Interpretation Memo

NYSE
New York
Stock Exchange, Inc.
20 Broad Street
New York, NY 10005

Member Firm Regulation

Number 89-9
July 14, 1989

Please Route to Financial and Operations Officer/Partner
and Compliance and Margin Departments

To: Members, Member Organizations and Handbook Subscribers

Subject: Update of Interpretation Handbook for SEC Rule 15c3-1

Attached find a no-action letter issued by the SEC on June 5, 1989 to the Securities Industry Association which presents alternative procedures that may be applied in lieu of the provisions of subparagraph (c)(2)(ix) for fail to deliver and of subparagraph (c)(2)(iv)(E) for fail to receive of foreign issued, foreign settled securities transactions. Updated Interpretation Handbook pages relative to these provisions are also attached.

In addition, other updated handbook pages are being distributed. The following should be carefully reviewed before insertion into the handbook.

Page & Reference	Subject
112, (a)(4)/04	Warrant and underlying stock treated as separate securities to determine minimum net capital requirement.
171, (c)(2)(iv)(C)/15	Introduced commissions/fees receivable from B-Ds need not be deducted for 30 days after month end accrual date.
179, (c)(2)(iv)(E)/13	Alternative procedures on treatment of aged fail to receive of foreign issued, foreign settled securities.
193, (c)(2)(iv)/07	Net capital value allowed for certain securities underwritten for a parent bank. Restrictions apply.
225, (c)(2)(iv)(M)/07	Undue concentration charges do not apply to the hedged portion of convertible or exchangeable securities.
236, (c)(2)(ix)/06	Alternative procedures on treatment of aged fail to deliver of foreign issued, foreign settled securities.
282, (f)(3)(iii)/04	Undue concentration charges do not apply to the hedged portion of convertible or exchangeable securities.

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

June 5, 1989

Paul J. Isaac, Chairman
Securities Industry Association
Capital Committee
120 Broadway
New York, New York 10271

Maxine Chou, Chairman
Securities Industry Association
International Operations
Association Compliance Committee
120 Broadway
New York, New York 10271

Dear Mr. Isaac and Ms. Chou:

This is in response to your letter to the Division of Market Regulation (the "Division") dated November 7, 1988, in which you request, on behalf of the Securities Industry Association ("SIA"), a no action position regarding the deductions broker-dealers are required to take in connection with failed to deliver and failed to receive contracts involving foreign issued, foreign settled securities pursuant to subparagraphs (c)(2)(ix) and (c)(2)(iv)(E) of Rule 15c3-1 under the Securities Exchange Act of 1934 (17 C.F.R. §240.15c3-1). You raise three specific areas of concern: a) the timing of capital charges on foreign fails to deliver; b) the size of capital charges on foreign fails to deliver; and c) the timing of capital charges on foreign fails to receive.

We understand the pertinent facts which prompted your request to be as follows: Paragraph (c)(2)(ix) of Rule 15c3-1 requires a broker-dealer to take proprietary haircut charges (in accordance with subparagraph (c)(2)(vi), or where appropriate, paragraph (f) of Rule 15c3-1), for each failed to deliver contract outstanding five business days or longer, reduced by the equity (or increased by the deficit) in the transaction on a mark-to-market basis. Rule 15c3-1(c)(2)(iv)(E) requires a broker-dealer to take a charge equal to the amount by which the market value of failed to receive securities outstanding longer than 30 calendar days exceeds the contract value of such failed to receive securities.

These rules have been construed to require that a transaction in foreign issued, foreign settled securities be treated as a failed to deliver five business days after trade date and a failed to receive five business days after trade date. You point out that settlement periods and procedures vary throughout the international securities market. Some countries have similar or more rapid automated securities settlement systems than those in the United States; other countries have settlement procedures which are substantially slower than those in the United States. Some countries employ manual securities settlement procedures (e.g., physical delivery of certificates, re-issuance and re-registration of certificates and multiple clearing agents), which are relatively inefficient and result in high fail rates. Settlement delays, in many cases beyond sixty days, are prevalent due to the limitations of some foreign settlement systems.

You assert that the high systemic fail rates in some countries cause broker-dealers to incur capital charges which do not effectively encourage the settlement of foreign transactions and which exceed the level of risk of such transactions.

