Although the relative market prices of a particular issue of Government debt securities and a particular issue of nonconvertible debt securities may vary in response to such factors as changes in interest rates and relative supply and demand, the variation in the differences between the prices of the two debt obligations (the "spread") appears to be relatively narrow.

The Commission examined the range of dollar price spreads over a 6 month period between 31 corporate debt securities (including 13 industrials, 6 telephone and 12 utilities) and 4 Treasury bills that would appear to be logical choices for hedging market risks associated with long positions in the corporate debt securities. The spreads between the corporate debt securities and the appropriate hedging Government debt obligations did not vary significantly with different types of corporate obligations of the same maturity. Although the range of spreads varied depending on the date of maturity of the hedged positions, all hedged positions appeared to have spread fluctuations that, with the exception of corporate debt securities with maturity dates of less than 2 years, were less than half of the percentage deductions that are currently required under the Rule.

On the basis of this somewhat limited study, the Commission believes that it is appropriate to propose amendments to the Rule that would allow brokers and dealers to reduce applicable haircuts on nonconvertible debt securities that are hedged by certain debt obligations of the United States or agencies thereof. The proposed amendments, if adopted, would permit a broker or dealer to exclude from the haircut categories in computing haircuts on nonconvertible debt obligations those securities that are hedged by short or long positions in securities issued by the United States or any agency thereof having certain specified maturities.

The amendments would also permit the exclusion of the long or short position in Government securities from the applicable categories under Rule 15c3-1(c)(2)(iv)(A), thereby eliminating the requirement that the broker or dealer take a deduction with respect to both the long and short components of the hedged position. The amendments would require, however, that the electing broker or dealer deduct a specified percentage of the market value of the hedged nonconvertible debt securities position (depending upon its length to maturity), that would be generally equal to one-half of the percentage deduction that would otherwise be required with respect to a long or short position in nonconvertible debt securities of the same length to maturity. The required deduction under the amendments would also be substantially below the combined deduction that would be required if a haircut with respect to the Government securities position were also required.

The Commission specifically requests commentators to submit additional data concerning the price spreads of nonconvertible debt securities that are hedged by Government debt obligations. The Commission also invites commentators to submit data on price spreads involving other hedging strategies.

IV. Preferred Stock

Rule 15c3-1(c)(2)(vi)(H) requires in the case of cumulative, nonconvertible preferred stock a deduction of 20% of the market value of the greater of the long or short position. In its 1979 Report to the Commission on the net capital rule, the SIA proposed that the haircut on preferred stock be reduced from 20% to 15% for firms electing the Alternative.

In Securities Exchange Act Release No. 17208,[11] the Commission noted that the SIA failed to address the fact that the prices of preferred stocks tend to move in tandem with those of debt instruments and are thus influenced by factors other than those affecting common stocks. Noting that the present haircuts for debt securities are based on historical data of the fluctuation of these instruments over a long period, the Commission stated tht the same kind of record should be made for preferred stocks. The Commission also observed that, since preferred stocks, like corporate debt securities, are rated by nationally recognized statistical rating rating services, it might be appropriate to require a greater haircut for those preferred stocks that are not rated in the higher categories by statistical rating services.

In response to the Commission's proposal, the SIA revised its proposal and recommended that the haircut on nonconvertible preferred stock for firms electing the Alternative be lowered to 10% for securities rated on one of the four highest categories by statistical rating organizations and 15% for all other nonconvertible preferred stock. This revised proposal was based on data submitted by the SIA indicating that a 10% haircut for utility preferred stocks rated in one of the four highest categories by a nationally recognized statistical rating organization would cover approximately 95% of the monthly price movements.

Preferred stock is a hybrid security. While some of its characteristics are similar to those debt obligations, others more closely approximate those of equity securities. For this reason, problems related to this class of security are derived in part from those of debt obligations and in part from those of equity securities.

As approximately 85% of preferred stocks are rated by nationally recognized statistical rating organizations, the Commission believes it would be appropriate to treat those preferred stocks that are rated in one of the four highest categories by those

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

organizations in the same manner as nonconvertible debt securities. The higher rated preferred stocks present virtually no risk of non-payment of dividends when due. Giving preferential treatment to higher rated preferred stocks would more fairly reflect the degree of risk involved.

Accordingly, the Commission proposes to reduce the haircut from 20% to 10% for nonconvertible preferred stocks which are rated in one of the four highest categories by at least two of the nationally recognized statistical rating organizations.

With respect to lower rated preferred stocks, however, the Commission believes it would be more appropriate to treat these securities like common stock. This is primarily because, since the financial health of the issuer affects its ability to pay dividends on its preferred stock, the price of lower rated preferred stocks is more likely to approximate the volatility of the issuer's common stock rather than its debt obligations. Since Rule 15c3-1(c)(2)(vi)(H) will deal only with higher rated preferred stocks, every other issue will thereby be treated under Rule 15c3-1(c)(2)(vi)(J) which requires a haircut of 30%. For those firms on the Alternative, however, the haircut will only be 15%.

V. Securities of Certain Registered Investment Companies

Rule 15c3-1(c)(2)(vi)(D) requires in the case of securities of registered investment companies a deduction of 5% of the greater of the long or short position, if the assets of the investment company consist exclusively of one or more of the following: (1) Cash; (2) securities issued or guaranteed as to principal or interest by the United States Government or an agency thereof; (3) municipal securities; (4) securities issued or unconditionally guaranteed by the Canadian Government; (5) commercial paper which is rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations; and (6) bankers acceptances and certificates of deposit issued by any bank as defined in Section 3(a)(6) of the Securities Exchange Act of 1934.

In light of proposed changes in the haircut schedules for certain debt securities, the Commission believes it appropriate to adjust the haircut provisions relating to redeemable securities issued by registered investment companies investing in such debt securities. The Commission also believes that Rule 15c3-1(c)(2)(vi)(D) should be amended to clarify that it applies only to "redeemable" securities of registered investment companies.

With respect to the haircut provisions, the Commission proposes to amend the Rule to provide for: (1) A deduction of 2% of the market value of the greater of the long or short position of redeemable securities of a registered investment company whose assets consist of investments restricted to debt securities with one year or less to maturity ("the 2% Haircut") ("money market funds"), (2) a deduction of 7% of the market value of the long or short position of redeemable securities of a registered investment company whose assets consist of investment in long-term debt securities (other than corporate debt securities) with one year or more to maturity ("the 7% haircut"); and (3) a deduction of 9% of the market value of the long or short position of redeemable securities of a registered investment company whose assets consist of investments in long-term debt securities and nonconvertible debt securities ("the 9% Haircut").[12]

The 2% Haircut

Redeemable securities issued by investment companies are required to be sold and redeemed at their current net asset value. The current net asset value per share is the current market value of the company's assets less liabilities divided by the number of shares outstanding.[13] As a result, the net asset value per share would fluctuate with the market value of the investment company's portfolio. Since, however, most money market funds have obtained exemptive relief from the Commission to allow them to maintain a constant price per share (usually $1), few have fluctuating net asset values.

While the Commission recognizes that minimal risks are involved with maintaining positions in money market instruments, it nontheless recognizes that some risks are involved in managing the assets of the money market fund. Even though under normal circumstances the broker or dealer should be able to recover the full principal of his investment, the possibility of loss does exist. For these reasons, the Commission proposes a 2% haircut for redeemable securities of registered investment companies which invest in short-term debt securities with one year or less to maturity.

The 7% Haircut

Due to the changes in the haircut schedules for long-term Government and municipal securities, the Commission believes that it is appropriate to adjust the haircut provision for redeemable securities of investment companies which invest in those securities. Accordingly, since the Commission is proposing to increase the haircut for long-term Government securities to 6% and the haircut for certain long-term municipal securities to 7%, the Commission proposes a haircut of 7% for redeemable shares of registered investment companies which invest in those securities.

The 9% Haircut

The 9% Haircut applies to securities of all other investment companies which, in addition to investing in Government and municipal securities, invest in high-quality nonconvertible debt securities. It has been the Commission's experience that nonconvertible debt securities are subject to a much greater risk of fluctuation in their market value, especially those with five years or more to maturity. Thus, investment companies which invest in these securities bear a greater risk. In order to protect against such market fluctuations, the Commission proposes a haircut of 9% for redeemable securities of registered investment companies which invest in long-term nonconvertible debt securities.

VI. Repurchase, Reverse-Repurchase and Matched Repurchase Agreements

The use of repurchase, reverse-repurchase and matched repurchase agreements by brokers and dealers as a means of financing proprietary, customer and institutional securities positions, primarily Government securities positions, has increased substantially during the past 10 years. These agreements, as represented on the balance sheets of brokerage firms, constitute the single largest liability and asset.[14]

A repurchase agreement, viewed from the perspective of a broker or dealer, is a method of financing a particular securities position, primarily Government securities and Federal

[12] Nonconvertible debt securities are defined in Rule 15c3-1(c)(2)(vi)(F) as those securities having a fixed interest rate and fixed maturity date and which are not traded flat or in default as to principal or interest and which are rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating services.

[13] See Rule 22c-1 of the Investment Company Act.

[14] According to data compiled by the Commission's Directorate of Economic and Policy Analysis, securities purchased under agreements to resell represented 32.0% of the aggregate total assets and securities sold under repurchase agreements represented 32.6% of the aggregate total liabilities of the approximately 2,532 broker-dealers that filed four quarterly FOCUS Reports in 1979. *See* Securities and Exchange Commission, *Staff Report on the Securities Industry in 1979*, at 24-28 (1980).

agency securities, whereby the broker or dealer sells the securities to another party subject to a commitment to repurchase the same securities at some future date. The broker or dealer usually obtains funds representing nearly 100% of the value of the securities and the repurchase price usually includes what is essentially an interest payment. A reverse-repurchase agreement is simply the other side of a repurchase transaction. Thus, when viewed from the perspective of a broker or dealer, a reverse-repurchase agreement represents an agreement whereby a broker or dealer agrees to finance a securities position of another party; the broker or dealer agrees to purchase securities from another party subject to a commitment to resell the same securities to that party.

A matched repurchase agreement represents a transaction whereby a broker or dealer provides financing for securities held by others by selling all or part of the securities to another party under a repurchase agreement. Maturities of repurchase, reverse-repurchase and matched repurchase agreements vary from 1 day to over 90 days, although the majority of these agreements mature in less than 30 days.[15]

Based upon concerns expressed by brokers and dealers, the Commission staff indicated by way of informal interpretation that, in repurchase transactions with certain persons, a broker or dealer could deduct, in lieu of total deficit,[16] a percentage of the total deficit with respect to a reverse-repurchase agreement determined by reference to the number of days to maturity of that agreement as of the net capital computation date as follows:

(1) 30 calendar days or less to maturity—0%.

