DEPARTMENT OF THE TREASURY
BUREAU OF THE PUBLIC DEBT
WASHINGTON, D.C. 20239-0001

November 22, 1989

Dear Mr. Ingber:

This is in response to your letter of June 20, 1989, in which you request interpretations of three provisions of the Treasury regulations implementing the Government Securities Act of 1986 (GSA regulations, 17 CFR 400, et seq.). Specifically, you request that, for purposes of sections 402.2, 403.4, and 403.5 (capital and customer protection rules), government securities brokers or dealers that participate in the Government Securities Clearing Corporation (GSCC) system for netting compared trades (Netting System) be allowed to consider the settlement date for a fail to receive or deliver to be the most recent business day for which such fail has been marked to market and repriced through GSCC's Netting System.

We understand the facts to be as follows. GSCC is registered as a clearing agency with the Securities and Exchange Commission (SEC) pursuant to Sections 17A(b)(2) and 19(a) of the Securities Exchange Act of 1934 (Exchange Act) (15 U.S.C. 78q-1(b)(2) and 78s(a)). Registration was granted on May 24, 1988, for a period not to exceed 36 months. In this role, GSCC has filed various proposed rule changes with the SEC in order to establish a legal framework for its Netting System (rule filings 89-4, 89-5, 89-6, and 89-7). Upon receiving SEC approval, GSCC began its netting operation on July 7, 1989.

Each business day, GSCC calculates and reports to participants in the Netting System (Netting Members) each net settlement position, including fails, that Netting Members have in an eligible netting security. When GSCC releases its report detailing netted positions, all deliver and receive obligations (together with related payment obligations) that were created by the Netting Members' trades submitted for netting are terminated and replaced by deliver, receive, and payment obligations to or from GSCC. For each net position, the Netting Member is either obligated to deliver securities to GSCC or to receive securities from GSCC; the Netting Member could also have a flat position. Every delivery and receipt by a Netting Member to and from GSCC is done against simultaneous payment, through Fedwire, at a uniform system price established by GSCC each business day for each eligible netting security. The uniform system price represents an approximation of the market value of a security for a day's trades. Fails are not netted with other fails or with new trades. Instead, they are maintained on an independent basis until settled.

On each business day, Netting Members pay to, or collect from, GSCC a funds-only settlement amount, which is separate from the settlement of delivery obligations described above. Included in the funds-only settlement are: (1) an adjustment consisting of the difference between the contract value and the uniform system price for settling trades, and (2) a mark-to-market adjustment for every fail net settlement position, including accrued interest.

You represent that capital charges related to "aged" fails (defined below) and mark-to-market requirements for aged fails are designed to take into account situations where market prices move significantly away from contract prices as the original settlement date becomes more remote. For purposes of the GSA regulations, a fail occurs when a security is not delivered or received on settlement date. Settlement date is the date on which delivery and receipt of a security and payment are contracted to occur. A fail becomes aged when it remains unsettled for more than a specifically prescribed period of time beyond settlement date.

You also represent that GSCC requires Netting Members to confirm their trading obligations and make daily mark-to-market adjustments, which consist of payments to, and collections from, Netting Members who are parties to a fail in order to update the price of the fail position to the current market value of the underlying securities. Based on these representations, you assert that for purposes of the capital and customer protection rules, Netting Members should be allowed to consider the settlement date for a fail to be the most recent business day for which the fail has been marked to market. In effect, you request that Netting Members be allowed to treat fails as unaged (i.e., only one business day old) for purposes of the capital and customer protection rules.

The GSA regulations address the treatment of aged fails in the liquid capital computation. The definition of liquid capital, set out at section 402.2(d), incorporates the SEC's definition of net capital (17 CFR 240.15c3-1(c)(2)), with certain modifications that are not material to your interpretation request. Paragraph (ix) of the incorporated definition of net capital provides that fail to deliver contracts outstanding for five business days or longer require deductions from net worth based on the appropriate haircut for the underlying security and deductions from, or additions to, net worth depending on the difference between the contract price and the market value of a trade. Moreover, paragraph (iv)(E) of the incorporated net capital rule requires deductions from net worth if the market value of securities failed to receive outstanding longer than 30 days exceeds the contract value of such fails.