A. Timing of Capital Charges on Foreign Fails to Deliver

You assert that the settlement date for transactions in foreign issued, foreign settled securities should be based on the current settlement cycle of the country in question, except for transactions in securities where settlement is on a seller's option basis. You assert that the settlement date in jurisdictions where settlement is on a seller's option basis should be considered to be a day not more than thirty days from trade date. Further, to alleviate the Division's concerns with the risk imposed by certain large unsettled transactions with a single counterparty involving undelivered foreign issued, foreign settled securities, you suggest that a broker-dealer incur a concentration charge, during the period from the trade date until an aged failed to deliver charge is taken equal to 100 percent of the excess of all trade date based failed to deliver deficits with a single counterparty in excess of twenty-five percent of the broker-dealer's tentative net capital [i.e., net capital before the application of subparagraphs (c)(2)(vi) or (f)(3) of Rule.]

Based on the above, the Division will not recommend any action to the Commission if instead of treating a fail to deliver as aged five business days after trade date for purposes of paragraph (c)(2)(ix) as to foreign issued, foreign settled securities transactions, a broker-dealer elects the following treatment:

1. Five calendar days after settlement date (in accordance with the customary foreign settlement cycle), the broker-dealer shall take a proprietary haircut charge for the foreign issued, foreign settled securities failed to deliver pursuant to Rule 15c3-1, reduced by the equity (or increased by the deficit) in the transaction on a mark-to-market basis. In those countries where settlement is on a seller's option basis, the settlement date for purposes of this computation will be considered to be a day not more than thirty calendar days from the trade date;

2. During the period from trade date until the aged failed to deliver charge is required to be taken, the broker-dealer shall take a concentration charge on a mark-to-market basis equal to 100 percent of the excess of all trade date based deficits with a single counterparty in excess of 10 percent of the broker-dealer's tentative net capital; 1/

3. In determining a required deduction, the broker-dealer may reduce such deficit by any margin or other deposit held by the broker-dealer in connection with such transaction with the same party and any net equity in all failed to receive transactions, on a trade date basis, with the same party;

1/ Your letter suggests that the deficit should equal 25% of tentative net capital before a charge would be required. Considering the possibly lengthy settlement period and possible volatility and relative illquidity of some of the securities involved, this appears to be too great an extension of credit as to one entity, at least until the matter can be further studied.

4. In determining a required deduction, the broker-dealer may reduce such deficit by any margin calls issued by the broker-dealer, outstanding not more than two business days. A broker-dealer may take advantage of this provision regarding margin calls only if it has a written agreement with the customer regarding the issuance and satisfaction of margin calls;

5. The broker-dealer shall file a written notice with the national securities exchange or registered national securities association which is its designated examining authority of its intention to apply this alternative treatment instead of the requirements of subparagraph (c)(2)(ix) of Rule 15c3-1; and

6. The broker-dealer will maintain in its records a schedule of the current settlement cycle of each country in which it trades.

B. Size of Capital Charges on Foreign Fails to Deliver

You also express concern with the 100 percent capital charge a broker-dealer is required to take for fails to deliver of securities traded on foreign exchanges that were not included in a December 29, 1975 no-action letter from the Division to the SIA, which set forth ready market criteria for foreign listed securities. You concede that the longer such securities are failed to deliver, the greater the risk of loss to the broker-dealer. However, rather than a 100 percent charge, you suggest the imposition of certain graduated charges for such failed to deliver securities.

You propose that a broker-dealer, in lieu of taking the haircut charges for foreign failed to deliver securities required pursuant to Rule 15c3-1(c)(2)(vi), take an alternative haircut charge for foreign securities which are traded on exchanges in Australia, Austria, Belgium, Canada, Denmark, Federal Republic of Germany, Finland, France, Hong Kong, Italy, Japan, Luxembourg, Malaysia, Netherlands, New Zealand, Norway, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland and the United Kingdom, that were not included in the December 29, 1975 no-action letter from the Division to the SIA.