(2) 31 calendar days to 90 calendar days to maturity—25%.

(3) 91 calendar days or more to maturity—100%.

In addition, the Commission staff stated that a charge should be taken equal to the amount by which the deficit in all reverse-repurchase agreements with 90 calendar days or less to maturity exceeds 5% of net capital before the application of subparagraphs (c)(2)(bi), (f)(3) or Appendix A to the Rule. Finally, the Commission staff indicated that the excess collateral in one reverse-repurchase agreement could be used to reduce the deficit in the same account or related accounts of the same "customer or non-customer."[17]

The Commission is proposing to amend Rule 15c3-1(c)(2)(iv) to clarify the treatment of repurchase, reverse-repurchase and matched repurchase agreements. The Commission believes that the proposed amendments will provide an appropriate framework for a discussion of these agreements, including the risks to brokers and dealers and customers of brokers and dealers and how these agreements should be treated under the financial responsibility rules.[18] The Commission also believes that these proposed amendments, if adopted, will eliminate some uncertainties surrounding the treatment of reverse-repurchase agreements and the different components of matched repurchase agreements under the Rule.

The proposed amendments would not change the current treatment of repurchase agreements and, if adopted, would codify the exclusion from the applicable haircut provisions of the Rule of those securities that are sold subject to repurchase as a component of matched repurchase agreements. Furthermore, the proposed amendments would codify the treatment currently accorded reverse-repurchase agreements (individually and as components of matched repurchase agreements)[19] and would require a deduction equal to only 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 of the reverse-repurchase agreement. The proposed amendments, however, would alter the percentage deduction required with respect to 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.

The Commission invites commentators to explore the credit risks to brokers and dealers and to address whether these transactions raise regulatory concerns under the federal securities laws. In particular, brokers and dealers are invited to submit sample agreements and data concerning average daily commitments under repurchase, reverse-repurchase and matched repurchase agreements, length to maturity of these agreements, fluctuations in market value of securities under these agreements, and history of loss in connection with these agreements.

Summary of Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (the "Analysis") in accordance with 5 U.S.C. 603 regarding the proposed amendments to Rule 15c3-1.

The Analysis notes that the amendments to Rule 15c3-1 are being proposed as a part of the Commission's

[15] According to a 1977 survey of 46 large member banks by the staff of the Board of Governors of the Federal Reserve System, 10% of their repurchase agreements extended for periods beyond 30 days; 39% ranged from 2 to 30 days; and 42% matured overnight or were terminable without advance notice. Approximately 25% of the average daily dollar volume of repurchase agreements with securities dealers, however, matured in more than 30 days. *See* "Repurchase Agreements and Federal Funds." *Federal Reserve Bulletin* at 353, 355–57 (May 1978).

[16] The Commission described the net capital treatment to be accorded repurchase, reverse-repurchase and matched repurchase agreements in Securities Exchange Release No. 11497 (June 26, 1975), 40 FR 29795 (July 16, 1975) (the "1975 Release"). Securities sold subject to repurchase agreements were to be treated as if owned by the broker or dealer with an appropriate haircut applied to the market value of the securities. Securities purchased under a reverse-repurchase agreement were to be treated as a secured receivable, inasmuch as the other party, in effect, borrowed funds from the broker or dealer; therefore, the broker or dealer was required to take a charge with respect to the deficiency, if any, in the securities collateralizing the receivable. Finally, the Commission stated that "matched repurchase agreements which result in fully secured matched contractual commitments to buy or sell U.S. Government securities should not normally receive a capital charge." Brokers and dealers argued that requiring a capital charge with respect to a reverse-repurchase agreement equal to the total deficit between the amount paid by the broker or dealer and the market value of the securities could have a significant negative impact on brokers and dealers reverse-repurchase operations.

[17] *See* NYSE Interpretation Handbook: Regulation and Surveillance at 139–140 (1979) [hereinafter "NYSE Interpretation Handbook"].

[18] Since a reverse-repurchase transaction, in essence, is a secured loan and is carried on the books of the broker or dealer as a secured receivable, a decline in the market value of the securities exposes the broker or dealer to a credit risk. In the event that the other party to the reverse-repurchase agreement refuses to accept delivery of the securities, the broker or dealer may be exposed to a loss in excess of any unrealized profit. Moreover, the existence of a matched repurchase agreement with regard to all or some of the securities subject to the reverse-repurchase agreement does not appear to substantially reduce or eliminate this credit risk, since the other party to the repurchase component of the matched repurchase agreements almost always will deliver the securities to the broker or dealer in the event of a decline in the value of the securities in order to obtain the return of cash.

[19] Although the 1975 Release excludes fully secured matched repurchase agreements, Commission staff interpretations, as reported in the NYSE Interpretation Handbook, imply that a haircut may be required with respect to the repurchase side of the matched repurchase agreement. *See* NYSE Interpretation Handbook at 140.

review of the broker-dealer financial responsibility and customer protection rules. The proposed amendments are intended, among other things, to reflect in the rule more accurately changing economic conditions and business practices in the securities industry.

The Analysis notes that the amendments to Rule 15c3–1 with respect to haircuts on securities would apply to all brokers or dealers that hold such securities and, therefore, could affect all brokers and dealers, including small brokers and dealers.[20]

The proposed amendments to Rule 15c3–1, as discussed in the Analysis, would change the amount of deductions required to be taken by brokers and dealers in computing regulatory capital requirements, and in the case of government securities the method by which the deductions are computed. A change in the applicable deductions will result in a change in the amount of cash or other liquid assets which a broker or dealer must maintain to satisfy regulatory requirements. An increase in applicable deductions may force some brokers and dealers to obtain additional capital through an offering of equity interests or through loans under subordinated loan agreements (which must satisfy the requirements of Appendix D to Rule 15c3–1).[21] For those brokers and dealers, including small brokers and dealers, that compute net capital under the alternative method, it would appear that an increase costs under the proposed amendments will be more than offset by the reduction in minimum regulatory capital requirements announced today in Securities Exchange Act Release No. 18417. For those that compute their net capital requirements using the basic method, the proposed amendments may, however, result in an overall increase in regulatory capital costs. Finally, the Analysis notes that reporting and recordkeeping requirements for all brokers and dealers would not appear to be significantly altered.

The Commission recognizes the need to formulate compliance and reporting requirements that take into account the economic impact on small brokers and dealers. The Regulatory Flexibility Act directs the Commission to consider significant alternatives to the proposed amendments that would accomplish the stated objectives of applicable statutes and minimize any significant economic impact on small brokers and dealers. As discussed in the Analysis, the Commission believes that it would be inconsistent with the purposes of the Exchange Act to exempt, categorically, any small brokers and dealers from the proposed provisions of these amendments. The Commission, however, has devised an alternative to the proposed provisions for computing haircuts on U.S. Government securities that, as discussed earlier in this release, it believes, will substantially reduce the costs to small brokers and dealers in computing those haircuts. The other proposed amendments do not appear to entail significant additional computational costs and do not appear to impose additional reporting or recordkeeping requirements on small brokers and dealers.

A copy of the Analysis may be obtained by contacting Michael A. Macchiaroli, Division of Market Regulation, U.S. Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549 at (202) 272–2372.

Statutory Basis

Pursuant to the Securities Exchange Act of 1934 and particularly Sections 15(c)(3) and 23(a) thereof, 15 U.S.C. sections 78(c)(3) and 78*w*(a), the Commission proposes to amend § 240.15c3–1 in Chapter II of Title 17 of the Code of Federal Regulations in the manner set forth below.

Text of Proposed Amendments

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

It is proposed to amend 17 CFR Part 240 as follows:

By adding paragraph (c)(2)(iv)(F) to § 240.15c3–1 and revising (c)(2)(vi) (A), (B)(*2*), (D), (F) and (H) to read as follows:

§ 204.15c3–1 Net capital requirements for brokers or dealers.

* * * * *

(c) * * *

(2) * * *

(iv) * * *

(F)(*1*) For purposes of this subparagraph:

(*i*) The term "repurchase agreement" shall mean an agreement to sell securities subject to a commitment to repurchase from the same person securities of the same quantity, issuer and maturity;

(*ii*) The term "reverse-repurchase agreement" shall mean an agreement to purchase securities subject to a commitment to resell the same person securities of the same quantity, issuer and maturity; and

(*iii*) The term "matched repurchase agreement" shall mean the purchase of securities pursuant to a reverse-repurchase agreement and the resale of such securities pursuant to a repurchase agreement.

(*2*)(*i*) In the case of a reverse-repurchase agreement, the deduction shall be equal to a percentage of the difference between the contract price for resale of the securities under the reverse-repurchase agreement and the market value of those securities, determined on the basis of the date to maturity of the reverse-repurchase agreement, as of the net capital computation date, as follows:

(*A*) 7 days or less: 0%

(*B*) 8 days to 14 days: 5%

(*C*) 15 days to 30 days: 10%

(*D*) 31 days to 60 days: 25%

(*E*) 61 days to 90 days: 50%

(*F*) 91 days or more: 100%

(*ii*) If the market value of the securities subject to the reverse-repurchase agreement declines to below 50% of the contract price for resale under that agreement, the applicable deduction shall equal 100% of the difference between the contract price for resale of the securities under the agreement and the market value of those securities.

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[20] For purposes of this rulemaking proceeding, the Commission is proposing to define as small any broker or dealer that: (1) had total capital of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) or, if not required to file such statements, had total capital of less than $500,000 on the last business day of the preceding fiscal year (or in the time it has been in business, if shorter); and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in the Regulatory Flexibility Act. "Total capital" for these purposes consists of net worth plus subordinated liabilities, including those subordinated liabilities that do not qualify for purposes of determining a firm's net capital under Rule 15c3–1. On the basis of data compiled by the Directorate of Economic and Policy Analysis from FOCUS Reports filed by brokers and dealers, it would appear that in excess of approximately 4100 brokers and dealers would qualify as small under this definition. As discussed in the Analysis, the Commission invites comments on the appropriateness of this definition and suggestions of alternative definitions.