The customer protection rules also impose requirements on government securities broker-dealers regarding aged fails. Section 403.4 of the GSA regulations adopts the SEC's customer protection requirements (17 CFR 240.15c3-3 and 240.15c3-3a), with certain modifications that are not relevant to your request. Paragraph (d)(2) of the adopted customer protection rule provides that buy-ins must be conducted when securities failed to receive are outstanding more than 30 days. In addition, the adopted customer protection rule requires that broker-dealers maintain a special reserve bank account for the exclusive benefit of customers. The amount required to be deposited into the account is derived from a formula set out at section 240.15c3-3a (Exhibit A) of the adopted rule. Exhibit A, Note D of Item 4 requires that broker-dealers credit to the reserve formula the amount by which the market value of securities failed to receive and outstanding more than 30 days exceeds their contract value. Exhibit A, Item 12 provides that when fail to deliver contracts become older than 30 calendar days, broker-dealers must remove debits that were recorded in the reserve formula for such fails. Finally, section 403.5(c)(1)(iii) of the GSA regulations establishes buy-in requirements for financial institution government securities brokers or dealers when failed to receive securities are outstanding for over 30 days.

Although, as discussed below, GSCC has taken steps to reduce the risks to Netting Members with respect to fails, fails that continue to be unsettled after a specified time, regardless of whether they are marked to market, remain within the definition of aged fails as applied in the capital and customer protection rules. We believe that a wider definition would be inconsistent with the application of the GSA rules. Accordingly, we are unable to provide you with the particular interpretations you request since they would conflict with the definition of aged fails.

However, our analysis indicates that GSCC's daily mark-to-market procedure, which includes payments through GSCC from one Netting Member to another, provides financial safeguards to Netting Members for credit and market risk that parallel the capitalization required of such members under the capital rule. Additionally, the protection provided to customers through the mark-to-market mechanism is comparable to that provided under the customer protection requirements. Like the customer protection requirements, the mark-to-market procedure provides brokers and dealers with sufficient funds to satisfy contractual obligations to customers. Moreover, mark-to-market payments constitute incentives for brokers and dealers to complete deliver and receive obligations. Similar conclusions were reached by the SEC staff in two no-action letters (dated June 11, 1987 and December 22, 1987) addressed to the National Securities Clearing Corporation (NSCC) regarding its Reconfirmation and Price Service (RECAPS) and as evidenced by the NSCC's treatment of fails in its Continuous Net Settlement (CNS) system as unaged under the SEC net capital rule.

Based on these factors and your representations of the structure and operation of the Netting System and the daily mark-to-market process, we believe that exemptions from certain capital and customer protection requirements regarding aged fails are warranted. We have consulted with the staff of the SEC in arriving at our decisions, and we have determined that such exemptions are consistent with the public interest, the protection of investors, and the purposes of the Government Securities Act given GSCC's current operating structure.

Accordingly, pursuant to 15 U.S.C. 78o-5(a)(4), we hereby grant exemptions, only for trades processed through GSCC's Netting System, to GSCC Netting Members that are government securities brokers and dealers from the following GSA rules: (i) as incorporated in 17 CFR 402.2(d), paragraphs 17 CFR 240.15c3-1(c)(2)(iv)(E) and (c)(2)(ix); (ii) as incorporated in 17 CFR 403.4, paragraph 240.15c3-3(d)(2) and Exhibit A (Note D of Item 4 and Item 12); and (iii) 17 CFR 403.5(c)(1)(iii).