Pending further study by the Commission, the Division will not recommend any action to the Commission, if a broker-dealer which has given the written notice described above incurs the following charges instead of the 100% charge otherwise required as to those securities traded on exchanges and settled in the

countries you enumerate 2/: 1) For failed to deliver securities which are outstanding 5-29 calendar days from settlement date, the haircut charge would be equal to the standard proprietary haircut charge for securities which meet the Commission's criteria as readily marketable securities under Rule 15c3-1(c)(11); 2) for failed to deliver securities outstanding 30-59 calendar days from settlement date, the haircut charge would be equal to twice the standard proprietary haircut charge for securities which meet the readily marketable criteria of Rule 15c3-1(c)(11), but no greater than thirty percent of the market value of said securities; 3) for failed to deliver securities outstanding 60-89 calendar days from settlement date, the haircut charge would be equal to four times the standard proprietary haircut charge for securities which meet the readily marketable criteria of Rule 15c3-1(c)(11), but no greater than sixty percent of the market value of said securities; and 4) for failed to deliver securities outstanding 90 calendar days or more from settlement date, the haircut charge would be 100 percent of the market value of said securities.

C. Timing of Capital Charges on Foreign Fails to Receive

You also state that the aging period for purchases of foreign issued, foreign settled failed to receive securities which have a customary settlement date longer than five business days from trade date, should begin upon completion of the current settlement cycle in that foreign country. In those jurisdictions where settlement occurs on a seller's option basis, settlement date would be considered to be a day not more than thirty days from trade date. In response to the concern with the risk of large unsettled failed to receive transactions with a single counterparty, you recommend a concentration charge equal to 100 percent of the excess of all failed to receive deficits with a single counterparty in excess of twenty-five percent of the broker-dealer's tentative net capital. Upon completion of the thirty calendar day aging period from settlement date, the broker-dealer would of course take the full deficit charge without regard to the charge's relationship to the broker-dealer's tentative net capital.

2/ This has no affect on the ready market criteria set forth in the letter of December 29, 1975 as to proprietary positions in these securities.

Based on the above, the Division will not recommend any action to the Commission if a broker-dealer elects the following treatment, instead of the requirements of Rule 15c3-1(c)(2)(iv)(E) for foreign issued, foreign settled failed to receive securities transactions:

1. Thirty calendar days after settlement date (in accordance with the current foreign settlement cycle) or forty-five calendar days after trade date, whichever comes first, the broker-dealer shall take a charge equal to the amount by which the market value of the foreign

issued, foreign settled securities failed to receive exceeds the contract value of such securities failed to receive (the "deficit"). In those countries where settlement is on a seller's option basis, the settlement date for purposes of this computation will be considered to be a day not more than thirty calendar days from trade date;

2. During the period from settlement date until the aged failed to receive charge is required to be taken, the broker-dealer will take a concentration charge on a mark-to-market basis equal to 100 percent of the excess of all failed to receive deficits with a single counterparty in excess of ten percent of the broker-dealer's tentative net capital; 3/

3. In determining a required deduction, the broker-dealer may reduce such deficit by any margin or other deposit held by the broker-dealer in connection with such transaction with the same party and any net equity in failed to deliver transactions not older than five business days past settlement date and/or the net equity in all other failed to receive transactions with the same party;

3/ For the same reasons cited above in footnote 1, the Division believes the concentration level should arise at ten percent rather than twenty-five percent of tentative net capital.

4. In determining a required deduction, the broker-dealer may reduce such deficit by any margin calls issued by the broker-dealer, outstanding not more than two business days. A broker-dealer may take advantage of this provision regarding margin calls only if it has a written agreement with the customer regarding the issuance and satisfaction of margin calls;

5. The broker-dealer shall file a written notice with the national securities exchange or registered national securities association which is its designated examining authority of its intention to apply this alternative treatment in lieu of the requirements of subparagraph (c)(2)(iv)(E) of Rule 15c3-1; and

6. The broker-dealer will maintain in its records a schedule of the current settlement cycle of each country in which it trades.

D. Conclusion

The broker-dealer which takes advantage of the alternative procedures described above should maintain and preserve separate records, in whatever form appropriate, detailing, by country, the total number of failed to receive and failed to deliver contracts when the alternate procedures set forth in this letter have been relied upon, and the total contractual value of those contracts and transactions.

You should understand that the positions expressed herein are staff positions with respect to enforcement only and do not purport to express any legal conclusions on these matters. The Division believes the outlined treatment is a reasonable interim approach to the issues discussed herein. The Division expects to monitor this program to assure that the procedures outlined function in a manner consistent with the objectives of Rule 15c3-1. On or before December 31, 1989, the Division will determine whether the no-action position expressed in this letter should be continued, modified or terminated. The Division's positions are necessarily confined to the facts as represented herein. Any material change in these conditions must be brought to the Division's attention immediately.

Sincerely,

Michael A. Macchiaroli
Assistant Director