[21] As discussed in the Analysis, the revision in haircuts on government securities, without taking into account the impact of those provisions that would reduce capital requirements by recognizing certain hedging strategies, could increase aggregate industry regulatory capital requirements with respect to such securities by approximately 120% to 180% or $42 million to $63 million and the revision in haircuts on municipal securities could increase aggregate industry capital requirements with respect to such securities by approximately 40% or $40 million to $45 million. The Analysis also notes that the proposed amendments, if in effect during 1980, would have increased aggregate industry haircuts with respect to nonconvertible debt securities (without accounting for the impact of provisions which would allow reduced haircuts for certain hedges between nonconvertible debt and U.S. government debt securities) by approximately $24 million.

(*iii*) A deduction on account of a reverse-repurchase agreement may be offset by any margin or other deposits held by the broker or dealer on account of the reverse-repurchase agreement or by any excess market value of securities over the contract price for the resale of those securities under any other reverse-repurchase agreement with the same person.

(*iv*) A broker or dealer shall deduct an amount equal to the excess of the difference between the market value of the securities and the contract prices for resale under reverse-repurchase agreements with 90 calendar days to maturity or less, which exceeds 5% of net capital before the application of paragraphs (c)(2)(vi), or (f)(3) of this section, or Appendix A to Rule 15c3-1 (240.15c3-1a).

(*3*) In the case of a matched repurchase agreement, a broker or dealer shall not be required to deduct a percentage of the value of the securities sold under the repurchase agreement pursuant to paragraphs (c)(2)(vi)(A) of this section, *Provided,* That a deduction is taken with respect to the securities purchased under the reverse-repurchase agreement pursuant to paragraphs (c)(2)(iv)(F)(*2*) of this section.

* * * * *

(c) * * *

(2) * * *

(vi) * * *

(A)(*1*) In the case of a security issued or guaranteed as to principal or interest by the United States or any agency thereof, the applicable percentages of the market value of the net long or short position in each of the categories specified below are:

Category 1

(*i*) Less than 3 months to maturity—0%;

(*ii*) 3 months but less than 6 months to maturity—½ of 1%;

(*iii*) 6 months but less than 9 months to maturity—¾ of 1%;

(*iv*) 9 months but less than 12 months to maturity—1%.

Category 2

(*i*) 1 year but less than 2 years to maturity—1½%;

(*ii*) 2 years but less than 3 years to maturity—2%.

Category 3

(*i*) 3 years but less than 5 years to maturity—3%;

(*ii*) 5 years but less than 10 years to maturity—4%.

Category 4

(*i*) 10 years but less than 15 years to maturity—4½%;

(*ii*) 15 years but less than 20 years to maturity—5%;

(*iii*) 20 years but less than 25 years to maturity—5½%;

(*iv*) 25 years or more to maturity—6%.

Except as provided in paragraph (c)(2)(vi)(A)(*2*) of this section and as modified by paragraphs (c)(2)(vi)(A) (*3*) and (*4*) of this section, brokers or dealers shall compute a deduction for each category above as follows: Compute the deductions for the net long or short positions in each sub-category above. The deduction for the category shall be the net of the aggregate deductions on the long positions and the aggregate deductions on the short positions in each subcategory plus 50% of the lesser of the aggregate deductions on the long or short positions.

(*2*) A broker or dealer may elect to deduct, in lieu of the computation required under paragraph (c)(2)(vi)(A)(*1*) of this section, the applicable percentages of the market value of the net long or short positions in each of the sub-categories specified in paragraph (c)(2)(vi)(A)(*1*) of this section.

(*3*) In computing deductions under paragraph (c)(2)(vi)(A)(*1*) of this section, a broker or dealer may elect to exclude the market value of a long or short security from one category and a security from another category *Provided,* That:

(*i*) Such securities have maturity dates:

(*A*) Between 9 months and 15 months and within 3 months of one another;

(*B*) Between 2 years and 4 years and within 1 year of one another; or

(*C*) Between 8 years and 12 years and within 2 years of one another; and

(*ii*) The broker or dealer includes the net market value of the two securities in the category for the security with the longer date to maturity.

(*4*) In computing deductions under paragraph (c)(2)(vi)(A)(*1*) of this section, a broker or dealer may exclude from the categories specified in paragraph (c)(2)(vi)(A)(*1*) of this section, long or short positions in securities issued by the United States or any agency thereof that are hedged by long or short positions in futures contracts on a contract market in securities issued by the United States or any agency thereof, *Provided,* That the securities deliverable under the futures contract and the related long or short securities position mature in: (*A*) Less than 15 months and within 3 months of one anothr; (*B*) more than 1 year but less than 5 years and within 1 year of one another; (*C*) more than 5 years and within 5 years of one another; and *Provided, Further* that the broker or dealer deducts the applicable percentage with respect to the positions in futures contracts in accordance with the requirements of Appendix B (17 CFR 240.15c3-1b).

(B)(*1*) * * *

(*2*) In the case of any municipal security, other than those specified in paragraph (c)(2)(vi)(B) (*1*) of this section, which is not traded flat or in default as to principal or interest, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

(*i*) Less than 1 year to maturity—1%;

(*ii*) 1 year but less than 2 years to maturity—2%;

(*iii*) 2 years but less than 5 years to maturity—5%;

(*iv*) 5 years or more to maturity—7%.

* * * * *

(D)(*1*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are limited to cash or securities or money market instruments with 1 year or less to maturity which are described in paragraphs (c)(2)(vi) (A) through (C) or (E) of this section, the deduction shall be 2% of the market value of the greater of the long or short position.

(*2*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments of any maturity which are described in paragraphs (c)(2)(vi) (A) through (C) or (E) of this section, the deduction shall be 7% of the market value of the greater of the long or short position.

(*3*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments which are described in paragraphs (c)(2)(vi) (A) through (C) or (E) and (F) of this section, the deduction shall be 9% of the market value of the long or short position.

* * * * *

(F)(*1*) In the case of nonconvertible debt securities having a fixed interest rate and fixed maturity date and which are not traded flat or in default as to principal or interest and which are rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

(*i*) Less than 1 year to maturity—2%;

(*ii*) 1 year but less than 2 years to maturity—3%;

(*iii*) Two years but less than three years to maturity—5%;

(*iv*) 3 years but less than 4 years to maturity—6%;

(*v*) 4 years but less than 5 years to maturity—7%;

(*vi*) 5 years or more to maturity—9%;

(*2*) A broker or dealer may elect to exclude from the above categories long or short positions that are hedged with short or long positions in securities issued by the United States or any agency thereof and that have maturity dates of within—3 months, if the nonconvertible debt security has a maturity date or less than 15 months; 6 months, if the nonconvertible debt security has a maturity date of greater than 15 months but less than 2 years; 1 year, if the nonconvertible debt security has a maturity date of greater than 2 years but less than 5 years; and 5 years, if the nonconvertible debt security has a maturity of 5 years or more. The electing broker or dealer shall also exclude the hedging short or long securities position from the applicable under paragraph (c)(2)(vi)(A) of Rule 15c3–1(§ 240.15c3–1(c)(2)(vi)(A)), but shall deduct a percentage of the market value of the hedged long or short position in nonconvertible debt securities as specified in each of the categories below:

(*i*) Less than 1 year to maturity—1%;

(*ii*) 1 year but less than 2 years to maturity—1½%;

(*iii*) 2 years but less than 3 years to maturity—2½%;

(*iv*) 3 years but less than 4 years to maturity—3%;

(*v*) 4 years but less than 5 years to maturity—3½%;

(*vi*) 5 years or more to maturity—4½%.

* * * * *

(H) In the case of cumulative, nonconvertible preferred stock ranking prior to all other classes of stock of the same issuer, which is rated in one of the four highest categories by at least two of the nationally recognized statistical rating organizations and which is not in arrears as to dividends, the deduction shall be 10% of the market value of the greater of the long or short position.

* * * * *

By the Commission.

George A. Fitzsimmons,

Secretary.

January 13, 1982.

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17 CFR Part 240

[Release No. 34-18419, File No. S7-922]

Treatment of Fails To Deliver and Fails To Receive Under the Uniform Net Capital Rule and the Customer Protection Rule; Proposed Rule

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule interpretation and proposed rule amendments.

SUMMARY: The Commission proposes 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 its uniform 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 under prescribed circumstances.

DATE: Comments must be received on or before March 15, 1982.

ADDRESSES: All comments should be submitted in triplicate and addressed to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. All comments should refer to File No. S7-922 and will be available for public inspection at the Commission's Public Reference Room, 1100 L Street, NW., Washington, D.C.

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

SUPPLEMENTARY INFORMATION: Presently, fails to deliver [1] and fails to receive,[2] if aged, result in deductions to a broker's or dealer's net worth in computing its net capital pursuant to Rule 15c3-1 (the "net capital rule"). Under the net capital rule, the amount by which the market value of securities failed to receive outstanding longer than 30 calendar days exceeds the contract value of those fails to receive is deducted from net worth.[3] In addition, fail to deliver contracts are the subjects of deductions if they are outstanding 11 business days or longer (21 business days or longer in the case of municipal securities).[4] Under Rule 15c3-3 (the "customer protection rule"), customer related fails to receive and customer related fails to deliver not older than 30 calendar days are included in the Reserve Formula under items 4 and 12 respectively. The inclusion of fails to receive in the Reserve Formula (a credit item) increases a broker's or dealer's potential cash deposit requirement. For a firm electing to compute its net capital under the alternative method (Rule 15c3-1(f)), the inclusion of fails to deliver in the Reserve Formula (a debit item) raises the broker's or dealer's net capital requirement.

The current treatment of fails to receive and fails to deliver is derived in large part from the excessive number of fails which existed during the "Paperwork Crisis" of 1968-70. During this period, increased trading volume coupled with the inability of brokers and dealers to handle this increased volume caused the number of fails to reach unprecedented levels.[5] In its Unsafe and Unsound Study, the Commission noted that allowing fails to deliver to remain outstanding for long periods of time exposed the "failing" broker or dealer to great risks of loss. That is, the greater the duration of a fail to deliver, the more the "failing" broker or dealer is exposed to the risks of possible financial difficulties of the party to whom he is obligated to make delivery. Moreover, in order to fulfill its delivery obligation, the "failing" broker or dealer may ultimately be forced to procure the security at a price in the open market higher than the contract price.[6]

When the altenative method of computing net capital was adopted, the Commission authorized conservative interpretations regarding Reserve Formula items, when an allocation procedure was used. Fails to receive not allocable to the broker's or dealer's proprietary long positions and fails to deliver not allocable to the broker's or dealer's proprietary short positions were presumed to be customer-related and thus includable in the Reserve Formula. These interpretations were intended to insure that customer related fails would be provided for through a Reserve Formula deposit or increased capital requirement.