These exemptions apply solely to GSCC Netting Members' trades that are processed through GSCC's Netting System and are conditioned upon the following: (i) in lieu of adhering to the Treasury customer protection (section 403.4) rule's adopted requirement at 17 CFR 240.15c3-3a (Exhibit A) Note D of Item 4, GSCC Netting Members that are government securities broker-dealers required by section 403.4 to maintain a special reserve bank account for the exclusive benefit of customers will at all times maintain a credit balance in Item 4 of the reserve requirement in an amount representing the current market price of the underlying fail to receive security, regardless of the age of such fail; and (ii) the system price will continue to be established by GSCC each business day, as represented by you, based on current market prices of government securities. Any change in the facts or circumstances of your request would require further analysis and could lead to a termination of the exemptions.

Pursuant to 17 CFR 400.2(c)(7)(i), your incoming letter and this response will be immediately available to the public.

Sincerely,

Richard L. Gregg

Richard L. Gregg
Commissioner

Jeffrey F. Ingber
Associate General Counsel
Government Securities Clearing Corporation
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New York, New York 10041

Government Securities Clearing Corporation

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June 20, 1989

Michael A. Macchiaroli, Esq.
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Stop 5-1
Washington, D.C. 20549

Re: 17 C.F.R. Sections 240.15c3-1 and 15c3-3

Office of the Commissioner
Bureau of the Public Debt
Room 553
999 E Street, N.W.
Washington, D.C. 20239
Attn: Mr. Richard L. Gregg, Commissioner

Re: 17 C.F.R. Sections 402.2, 403.4 and 403.5

Dear Mr. Macchiaroli and Mr. Gregg:

The Government Securities Clearing Corporation ("GSCC"), which was, on May 24, 1988, granted temporary registration by the Securities and Exchange Commission (the "Commission") pursuant to Sections 17A(b)(2) and 19(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as a clearing agency for a period not to exceed 36 months1/, has filed with the Commission various proposed rules changes (GSCC rule filings 89-4, 89-5, 89-6, and 89-7) that would establish the legal framework for a

1/ 53 Fed. Reg. 19839 (May 31, 1988).

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system for the netting of compared trades of certain eligible Government securities (hereinafter, the "Netting System") that GSCC proposes to implement on behalf of its Netting Members. These rule filings were published in the Federal Register on May 19, 1989 2/; the comment period provided for in the Federal Register notice ended on June 9, 1989. At this time, subject to Commission approval, GSCC anticipates commencing the netting operation on July 7, 1989.

The purpose of this letter is to describe the proposed Netting System and the treatment under that System of net settlement positions that are open after having failed to settle on their scheduled settlement date (hereinafter "fails"), and to request your advice, based on the facts and circumstances as described herein, (1) that the Division of Market Regulation (hereinafter, the "Division") would neither raise question with nor recommend enforcement action to the Commission if GSCC's Netting Members that are registered with the Commission as a broker or a dealer pursuant to Section 15 of the Exchange Act (hereinafter, "registered brokers and dealers") (a) for the purposes of the Commission's Rule 15c3-1 3/ (hereinafter, "the Net Capital Rule"), consider the settlement date for a fail to be the most recent business day for which such fail has been marked to the market and repriced through GSCC's Netting System, and (b) for purposes of the Commission's Rule 15c3-3 4/ (hereinafter, the "Customer Protection Rule"), treat the most recent business day for which a fail has been marked to the market and repriced through GSCC's Netting System as the date of the trade for the securities underlying such fail, and (2) the Office of the Commissioner of Public Debt (hereinafter, the "Office") issue an interpretation, pursuant to 17 C.F.R. Section 400.2(c), of Sections 402.2, 403.4, and 403.5 of the Treasury Department Regulations promulgated under Section 15C of the Exchange Act 5/

2/ 54 Fed. Reg. 21701.

3/ 17 C.F.R. Section 240.15c3-1.