In its 1979 Report to the Commission on the net capital rule, the Securities Industry Association (the "SIA") recommended that fails to deliver and fails to receive which allocate to one another ("matched fails") be excluded from both sides of the Reserve Formula.[7] The SIA reasoned that, since matched fails occur with other brokers and dealers, customer assets are jeopardized only to the extent that the broker or dealer on the other side of the fail to deliver can demonstrate an obligation to redeliver to a customer. For this reason, the SIA argued that the current Reserve Formula treatment of matched fails was not justified in light of the purposes of the customer protection rule. In support of its recommendation, the SIA also argued that a fail situation creates a risk of loss only in the event of an "aged" fail to deliver, and Rule 15c3-1(c)(2)(ix) requires a capital charge for that aged fail to deliver.

In Securities Exchange Act Release No. 17208,[8] the Commission acknowledged that the present treatment of matched fails may no longer be justified. Noting that elimination of these fails from the Reserve Formula would exclude from net capital consideration a firm's collection risk on fails to deliver until these items became "aged," however, the Commission proposed an amendment under which a broker or dealer could elect to exclude from the Reserve Formula both fails to receive and fails to deliver which allocate to one another. The broker or dealer

[1] A "fail to deliver" arises when the selling broker or dealer fails to deliver the certificates in proper form at the agreed upon settlement date to the buying broker or dealer. A fail to deliver is an asset since it represents monies due to the firm for sales of securities.

[2] A "fail to receive" arises when a buying broker or dealer has not taken delivery from the selling broker or dealer as of settlement date. A fail to receive is a liability which the buying broker or dealer must satisfy when the securities are delivered.

[3] *See* paragraph (c)(2)(iv)(E) of Rule 15c3-1.

[4] *See* paragraph (c)(2)(ix) of Rule 15c3-1.

[5] The Commission noted in its Unsafe and Unsound Study that fails to deliver of New York Stock Exchange (NYSE) member firms in December of 1968 amounted to $4 billion. Securities and Exchange Commission, *Study of Unsafe and Unsound Practices of Brokers and Dealers,* H. Doc. No. 231, 92nd Cong., 1st Sess. (1971) at 19.

[6] *Id.* It was in this context that the Commission and the exchanges adopted amendments to their net capital rules to provide deductions from net worth for fails to deliver outstanding beyond specified periods of time. *See* Securities Exchange Act Release No. 8508 (Jan. 30, 1969), 34 FR 1587 (Feb. 1, 1969).

[7] Such allocation procedure would allow a broker or dealer to match a security which he had failed to receive with a security of the same class and issuer he had failed to deliver and exclude both from the Reserve Formula.

[8] *See* Securities Exchange Act Release No. 17208 (Oct. 9, 1980), 21 SEC Docket 139, 45 FR 69915 (Oct. 22, 1980).

would, however, for purposes of Rule 15c3–1(c)(2)(ix) be required to treat these fails to deliver as "aged" 3 business days or longer after settlement (11 business days or longer for municipal securities). A broker or dealer who elected not to match fails would follow Rule 15c3–1(c)(2)(ix) as it presently stands. Under either election, the Commission reasoned, the net capital rule would assure protection of any customers who may be involved by providing incentives for the broker or dealer to resolve these items, and reduce the potential risk.

In response to this proposal, the SIA contended that a fail to deliver does not "age" more rapidly from a credit risk standpoint solely because it is offset by a fail to receive. Asserting that the provisions of the present Rule 15c3–1(c)(2)(ix) appropriately reflect the credit risk presented by fails to deliver under all circumstances, the SIA renewed its recommendation that, subject to the present provisions of Rule 15c3–1(c)(2)(ix), matching fails be excluded from the Reserve Formula.

The SIA, however, in a letter dated July 22, 1981, withdrew this recommendation. Instead, it recommended that: (1) Subject to the net capital rule's existing treatment of aged fails, a firm should have the option of completely or selectively excluding its matching fails from the Reserve Formula; (2) the minimum net capital requirement of a firm operating under the alternative method should be equal to the greatest of (a) the alternative's minimum capital requirement ($100,000 under the current net capital rule) or (b) 2 percent of the firm's aggregate Reserve Formula debits (other than debits arising from excluded matching fails) or (c) that the firm should be required to have net capital equal to some appropriate percentage of the firm's excluded matching fail debits.

II

The Commission has considered carefully the SIA's proposal in light of the underlying purposes of the uniform net capital and the customer protection rules, and has determined that, although the proposal is consistent with the purposes of those rules, it reaches its goal at the cost of greatly increasing the complexity of the net capital rule. Accordingly, the Commission proposes herein an alternative scheme which it believes will achieve essentially the same results without increasing the difficulty of monitoring the net capital rule.

First, the Commission proposes that fails to deliver and fails to receive which allocate to one another should be excluded from both sides of the Reserve Formula. This will equate somewhat the treatment of matched fails under the alternative method to that now afforded matched fails under the aggregate indebtedness method.[9] More importantly, however, it appears that excluding matched fails from both sides of the Reserve Formula would have the effect of providing the greatest reduction in capital requirements for those firms having the fewest retail customers. It would appear that these amendments will benefit particularly those firms dealing heavily with municipal securities.[10]

In its original proposal the Commission would have amended the net capital rule to provide different aging criteria under paragraph (c)(2)(ix) for fails to deliver which allocated to fails to receive. In contrast to its earlier recommendation, however, the Commission believes that all fails to deliver should age at the same rate regardless of whether they are excluded from the Reserve Formula, but believes that the net capital rule allows too long a time before fails to deliver must be aged. At the same time, however, the Commission recognizes that its original proposal of allowing only 3 business days (11 business days in the case of municipal securities) before aging may be too short to be implemented practically and may not reflect current industry practices.[11] In order to reflect more realistically the time frame in which the industry operates, the Commission proposes that the time period for aging a fail to deliver be cut gradually from 11 business days or longer to 5 business days or longer (or from 21 business days or longer to 15 business days or longer in the case of municipal securities).

Since fails to deliver which allocate to fails to receive would be excluded from the Reserve Formula, the Commission proposes that fails to deliver excluded by allocation be subject to an additional capital charge of 1% of the contract value of the fail to deliver. Imposition of this additional capital charge will alleviate the problem of providing dangerously low minimum net capital requirements for those firms whose Reserve Formula debits consist largely of fails to deliver allocable to fails to receive. In addition, this proposal will impose a capital requirement for those firms with retail business which more closely approximates the customer risk involved, and, for any customers which may be involved, insure protection by providing incentives for the broker or dealer to resolve those items.[12]

Finally, the Commission proposes to amend the net capital rule to provide authority to the designated examining authority (the "DEA") to grant, upon application, an extension under appropriate circumstances of the number of days allowed before application of the required percentage deductions for "aged" fails under the net capital rule. The DEA may allow an extension for a period up to five business days before the provision of this subparagraph is applied upon an appropriate showing that the extension is warranted. Among other things, the firm must be able to show that the fail has not been disavowed in some way.

* * * * *

The proposed new interpretation is as follows:

(1) Fails to receive which are not allocable to long positions in the proprietary or other accounts of the broker or dealer or to fails to deliver of the same quantity and issue are customer related and should be included in the computation of the Reserve Formula; and (2) fails to deliver which are not allocable to short positions in the proprietary or other accounts of the

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[9] Although firms electing the basic method of computing net capital are required to take a deduction for aged fails to deliver under Rule 15c3–1(c)(2)(ix), these firms are allowed to exclude fails to receive for which the firm has matching fails to deliver from the aggregate indebtedness computation pursuant to Rule 15c3–1(c)(1)(iii). No such treatment is afforded firms having matched fails and electing the alternative method since, under the present rule, fails to deliver must be included as debit item in the Reserve Formula (thereby raising the broker's or dealer's capital requirement) regardless of whether the broker or dealer has corresponding fails to receive.

[10] The Commission has been advised that firms who do a substantially retail-oriented business have the largest percentage of fail items which would not match and therefore would continue to be included in the Reserve Formula. Conversely, those firms which do business primarily with other professionals have the largest percentage of matched fails and thus would benefit the greatest from this proposal. Excluding matched fails from the Reserve Formula has the desired effect of providing a reduction in the net capital requirement for all firms, with the greatest reduction going to those firms with minimal customer exposure.

[11] Some industry commentators objected to the proposed accelerated aging of fails to deliver excluded from the Reserve Formula, citing, among other things, the inadequacy of the present clearing systems to allow brokers and dealers to liquidate fails to deliver for securities within three business days. Also in this regard, the National Association of Securities Dealers, Inc. (the "NASD"), in a letter to the Commission dated March 16, 1981, suggested that five business days in the case of non-municipal securities was a more realistic guide for aging than the three business days proposed by the Commission. The NASD further stated that experience of NASD members indicate that many fails are resolved within five business days after settlement.

[12] The Commission responses in its letter to M. S. Wein & Co., Inc., dated July 15, 1976, and in similar letters to other brokers or dealers will no longer be applicable.

broker or dealer or to fails to receive of the same quantity and issue are customer related and should be included in the computation of the Reserve Formula.

Summary of Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (the "Analysis") in accordance with 5 U.S.C. 603 regarding the proposed amendments to Rule 15c3-1.

The Analysis notes that the amendments to Rule 15c3-1 are being proposed as a part of the Commission's review of the broker-dealer financial responsibility and customer protection rules. The proposed amendments are intended to eliminate a disparity in the treatment of failed to deliver contracts that match with certain failed to receive contracts under the two methods of computing net capital requirements. The Analysis also notes that the reduction, in stages, of the time frame within which brokers and dealers are required to take a deduction from net worth for failed to deliver contracts is intended to reflect in the rule more accurately the time frame within which the industry operates to resolve those items.

The Analysis notes that the amendments to Rule 15c3-1 concerning the amount of deduction with respect to certain failed to deliver contracts that match with failed to receive contracts would affect those brokers and dealers, including small brokers and dealers,[13] that use the alternative method to compute required net capital. The Analysis also notes that the amendments to Rule 15c3-1 with respect to the timing of deductions from net worth on account of failed to deliver contracts would apply to brokers or dealers that carry customer accounts, including approximately 630 small brokers and dealers.

The Analysis notes that the proposed amendments to Rule 15c3-1 with respect to failed to deliver contracts that match with certain failed to receive contracts, in conjunction with a proposed interpretation of Rule 15c3-3, would decrease the amount of liquid assets that must be maintained by brokers and dealers that use the alternative method to compute capital requirements. The reduction in aggregate industry required minimum net capital, the Analysis notes, would be approximately $8 million and will likely accrue to the benefit of those brokers and dealers that do business primarily with other professionals and, therefore, have a large percentage of failed to deliver contracts that match with failed to receive contracts.

The Analysis notes that the reduction from 11 business days (21 business days for municipal securities) to 7 business days (17 business days for municipal securities) upon adoption of the proposed amendments and to 5 business days (15 business days for municipal securities) effective September 1, 1982, could increase, for some entities, the regulatory capital and securities processing costs associated with resolving failed to deliver contracts that remain outstanding. The time frames that will ultimately apply under the proposed amendments, however, conform to the time frames within which the industry operates and the proposed amendments, therefore, should not increase significantly the regulatory capital or securities processing costs of brokers and dealers whose operations conform to industry standards. Furthermore, any increase in costs associated with these amendments would appear to have no significant impact on competition among brokers and dealers.

The Commission recognizes the need to formulate compliance and reporting requirements that take into account the economic impact on small brokers and dealers. The Regulatory Flexibility Act directs the Commission to consider significant alternatives to the proposed amendments that would accomplish the stated objectives of applicable statutes and minimize any significant economic impact on small brokers and dealers. As discussed in the Analysis, the Commission believes that it would be inconsistent with the purposes of the Exchange Act to exempt, categorically, any small brokers and dealers from the proposed provisions of these amendments. The Commission, however, as noted in the Analysis, invites interested persons to suggest alternatives to the proposed amendments that they believe will accomplish the stated objectives of the Exchange Act and minimize any significant economic impact on small brokers and dealers.

A copy of the Analysis may be contained by contacting Michael A. Macchiaroli, Division of Market Regulation, U.S. Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549 at (202) 272-2372.

Statutory Basis

Pursuant to the Securities Exchange Act of 1934 and particularly Sections 15(c)(3) and 23(a) thereof, 15 U.S.C. §§ 78*o*(c)(3) and 78*w*(a), the Commission proposes to amend § 240.15c3-1 in Chapter II of Title 17 of the Code of Federal Regulations in the manner set forth below.

Text of Proposed Amendments

It is proposed to amend 17 CFR Part 240 as follows:

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

By revising paragraph (c)(2)(ix) of § 240.15c3-1 and adding (f)(5)(iv) to read as follows:

§ 240.15c3-1 Net capital requirements for brokers or dealers.

* * * * *

(c) * * *

(2) * * *

(ix) Deducting from the contract value of each failed to deliver contract which is outstanding 5 business days or longer (15 business days or longer in the case of municipal securities) the percentages of the market value of the underlying security which would be required by application of the deduction required by paragraph (c)(2)(vi) of this section or, where appropriate, paragraph (f) of this

[13] For purposes of this rulemaking proceeding, the Commission is proposing to define as small any broker or dealer that: (1) had total capital of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) or, if not required to file such statements, had total capital of less than $500,000 on the last business day of the preceding fiscal year (or in the time it has been in business, if shorter); and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in the Regulatory Flexibility Act. "Total capital" for these purposes consists of net worth plus subordinated liabilities, including those subordinated liabilities that do not qualify for purposes of determining a firm's net capital under Rule 15c3-1. On the basis of data compiled by the Directorate of Economic and Policy Analysis from FOCUS Reports filed by brokers and dealers, it would appear that in excess of approximately 4,100 brokers and dealer would qualify as small under this definition. As of December 31, 1980, approximately 275 brokers and dealers elected to compute capital requirements using the alternative method; only a few of these would appear to qualify as small brokers and dealers. As discussed in the Analysis, the Commission invites comment on the appropriateness of this definition.

section. Such deduction, however, shall be increased by any excess of the contract price of the fail to deliver over the market value of the underlying security or reduced by any excess of the market value of the underlying security over the contract value of the fail but not to exceed the amount of such deduction; *Provided, however,* That until September 1, 1982, the deduction provided for herein shall be applied only to those fail to deliver contracts which are outstanding 7 business days or longer (17 business days or longer in the case of municipal securities). The designated examining authority for the broker or dealer may, upon application, extend for a period of up to 5 business days, any period herein specified where it is satisfied that the extension is warranted.

* * * * *

(f) * * *

(5) * * *

(iv) Deduct from net worth in computing net capital 1% of the contract value of all fails to deliver which are allocable to fails to receive of the same issue and which thereby are excluded from Item 12 of Exhibit A, 17 CFR 240.15c3–3a.

* * * * *

By the Commission.

George A. Fitzsimmons,

Secretary.

January 13, 1982.

[FR Doc. 82-1708 Filed 1-22-82; 8:45 am]

BILLING CODE 8010-01-M

17 CFR Part 240

[Release No. 34-18420; File No. S7-923]

Borrowing and Lending of Securities by Brokers and Dealers and Related Requirements; Proposed Rule

AGENCY: Securities and Exchange Commission.

ACTION: Notice of proposed rule amendments.

SUMMARY: The Commission today announced a proposal to amend the requirement in the customer protection rule that brokers and dealers obtain and maintain possession or control of customers' fully-paid and excess margin securities to exempt those 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 deficiencies in excess of five percent of the market value of the securities. In that connection, the Commission will interpret the customer protection rule so as to reduce the reserve and net capital requirements of certain brokers and dealers by excluding from the Formula for the Determination of the Reserve Requirements of Brokers and Dealers (the "Reserve Formula"), debit and credit items that are related to securities borrowed from financial institutions and other persons pursuant to a written agreement that provides, among other things, that the securities are collateralized by cash or United States Government securities. In connection with its review of the broker-dealer net capital and financial responsibility rules,[*] the Commission believes that it is appropriate to clarify the treatment of securities loans under those rules.

DATE: Comments must be received on or before March 15, 1982.

ADDRESSES: Persons wishing to submit written views should file three copies thereof with George A. Fitzsimmons, Secretary, Securities and Exchange Commission, Room 892, 500 North Capitol Street, Washington, D.C. 20549. All submissions should refer to File No. S7-923 and will be available for public inspection at the Commission's Public Reference Room, Room 6101, 1100 L Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT:
Michael A. Macchiaroni, Esquire, Division of Market Regulation, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. (202) 272-2372.

[*] Securities Exchange Act Release No. 34-18417.

SUPPLEMENTARY INFORMATION: Rule 15c3-3 [§ 240.15c3-3] under the Securities Exchange Act of 1934 (the "Exchange Act") requires, among other things, that a broker or dealer obtain and thereafter maintain possession or control of all fully-paid [1] and excess margin [2] securities carried for the account of customers ("customer securities"). For purposes of Rule 15c3-3, a "customer" is any person "from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of such person" and may be construed to include any person or entity, such as an institution, that lends securities to a broker or dealer, whether or not it maintains an account with that broker or dealer. Since, under that interpretation, customer securities that have been borrowed and reloaned would not generally be held in a control location as defined under paragraph (c) of Rule 15c3-3, brokers and dealers would, in effect, be precluded from borrowing and relending them. The Commission's staff, however, has generally not objected to the borrowing and lending of customer securities for particular purposes under circumstances established primarily by general practice in the securities industry.

In connection with its review of the broker-dealer net capital and financial responsibility rules,[3] the Commission believes that it is appropriate to clarify the treatment of securities loans under those rules. In particular, the Commission believes that it is appropriate to reduce the net capital requirements for brokers and dealers that borrow securities from persons other than brokers, dealers, or municipal securities dealers and that compute their minimum net capital requirement under the "alternative method" [4] (*i.e.*, on the basis of a percentage of aggregate debit items in the Reserve Formula) by removing those transactions from the Reserve Formula under certain circumstances. Coincident with this reduction in net capital requirements and in order to assure the financial responsibility of brokers and dealers and provide a framework for the borrowing and lending of securities, the Commission is proposing to amend Rule 15c3-3 to codify staff interpretations of the possession or control requirement of that rule and industry practices that provide for the initial delivery of collateral by the borrowing broker or

[1] *See* 17 CFR 240.15c3-3(a)(3).

[2] *See* 17 CFR 240.15c3-3(a)(5).

[3] Securities Exchange Act Release No. 34-18417.

[4] *See* 17 CFR 240.15c3-1(f).

dealer to secure the loan and the subsequent delivery of additional collateral as necessary to satisfy deficiencies in excess of a specified percentage of the value of the collateral.

Introduction

Rule 15c3-3 requires a broker or dealer holding customer funds or securities, among other things, to establish a cash reserve, based on periodic computations pursuant to the rule, correlated to the customer monies held by the borker or dealer that are not necessary to finance its customer business. Through the Reserve Formula,[5] a broker or dealer compares the monies that it owes customers (liabilities, or credits in the Reserve Formula) against monies owed by customers to it (assets, or debits in the Reserve Formula)[6] and deposits to a reserve bank account, in satisfaction of the requirements of Rule 15c3-3, an amount of money or qualified securities equal to the excess (if any) of liabilities over assets (the "Reserve Requirement"). The Reserve Formula also serves as a basis for the determination of the minimum net capital requirement for those brokers and dealers electing to comply with the alternative method of computing net capital requirements as set forth in Rule 15c3-1(f).[7] Under that provision, generally, electing brokers and dealers are required to maintain minimum net capital equal to the greater of $100,000 or four percent of aggregate debit items computed in accordance with the Reserve Formula.

Currently, securities loan transactions by brokers and dealers must be reflected in the Reserve Formula if the securities are borrowed to complete customer transactions.[8] Securities borrowed from persons other than brokers, dealers and municipal securities dealers, including financial institutions, have been considered to be[9] borrowed from a customer, and debit and credit items associated with these transactions are includable in the Reserve Formula.[10] As a consequence, brokers and dealers that borrow securities from such persons, in addition to providing cash or Government securities to fully collateralize the loan, are required to reflect such transactions in computing their Reserve Requirements under Rule 15c3-3. Brokers and dealers that compute their required net capital using the alternative method must also maintain liquid assets equal to four percent of the collateral deposited against the securities.

The Commission believes that inclusion in the Reserve Formula of securities that are borrowed pursuant to a written agreement under which the broker or dealer has delivered to the lender full collateral in the form of cash or Government securities may impose an unnecessary financial burden on brokers and dealers. The Commission, therefore, is revising the treatment of these transactions for purposes of the Reserve Formula and proposing amendments to Rule 15c3-3.