4/ 17 C.F.R. Sections 402.2, 403.4, and 403.5.

5/ 17 C.F.R. Section 240.15c3-3.

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providing for similar treatment as regards Netting Members that are a Government securities broker or a Government Securities dealer (hereinafter, "Government securities brokers and dealers") subject to the requirements of the above-referenced sections.

Description of the Proposed Netting System and the Treatment of Fails Thereunder

The Netting System is a system for aggregating and matching offsetting obligations resulting from trades made by Netting Members in eligible netting securities, which trades (1) have been compared, (2) have not been settled, (3) have not previously failed to settle, and (4) have not been excluded by GSCC from the net. Each business day, GSCC will calculate and report to Netting Members each net settlement position that they have in an eligible netting security, including fails; for each such position, the member is either obligated to deliver securities to GSCC or is obligated to receive securities from GSCC (alternatively, the member may have a flat position).

The establishment of net settlement positions for trades of a Netting Member in eligible netting securities will be done by GSCC by calculating the difference between the par value amounts of each purchase and sale of an eligible security. Resulting Netting Member deliver and receive obligations to and from GSCC will be allocated by GSCC on a random basis to Netting Members with corresponding receive and deliver obligations. The obligation of a Netting Member to deliver or receive securities will be fixed at the time that GSCC makes available its report detailing netted positions; at that time, all deliver and receive obligations, and related payment obligations, that were created by the Member's netted trades are terminated and replaced by deliver, receive, and payment obligations to GSCC as created by the net. Every delivery and receipt by a Netting Member to and from GSCC will be done against simultaneous payment at a uniform System price established by GSCC each business day for each eligible netting security; accrued interest from the contractual settlement date to the actual settlement date will be encompassed in the settlement price. Fails will not be netted with other fails or with new trades; rather, they will be maintained on an independent basis until settled.

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Securities deliveries and receipts by GSCC and by Netting Members must be made through clearing banks designated by each that have access to FedWire. Netting Members will be obligated to appropriately instruct their clearing banks to make securities movements on their behalf, and the Members will be responsible for any failure of their clearing bank to act appropriately on their behalf as regards settlement of netted positions.
On each business day, each Netting Member shall either pay to GSCC or collect from GSCC a net total funds-only settlement amount comprised of the following components (all but one of which -- fees owing to GSCC -- may, on any particular business day, be either a credit or a debit amount for the Member): (1) with regard to every net settlement position, an adjustment payment to reflect the System price established for the underlying securities, (2) with regard to every fail net settlement position, a mark-to-market adjustment that includes accrued interest, (3) with regard to fails that have remained open on a coupon payment date or on a maturity date for the underlying securities, a coupon adjustment payment (i.e., the coupon payments due and owing on each security that comprises the fail position)6/ and a redemption adjustment payment (i.e., the dollar difference between the System value and the maturity value of each security that comprises the fail position), respectively, (4) with regard to any settlement made at other than the appropriate System value, a clearance difference amount, (5) adjustments to a Netting Member's cash deposits to the Clearing Fund or other cash collateral, (6) fee amounts owing to GSCC, and (7) other miscellaneous adjustments. An exception is provided for Netting Members that are Inter-Dealer Brokers; they are not obligated to make mark-to-market payments or coupon adjustment payments (and are not entitled to collect such payments) until there occurs settlement of the fail positions from which these adjustments arise.

All payments and collections of funds-only settlement amounts must be done through depository institutions acting on behalf of Netting Members and GSCC. If a Netting Member is obligated to make payment of a funds-only settlement amount to GSCC on a business day, it must do so by 10:00 a.m. on such day; GSCC must make payment of funds-only settlement amounts owing to

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6/ For a fail, in order to avoid double-counting, each coupon payment adjustment is accompanied by an offsetting mark adjustment payment.

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Netting Members on a particular business day by 11:00 a.m. on such day. The obligation of GSCC to pay a funds-only settlement amount to a Netting Member is not contingent upon the collection by GSCC of any funds-only settlement amounts from any Member.

GSCC's proposed Netting System, and the treatment of fails thereunder, are discussed in more detail in GSCC rule filing 89-7 (copy enclosed), which delineates GSCC's operating rules for its Netting System.

Discussion

1. Net Capital Rule

The Net Capital Rule requires, for registered brokers and dealers, certain deductions from net worth for "aged" fail-to-deliver or "aged" fail-to-receive securities transactions. A fail becomes aged when it remains unsettled for more than a specifically prescribed period of time past settlement date. Specifically, pursuant to Paragraph (c)(2)(ix) of the Net Capital Rule, registered brokers and dealers may have to deduct from their net worth a certain amount for each fail-to-deliver contract that is outstanding for five business days or longer.

The amount depends on the appropriate haircut for the particular security and the difference between the contract price and the market price of the trade. Similarly, there is a potential capital charge for fail-to-receive contracts outstanding 30 days or longer under Section (c)(2)(iv)(E) of the Rule.7/

These capital charges are designed to take into account a situation where the market price of a trade may move significantly away from the trade's contract price, as the settlement date of the original contract becomes more remote. However, where the parties to the transaction confirm their obligations as regards the trade and make (or collect), on a daily basis, the level of payment necessary to update the price of the fail to the current market, as is the case with respect to GSCC's proposed Netting System, it would be appropriate, for purposes of the Net Capital

7/ See 17 C.F.R. Section 240.15c3-1(c)(2)(ix) (fails to deliver) and Section 240.15c3-1(c)(2)(iv)(E) (fails to receive).

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Rule, to consider the settlement date of the fail as the most current business day for which the fail has been marked and repriced.

GSCC requests, in effect, the same capital treatment for fails that are pending in its Netting System awaiting settlement as is afforded other transactions where the contract price is updated to the current market price. For example, in the continuous net settlement ("CNS") system operated by the National Securities Clearing Corporation ("NSCC"), NSCC members are marked-to-the-market on a daily basis for compared trades that do not settle on the original settlement day. Accordingly, CNS positions are not treated as aged fails under the Net Capital Rule. Similarly, with regard to the NSCC's Reconfirmation and Price Service ("RECAPS") for fails in municipal securities, the Division agreed that it would raise no question nor recommend any enforcement action if a broker-dealer participating in RECAPS treats the RECAPS' settlement date as the date of the fail to deliver or the fail to receive under the Net Capital Rule.8/

In view of the above, GSCC believes that, for purposes of the Net Capital Rule, a fail should be considered to have as its settlement date the most recent business day for which the fail has been marked and repriced through GSCC's Netting System, not the original scheduled settlement date of the transaction.

2. Section 402.2

Section 402.2(a) provides that no registered Government securities broker or dealer shall permit its liquid capital to be below an amount equal to 120 percent of "total haircuts", as defined in Section 402.2(g); Section 402.2(b) further provides that, notwithstanding the provisions of Section 402.2(a), a Government securities broker or dealer must have and maintain liquid capital in an amount not less than $25,000, after deducting total haircuts. "Liquid capital" is defined in Section 402.2(d) to mean net capital as defined in the Net Capital Rule,

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8/ See letter, dated December 22, 1987, to Michael J. Simon, Vice President and Associate General Counsel of NSCC, from Michael T. Dorsey, Attorney-Advisor, Division of Market Regulation (copies of this letter and of Mr. Simon's earlier request letter are enclosed).

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with certain modifications specified therein.9/

For the reasons given above with regard to the Net Capital Rule, GSCC believes that, for the purpose of calculation of liquid capital, a fail should be considered to have as its settlement date the most current business day for which the fail has been marked to the market and repriced through GSCC's Netting System, not the original scheduled settlement date of the transaction.