For purposes of the Reserve formula, securities borrowed by brokers or dealers from any person (other than a broker, dealer or municipal securities dealer) under certain circumstances should now be treated in the same way as securtities borrowed by borkers or dealers from other brokers, dealers or muncipal securities dealers. To qualify for exclusion from the Reserve Formula, the securities must be borrowed pursuant to a written agreement and the broker or dealer must (i) deliver collateral in the form of cash or Government securities equal to at least 100 percent of the value of the securities; and (ii) undertake to deliver additional collateral to satisfy the entire deficiency in the event that the market value of the securities exceeds by five perent the value of the collateral.[11] Thus, securities borrowed in conformity with these requirements should be treated as if securities borrowed from a broker, dealer or municipal securities dealer. Furthermore, for purposes of allocating funds associated with these securities in the Reserve Formula, a broker or dealer may treat lenders of securities as being non-customers, so long as the broker or dealer complies with the requirements of proposed paragraph (b)(3) of Rule 15c3-3.

The exclusion of the market value of securities that are borrowed from financial institutions and others can be expected to reduce potential Reserve Requirements for brokers and dealers. In addition, it can be expected to reduce substantially the net captial requirements of brokers and dealers that operate under the alternaitve method and that borrow securities from persons other than brokers and dealers.

II. Proposed Amendments to Rule 15c-3

As noted above, Rule 15c3-3(b) requires a broker or dealer to have and maintain physical possession or control of all fully-paid and excess margin securities held for the account of customers. The term "customer," as defined in Rule 15c3-3, includes any person, other than a broker, dealer or municipal securities dealer, that lends securities to a broker or dealer, whether or not the lender maintains an account with that broker or dealer.[12] Thus, Rule 15c3-3(b) could be read to require brokers and dealers to maintain physical possession or control of securities borrowed from such persons; the Commission's staff, however, has informally advised brokers and dealers of circumstances under which it will not take such a view.

The Commission is proposing to amend Rule 15c3-3 to codify the staff's informal advice regarding the circumstances under which borrowed securities will not be treated as subject to the possession or control requirement of that rule. While generally codifying standard industry practice in securities loan transactions, the proposed amendments are also desgined to establish safeguards to assure the financial responsibility of the borrowing

[5] *See* 17 CFR 240.15c3-3a.

[6] The credits and debits also include payables and receivables on account of customer-related transactions. The notes to the Reserve Formula specify that the debit items are to be reduced by a specified percentage in computing Reserve Requirements. *See* 17 CFR 240.15c3-3a.

[7] Approximately 275 firms, accounting for a significant percentage of industry gross revenues and a combined required net capital of approximately $1.1 billion, elected to comply with the alternative net capital requirement as of December 31, 1980.

[8] The cash collateral given by the broker or dealer to the lender is entered as a debit in the Reserve Formula; the dollar value of the securities, if borrowed from persons other than brokers or dealers, is entered as an offsetting credit in Reserve Formula. Loans allocable to properitary transactions, however, are not included in the Reserve Formula. *See* Securities Exchange Act Release No. 9922, 38 FR 1737 (Jan. 18, 1973).

[9] *See* New York Stock Exhcange, Inc. Interpretation Handbook: Regulation and Surveillance 1601 (1980).

[10] The broad reading of "customer transactions" for purposes of determining Reserve Requirements and net capital requirements under the alternative method reflected, in part, the possibility that loans of fully-paid and excess margin securities by persons other than brokers or dealers might be protected under the Securities Investor Protection Act of 1970 (the "SIPA"). Among other things, SIPA established the Securities Investor Protection Corporation ("SIPC") to oversee broker-dealer liquidations and a fund (administered by SIPC with annual contributions from brokers and dealers) to insure customers against certain losses. Congress amended SIPA in 1978, however, among other things, to clarify that lenders of securities who receive collateral or compensation, generally, are not customers under SIPA and, therefore, are not protected by the SIPA fund against certain losses. *See* discussion in Section II, *infra*.

[11] These requirements represent current industry practices in borrowing and lending securities that have developed as a consequence of the requirements Regulation T and Rule 15c3-3(b) under the Exchange Act. *See* 12 CFR 220.6(h) and 17 CFR 240.15c3-3(b). As discussed in greater detail in Section II of this release, the Commission is proposing to amend Rule 15c3-3(b) to codify informal staff interpretations of that rule and to codify certain industry practices.

[12] *See* 17 CFR 240.15c3-3(a)(1).

broker or dealer and protect its customers.

The proposed amendments would exclude from the possession or control requirement of Rule 15c3-3(b)(1) fully-paid and excess margin securities borrowed, loaned or arranged to be loaned in accordance with the requirements of new paragraph (b)(3) of the rule. That paragraph, as proposed to be adopted, would require that the broker or dealer and the lender enter into a separate written agreement with respect to the loan [13] that, at a minimum, contains each of the disclosures or undertakings specified in the rule.

The primary undertaking by a broker or dealer in the loan agreement contemplated by the proposed amendments (*see* proposed paragraph (b)(3)(ii) of rule 15c3-3) is that the lender receive, at the time of the execution of the consent to the loan (or by the close of the business day of the loan, if the loan occurs subsequent to the execution of the agreement), actual possession of collateral that fully secures the loan. This undertaking appears to be necessary in order to cover the credit risks and to dampen the financial leverage available to brokers and dealers.

In order to preserve the integrity of the collateral, the proposed amendments would require borrowing brokers and dealers to undertake to mark the securities to the market. When the market value of the securities increases by more than five percent over the value of the collateral, the borrowing broker or dealer would be required to deliver to the lender, by the end of the next business day, cash or Government securities of sufficient value to fully secure the loan. The Commission believes that determining the amount of collateral deficiencies on a daily basis and delivering additional collateral to satisfy collateral deficiencies of five percent or more will relieve borrowing brokers and dealers of the expense of delivering additional collateral because of insignificant increases in the value of the securities while at the same time substantially maintaining the integrity of the collateral. The Commission invites commentators, in considering the collateral delivery and maintenance requirements, to report on the present basis by which collateral requirements are determined and met and to discuss whether those requirements are manageable and provide adequate protection for lenders. [14]

The Board of Governors of the Federal Reserve System (the "Board"), in response to a request by a large brokerage house, has recently proposed for comment amendments to § 220.6(h) of Regulation T that bear upon the form of the collateral that may be given in exchange for borrowed securities. [15] The proposed amendments would permit brokers and dealers to use irrevocable letters of credit (issued by banks that are insured by the Federal Deposit Insurance Corporation) as the required deposit when securities are borrowed. The proposed amendments, if adopted, would alter general industry practice by eliminating, in many circumstances, the need to deposit cash as collateral for securities borrowed by a broker or dealer.

The Commission is concerned that the use of letters of credit to secure borrowed securities may provide an opportunity for financial leverage on short-term transactions that could expose brokers, dealers and their customers to risks inconsistent with the financial responsibility requirements of the federal securities laws. The proposed amendments to Rule 15c3-3, therefore, do not permit the use of letters of credit in lieu of cash or Government securities as collateral for the loan. The Commission, however, invites commentators to address whether use of letters of credit as collateral for borrowed securities would be consistent with the current financial responsibility requirements of the 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 where unsecured letters of credit are used to collateralize a loan of securities.

The proposed amendments also would require that the loan agreement contain a prominent notice that the provisions of the Securities Investor Protection Act of 1970 ("SIPA") may not protect the lender with respect to the loan transaction and that, therefore, the collateral delivered to the lender would constitute the first source of satisfaction of the broker-dealer's obligation in the event the broker or dealer failed to return the securities. Lenders of securities, generally, would not be afforded the protections of SIPA with respect to specific loans of customer securities to brokers or dealers for which collateral or consideration is paid, [16] since the receipt of collateral or consideration, as a general rule, precludes the lender from attaining the status of a "customer" under SIPA with respect to those transactions. [17]

The Commission invites commentators to discuss whether it is appropriate to mandate that the loan agreement contain, for the benefit of lenders of securities, certain disclosures regarding the lender's rights to incidents of ownership in securities that are subject to the agreement. Under current industry practice, the lender may surrender most incidents of ownership, including the right to transfer, vote and tender the securities, in order to enable the borrowing broker or dealer to transfer or relend the securities as necessary to complete transactions. Often, however, the lender retains some incidents of ownership and the right to receive distributions on the securities. Accordingly, the Commission invites comment as to whether the proposed amendments should require the agreement specifically and clearly to disclose the nature of the rights relinquished, the period for which they are surrendered and the procedures for the delivery of distributions, in kind or in equivalent value, to the lender. Interested persons may also wish to discuss whether the Commission should require that the agreement advise the lender that it may terminate the loan at any time by notifying the broker or dealer in writing and that the agreement

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[13] This requirement, however, should not be interpreted so as to preclude the parties from entering into an agreement that provides for the future delivery of loaned securities.

[14] Under the proposal, the lender could appoint an agent, other than the broker or dealer, to receive and maintain the collateral under the loan agreement. If the lender, however, appointed as its agent to receive the collateral either the borrowing broker or an associated person of the borrowing broker, the lender may significantly increase the risk of loss associated with the transaction. In the event that the broker failed to return the securities loaned or became insolvent, the lender could risk the loss of the securities and the collateral, since the lender would not appear to have a perfected security interest in either the securities or the collateral. *See*, U.C.C. 8-313, 317 (1977); U.C.C. 9-304 & 9-305 comment 2. Since it is not clear whether the lender would be protected under the Securities Investor Protection Act of 1970, *see* discussion *infra*, the Commission is considering whether to preclude borrowing brokers or their associated persons from retaining possession of the collateral and invites comment with regard to the appropriateness of such a restriction.

[15] *See* 46 FR 55533 (Nov. 10, 1981). Section 220.6(h) of Regulation T currently provides that:

[W]ithout regard to the other provisions of this part, a creditor (1) may make a bona fide deposit of cash in order to borrow securities (whether margin or nonmargin) for the purpose of making delivery of such securities in the case of short sales, failure to receive securities he is required to deliver, or other similar cases, and (2) may lend securities for such purpose against such a deposit.

[16] *See Securities Investor Protection Corp. v. Executive Securities Corp.*, 556 F.2d 98 (2d Cir. 1977).

[17] *See* Section 16(2) of SIPA as amended by the Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, 92 Stat. 249 (May 21, 1978). 15 U.S.C. 78*lll*(2).

specify the procedures for return of the securities and the collateral.[18]

III. Summary of Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (the "Analysis") in accordance with 5 U.S.C. 603 regarding the proposed amendments to Rule 15c3–3.

The Analysis notes that the amendments to Rule 15c3–3 are being proposed as a part of the Commission's review of the broker-dealer financial responsibility and customer protection rules. The objective of the proposed amendments to Rule 15c3–3 regarding borrowed securities is to assure the financial responsibility of brokers and dealers for the protection of their customers and lenders of securities through a codification of current industry practice.