3. Customer Protection Rule

The Customer Protection Rule imposes additional requirements on registered brokers and dealers with aged fails. First, it requires such a broker or dealer under certain circumstances to buy in fail-to-receives outstanding for more than 30 calendar days.10/ Also, it requires a broker or dealer, in computing its reserve requirement, to include as a credit the market value of all customers' fail-to-receives outstanding more than 30 calendar days, rather than the contract value of such fails, if the market value of the underlying securities exceeds the contract value of the fail.11/ Furthermore, a broker-dealer must exclude as a debit the contract value of all customers' fail-to-delivers where such fails have become older than 30 calendar days.12/

For the reasons set forth above with regard to the Net Capital Rule -- in particular, the daily mark-to-market protection provided Netting Members -- GSCC believes that, for purposes of the Customer Protection Rule, both fails-to-receive and

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9/ For example, Section 402.2(d)(1) provides that the percentages to be used to calculate the deductions for fail-to-deliver contracts, when the underlying instrument is a "Treasury market risk instrument," are the appropriate net position haircut factors specified in Section 402.2(f)(2).

10/ 17 C.F.R. Section 402.15c3-3(d)(2). Effective December 31, 1987, the Public Securities Association adopted procedures for implementing this buy-in requirement.

11/ 17 C.F.R. Section 240-15c3-3a, Item 4 and Note D.

12/ 17 C.F.R. Section 240-15c3-3a, Item 12.

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fails-to-deliver that arise from fail positions that are marked-to-market and repriced on a daily basis in the Netting System should be considered to arise from net settlement positions that have as their settlement date the most recent business day for which such positions have been marked to the market and repriced. In this regard, I note that, in the no-action letter to NSCC cited earlier, the Division agreed that it would not recommend enforcement action if a broker-dealer participating in RECAPS treated the RECAPS settlement date as the date of the fail for purposes of the Customer Protection Rule.

4. Sections 403.4 and 403.5

Section 403.4 provides that every registered Government securities broker or dealer shall comply with the requirements of the Customer Protection Rule, including its provisions pertaining to aged fails, with certain modifications specified therein. Section 403.5(a)(1) provides essentially that a Government Securities broker or dealer that is a financial institution shall comply with the requirements of Part 450 of subchapter B of the regulations promulgated under Title II of the Government Securities Act of 1986 (hereinafter, "Part 450") -- which delineates requirements for depository institutions that hold Government securities for the account of a customer -- with respect to all Government securities held for the account of customers in its capacity as a fiduciary or custodian. Section 403.5(a)(2) provides essentially that a Government securities broker or dealer that is a financial institution shall comply with the requirements of Part 450 and with paragraphs (b),(c), and (d) of Section 403.5 with respect to all fully paid and excess margin Government securities held for customers in its capacity as a Government securities broker or dealer, and with respect to Government securities that are the subject of a repurchase agreement between the financial institution and certain counterparties. Section 403.5(c)(iii) requires that a financial institution that is a Government securities broker or dealer take prompt action to obtain possession or control of fail-to-receives that are more than 30 days old.

For the reasons given above, GSCC believes that, for purposes of Sections 403.4 and 403.5, both fail-to-receives and fail-to-delivers that arise from fails that are marked-to-market and repriced on a daily basis in the Netting System should be

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considered to arise from net settlement positions that have as their settlement date the most current business day for which such positions have been marked and repriced.

If you have any questions regarding this letter or desire any additional information, please do not hesitate to contact me at (212) 510-0538.

Very truly yours,

Jeffrey F. Ingber

Jeffrey F. Ingber
Associate General Counsel

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Enclosure(s)

cc: Jonathan Kallman, Esq., Assistant Director, Division of Market Regulation
Ester Saverson, Esq., Branch Chief, Division of Market Regulation
Mr. Donald Hammond, Assistant Director, Office of the Commissioner
Don Ringsmuth, Esq., Associate General Counsel, Federal Reserve Bank of New York