The Analysis notes that the proposed amendments would apply to brokers and dealers that are subject to the possession or control requirement of Rule 15c3–3 and that borrow fully-paid or excess margin securities from persons or entities that are not brokers, dealers or municipal securities dealers. The Analysis also notes that, although the amendments could impose additional compliance costs on these brokers and dealers, the Commission believes that because many of the requirements of the proposed rule amendments (particularly the written-consent and collateralization requirements) represents accepted industry practice, the incremental costs associated with complying with the requirements of the amendments will not be substantial and will not be likely to have a detrimental effect on competition in the industry.

A copy of the Analysis may be obtained by contacting Michael A. Macchiaroli, Division of Market Regulation, U.S. Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549 at (202) 272–2372.

IV. Statutory Authority

The Commission is proposing to amend Rule 15c3–3 pursuant to authority granted in Sections 15(c)(3), 17(a), and 23(a) of the Exchange Act.[19]

V. Text of the Proposed Rule Amendments

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

Part 240 of 17 CFR is proposed to be amended as follows:

By revising paragraph (b)(1) of § 240.15c3–3 and adding paragraph (b)(3) to read as follows:

§ 240.15c3–3 Customer protection—reserves and custody of securities.

* * * * *

(b) *Physical possession or control of securities.* (1) A broker or dealer shall promptly obtain and shall thereafter maintain the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers, except those fully-paid securities and excess margin securities borrowed, loaned or arranged to be loaned in accordance with paragraph (b)(3) of this section.

* * * * *

(3) A broker or dealer shall be deemed not to be in violation of the provisions of paragraph (b)(1) of this section regarding physical possession or control of fully-paid or excess margin securities borrowed, loaned or arranged to be loaned from any person, provided that the broker or dealer and the lender, at the time of the loan, enter into a written agreement with respect to the loan that, at a minimum:

(i) identifies the securities to be loaned and the basis of compensation for the loan;

(ii) Specifies that the broker or dealer (A) must transfer to the lender, upon the execution of the agreement or by the close of the business day of the loan if the loan occurs subsequent to the execution of the agreement, actual possession of collateral, consisting exclusively of cash (in the form of a cashier's or a certified check) or United States Treasury bills and Treasury notes, which fully secures the loan of securities, and (B) must mark the loan to the market not less than daily and, in the event that the market value of all the outstanding securities loaned at the close of trading at the end of the business day exceeds 105 percent of the collateral then held by the lender, the borrowing broker or dealer must deliver additional cash or United States Treasury bills and Treasury notes to the lender by the close of the next business day, as necessary to equal, together with the collateral then held by the lender, not less than 100 percent of the market value of the securities loaned; and

(iii) Contains a prominent notice that the provisions of the Securities Investor Protection Act of 1970 may not protect the lender with respect to the securities loan transaction and that, therefore, the collateral delivered to the lender would constitute the first source of satisfaction of the broker's or dealer's obligation in the event the broker or dealer failed to return the securities.

* * * * *

By the Commission.

George A. Fitzsimmons,
Secretary.

January 13, 1982.

[FR Doc. 82–1706 Filed 1–22–82; 8:45 am]

BILLING CODE 8010-01-M

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[18] Upon notice of termination of the loan agreement, the broker or dealer would be required, in compliance with Rule 15c3–3(d) (17 CFR 240.15c3–3(d)), to act to obtain possession or control of the customer securities. Pursuant to paragraph (d)(1) of Rule 15c3–3, the broker or dealer must determine, on a daily basis, the quantity of customer securities required to be in its possession or control. If there is a deficiency (as may be likely if a lender withdrew its consent to the loan), the broker or dealer must issue instructions not later than the next business day following its possession-or-control determination for the return of the securities so that they could be forwarded to the lender. It must obtain physical possession or control of the securities within five business days following the date of issuing instructions. Alternatively, the broker may borrow the securities needed for possession or control rather than recall the securities loaned. *See* Securities Exchange Act Release No. 9922, 38 FR 1737 (Jan. 18, 1973).

[19] 15 U.S.C. 78o(c)(3), 78q(a) and 78w(a).

NOTICE TO MEMBERS: 82-7
Notices to Members should be retained for future reference.

NASD

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

February 8, 1982

TO: All NASD Members

RE: Slanker (T. E.) Company, Incorporated
9450 Southwest Commerce Circle
Wilsonville, Oregon

ATTN: Operations Officer, Cashier, Fail-Control Department

On Thursday, February 4, 1982, the United States District Court for the District of Oregon appointed a Temporary Receiver for the above captioned firm.

Members may use the "immediate close-out" procedures as provided in Section 59(i) of the NASD's Uniform Practice Code to close-out open OTC contracts. Also, MSRB Rule G-12 (h)(iv) provides that members may use the above procedures to close-out transactions in municipal securities.

Questions regarding the firm should be directed to:

Temporary Receiver

Douglas Thompson, Esquire
Schwabe, Williamson, Wyatt, Moore
& Roberts
Twelfth Floor
Standard Plaza
1100 S. W. Sixth Avenue
Portland, Oregon 97204
Telephone: (503) 222-9981

NOTICE TO MEMBERS 82-8
Notices to Members should be retained for future reference.

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

February 12, 1982

IMPORTANT

PLEASE SEE THAT ALL APPROPRIATE INDIVIDUALS
RECEIVE COPIES OF THIS MATERIAL.
EXTRA COPIES MAY BE OBTAINED AS NOTED BELOW.

TO: All NASD Members

RE: Commencement of Trade Reporting in National Market System Tier 1 Securities

Pursuant to SEC Rule 11Aa2-1, trade reporting in National Market System Tier 1 securities is expected to begin in March, 1982. Members will be notified as to the exact starting date as soon as it is established.

All NASD members are required to report, under certain circumstances, their trades in Tier 1 securities, whether or not they are registered NASDAQ market makers in such issues. Trade reports must be made within 90 seconds of execution except as noted below.

- NASDAQ Level 2 and Level 3 subscribers can report through their terminals;
- Non-NASDAQ subscribers, as well as subscribers that are experiencing equipment outages, can report via telephone or TWX to NASDAQ-NY as follows: Telephone: (212) 938-1055; TWX: 710 5815414.
- Members whose daily aggregate volume in all Tier 1 securities does not exceed 1,000 shares or $25,000 on five or more of the previous 10 trading days, can report weekly in writing on Form T, a copy of which is enclosed.

The following materials are included in this package:

Enclosure 1 A copy of Section XIV of Schedule D of the NASD By-Laws which covers reporting requirements for NASDAQ/NMS securities. The amendment to the By-Laws has

	been approved by the Board of Governors and submitted to the SEC for approval.
Enclosure 2	A chart showing which member is required to report a particular trade.
Enclosure 3	A list of Tier 1 securities.
Enclosure 4	A copy of Form T.

In addition to the foregoing materials, NASDAQ subscribers are being sent detailed instructions on the procedures for using their terminals to enter trade reports.

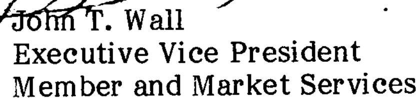
Further Information

Any questions on NASDAQ/NMS trade reporting should be directed to the following individuals:

Form T Reports	NASDAQ-NY	(212) 938-1055
Which Party Reports or What Price to Report	Don Heizer	(202) 833-7169
Additional Copies of Printed Materials	David Bowman	(202) 833-4899
How to Report Other Than on Form T (i.e., via Terminals, Telephone or TWX)	NASDAQ-NY	(212) 938-1055
General Questions	Molly G. Bayley	(212) 833-7213

* * * *

Sincerely,



John T. Wall
Executive Vice President
Member and Market Services

Enclosures

(c) Information To Be Reported

Each last sale report shall contain the following information:

(1) NASDAQ symbol of the designated security;

(2) Number of shares (odd lots shall not be reported);

(3) Price of the transaction as required by paragraph (d) below.

(d) Procedures for Reporting Price and Volume

Members which are required to report pursuant to paragraph (b) above shall transmit last sale reports for all purchases and sales in designated securities in the following manner:

(1) For agency transactions, report the number of shares and the price excluding the commission charged.

Example: SELL as agent 100 shares at 40 plus a commission of $12.50; REPORT 100 shares at 40.

(2) For dual agency transactions, report the number of shares only once, and report the price excluding the commission charged.

Example: SELL as agent 100 shares at 40 plus a commission of $12.50; BUY as agent 100 shares at 40 less a commission of $12.50; REPORT 100 shares at 40.

(3) For principal transactions, except as provided below, report each purchase and sale transaction separately and report the number of shares and the price. For principal transactions which are executed at a price which includes a mark-up, mark-down or service charge, the price reported shall exclude the mark-up, mark-down or service charge. Such reported price shall be reasonably related to the prevailing market, taking into consideration all relevant circumstances including, but not limited to, market conditions with respect to the security, the number of shares involved in the transaction, the published bids and offers with size at the time of the execution (including the reporting firm's own quotation), the cost of execution and the expenses involved in clearing the transaction.

Example: BUY as principal 100 shares from another member at 40 (no mark-down included). REPORT 100 shares at 40.

Example: BUY as principal 100 shares from a customer at 39 7/8, which includes a 1/8 mark-down from prevailing market of 40; REPORT 100 shares at 40.

Example: SELL as principal 100 shares to a customer at 40 1/8, which includes a 1/8 mark-up from the prevailing market of 40;
REPORT 100 shares at 40.

Example: BUY as principal 10,000 shares from a customer at 39 3/4, which includes a 1/4 mark-down or service charge from the prevailing market of 40;
REPORT 10,000 shares at 40.

Exception:

A "riskless" principal transaction in which a member that is not a market maker in the security after having received from a customer an order to buy, purchases the security as principal from another member or customer to satisfy the order to buy or, after having received from a customer an order to sell, sells the security as principal to another member or customer to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the mark-up or mark-down.

Example: SELL as principal 100 shares to another member at 40 to fill an existing order;
BUY as principal 100 shares from a customer at 40 minus a mark-down of $12.50;
REPORT 100 shares at 40.

(e) Transactions Not Required To Be Reported

The following types of transactions shall not be reported:

(1) transactions executed through the Computer Assisted Execution System ("CAES");

(2) odd-lot transactions;

(3) transactions which are part of a primary distribution by an issuer or of a registered secondary distribution (other than "shelf distributions") or of an unregistered secondary distribution;

(4) transactions made in reliance on Section 4(2) of the Securities Act of 1933;

(5) transactions where the buyer and seller have agreed to trade at a price substantially unrelated to the current market for the security, e.g., to enable the seller to make a gift;

(6) purchases or sales of securities effected upon the exercise of an option pursuant to the terms thereof or the exercise of any other right to acquire securities at a pre-established consideration unrelated to the current market.

SCHEDULE D

XIV

Reporting Transactions in NASDAQ National Market System Designated Securities

This Part has been adopted pursuant to Article XVI of the Corporation's By-Laws and applies to the reporting by all members of transactions in NASDAQ/National Market System securities ("designated securities") through the Transaction Reporting System. These securities have been designated pursuant to the "National Market System Securities Designation Plan With Respect to NASDAQ Securities" ("Plan") which has been approved by the Securities and Exchange Commission pursuant to Rule 11Aa2-1.

Section 1 — Definitions

(a) Terms used in this Part shall have the meaning as defined in the Association's By-Laws and Rules of Fair Practice, Rule 11Aa2-1 and the Plan, unless otherwise defined herein.

(b) "Transaction Reporting System" means the transaction reporting system for the reporting and dissemination of last sale reports in designated securities.

(c) "Registered Reporting Market Maker" means a member of the Association which is registered as a NASDAQ market maker in a particular designated security. A member is a Registered Reporting Market Maker in only those designated securities for which it is registered as a NASDAQ market maker. A member shall cease being a Registered Reporting Market Maker in a designated security when it has withdrawn or voluntarily terminated its quotations in that security or when its quotations have been suspended or terminated by action of the Corporation.

(d) "Non-Registered Reporting Member" means a member of the Association which is not a Registered Reporting Market Maker.

Section 2 — Transaction Reporting

(a) When and How Transaction Reported

(1) Registered Reporting Market Makers shall transmit through the Transaction Reporting System, within 90 seconds after execution, last sale reports of transactions in designated securities executed during the hours of the Transaction Reporting System. Transactions not reported within 90 seconds after execution shall be designated as late.

(2) Non-Registered Reporting Members shall transmit through the Transaction Reporting System, or if such System is unavailable, via Telex, TWX or telephone to the NASDAQ Department in New York City, within 90 seconds after execution, last sale reports of transactions in designated

securities executed during the trading hours of the Transaction Reporting System unless all of the following criteria are met:

(A) The aggregate number of shares of designated securities which the member executed and is required to report during the trading day does not exceed 1,000 shares; and

(B) The total dollar amount of shares of designated securities which the member executed and is required to report during the trading day does not exceed $25,000; and

(C) The member's transactions in designated securities have not exceeded the limits of (A) or (B) above on five or more of the previous ten trading days.

Transactions not reported within 90 seconds after execution shall be designated as late. If the member has reason to believe its transactions in a given day will exceed the above limits, it shall report all transactions in designated securities within 90 seconds after execution; in addition, if the member exceeds the above limits at any time during the trading day, it shall immediately report and designate as late any unreported transactions in designated securities executed earlier that day.

(3) Non-Registered Reporting Members shall report weekly to the NASDAQ Department in New York City, on a form designated by the Board of Governors, last sale reports of transactions in designated securities which are not required by paragraph (2) to be reported within 90 seconds after execution.

(4) All Members shall report weekly to the NASDAQ Department in New York City, on a form designated by the Board of Governors, last sale reports of transactions in designated securities executed outside the trading hours of the Transaction Reporting System.

(5) All trade tickets for transactions in designated securities shall be time-stamped at the time of execution.

(b) Which Party Reports Transaction

(1) In transactions between two Registered Reporting Market Makers, only the member representing the sell side shall report.

(2) In transactions between a Registered Reporting Market Maker and a Non-Registered Reporting Member, only the Registered Reporting Market Maker shall report.

(3) In transactions between two Non-Registered Reporting Members, only the Member representing the sell side shall report.

(4) In transactions between a member and a customer, the member shall report.

GENERAL REPORTING REQUIREMENTS FOR TRANSACTIONS IN NASDAQ/NMS DESIGNATED SECURITIES

Agency and Principal Transactions

Member	Transaction	Member Reports When Contra-Party Is		
		Market Maker	Non-Market Maker	Customer
Market Maker[1/]	buys from:	No	Yes	Yes
	sells to:	Yes	Yes	Yes
Non-Market Maker	buys from:	No	No	Yes
	sells to:	No	Yes	Yes

Reporting Requirements for "Riskless" Transactions by Non-Market Makers

Member	Transaction	Member Reports When Contra-Party Is		
		Market Maker	Non-Market Maker	Customer
Non-Market Maker	buys from customer and sells to:	No	Yes	Yes
	sells to customer and buys from:	No	No	Yes

1/ Defined as a NASDAQ registered market maker in the security.

TIER 1 LIST OF THE NASDAQ/NATIONAL MARKET SYSTEM

As of January 27, 1982

Company Name

1. Apple Computer, Inc.
2. Academy Insurance Group, Inc.
3. American Greetings Corporation
4. American International Group
5. American Microsystems, Inc. *
6. Amarex, Inc.
7. Avantek, Inc.
8. CPT Corporation
9. Color Tile, Inc.
10. Cross and Trecker Corp.
11. Cetus Corporation
12. Economics Laboratory, Inc.
13. El Paso Electric Company
14. Farmers Group, Inc.
15. Flagship Banks, Inc.
16. Graphic Scanning Corporation
17. Hadson Petroleum Corporation
18. Intergraph, Inc.
19. Intel Corporation
20. ISC Systems Corporation
21. Intermedics, Inc.
22. Jerrico, Inc.
23. Life Investors, Inc.
24. Mallinckrodt, Inc. **
25. MCI Communications Corporation
26. McRae Consolidated Oil & Gas, Inc.
27. Millipore Corporation
28. National Data Corporation
29. Nicklos Oil & Gas Company
30. Network Systems Corporation
31. Oceaneering International, Inc.
32. Pabst Brewing Company
33. Phoenix Resources Company ***
34. Seagate Technology
35. Service Merchandise Company, Inc.
36. St. Paul Companies, Inc.
37. Sykes Datatronics, Inc.
38. Tom Brown, Inc.
39. Tandem Computers, Inc.
40. Tampax, Inc.
41. Trans-Western Exploration, Inc.
42. United States Surgical Corp.
43. Wetterau, Inc.
44. Williams Electronics, Inc. ****

* American Microsystems has signed a definitive agreement to be acquired by Gould, Incorporated.

** Mallinckrodt, Inc., is conducting a special meeting of shareholders on March 8 to vote on proposed merger with Avon Products, Incorporated.

*** Phoenix Resources Company is currently considering a merger offer made by Texas International, Incorporated.

**** Williams Electronics, Inc., has applied for listing on the New York Stock Exchange.

Enclosure 4

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

FORM T

Name of Member ______________________________

Address ______________________________

Return This Form To:

NASDAQ-New York
Two World Trade Center
New York, New York 10048
Attn: Trade Reports

Trade Date	No. Shares	Security Name	Symbol	Price	Time Executed

Signature of Principal ______________________ Date Prepared ______________

Instructions

1. Members may report transactions in listed securities or NASDAQ/NMS securities on Form T if: (1) their aggregate daily volume in listed securities or (2) their aggregate daily volume in NASDAQ/NMS securities, does not exceed 1,000 shares or $25,000 on five or more of the previous 10 trading days. If a firm exceeds these amounts or has reason to believe it will exceed them, it must report its trades to the NASD within 90 seconds of execution or designate them as late.

2. This form should also be used to report transactions executed outside normal reporting hours, 10:00 a.m. ET to 4:30 p.m. ET.

3. Members need only report trades for which they have trade reporting responsibility:

   a. In trades between two market makers in the security or two non-market makers, the sell side reports.

   b. In trades between a market maker in the security and a non-market maker, the market maker reports.

   c. In trades between a customer and a member, the member reports.

   d. No trades executed on the floor of an exchange are reported.

4. This form should be returned to:

   NASDAQ - New York
   Two World Trade Center, 98th Floor
   New York, New York 10048
   Attn: Trade Reports

5. Further information on reporting trades in eligible listed securities can be found in Schedule G of the NASD By-Laws. The rules concerning reporting in NASDAQ/NMS securities are contained in Section XIV, Schedule D of the NASD By-Laws. Questions may be directed to NASDAQ - New York at (212) 938-1055.

NASD

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

February 22, 1982

TO: All NASD Members

RE: Stalvey & Associates, Inc.
125 S. Congress Street
Jackson, Mississippi 39201

ATTN: Operations Officer, Cashier, Fail-Control Department

On Thursday, February 18, 1982, the United States District Court for the Southern District of Mississippi appointed a SIPC trustee for the above captioned firm. Members may use the "immediate close-out" procedures as provided in Section 59(i) of the NASD's Uniform Practice Code to close-out open OTC contracts. Also, MSRB Rule G-12(h)(iv) provides that members may use the above procedures to close-out transactions in municipal securities.

Questions regarding the firm should be directed to:

<u>SIPC Trustee</u>

Henry E. Chatham, Jr.
Wise Carter Child & Caraway
925 Electric Building
P. O. Box 651
Jackson, Mississippi 39205
Telephone: (601) 354-2385

NASD

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

February 26, 1982

TO: All NASD Members

RE: Slanker (T. E.) Company, Incorporated
9450 Southwest Commerce Circle
Wilsonville, Oregon

ATTN: Operations Officer, Cashier, Fail-Control Department

On Wednesday, February 24, 1982, the United States District Court for the District of Oregon appointed a SIPC Trustee for the above captioned firm. Previously, a temporary receiver had been appointed for the firm on February 4, 1982.

Members may use the "immediate close-out" procedures as provided in Section 59(i) of the NASD's Uniform Practice Code to close-out open OTC contracts. Also, MSRB Rule G-12 (h)(iv) provides that members may use the above procedures to close-out transactions in municipal securities.

Questions regarding the firm should be directed to:

<u>SIPC Trustee</u>

Douglas Thompson, Esquire
Schwabe, Williamson, Wyatt
Moore & Roberts
Twelfth Floor
Standard Plaza
1100 S. W. Sixth Avenue
Portland, Oregon 97204
Telephone: (503) 222-9981

NOTICE TO MEMBERS: 82-10
Notices to Members should be retained for future reference.

NASD

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

February 26, 1982

TO: All NASD Members

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<u>SIPC Trustee</u>

Douglas Thompson, Esquire
Schwabe, Williamson, Wyatt
Moore & Roberts
Twelfth Floor
Standard Plaza
1100 S. W. Sixth Avenue
Portland, Oregon 97204
Telephone: (503) 222-9981