

SECURITIES EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

DIVISION OF MARKET REGULATION

January 18, 1983

Mr. Kevin P. Howe

Vice President and Assistant

General Counsel

Investors Diversified Services, Inc.

IDS Tower

Minneapolis, Minnesota 55402

Dear Mr. Howe:

This is in response to your letter of June 11, 1982 on behalf of IDS Marketing Corporation ("Marketing") in which you request a no action letter with respect to Marketing's proposed net capital treatment of certain long-term leases.

I understand the pertinent facts to be as follows: Marketing is a wholly owned subsidiary of Investors Diversified Services, Inc. ("IDS"). Both IDS and Marketing are registered broker-dealers and members of the National Association of Securities Dealers (NASD). Marketing provides logistical and administrative services to the IDS sales force, trains new representatives, provides advanced product knowledge and marketing techniques to veteran representatives, and acts as branch manager for IDS Life of New York, a wholly owned subsidiary of IDS Life Insurance Company. Marketing also sells investment company securities for IDS and its associated investment companies, oil and gas and real estate limited partnership interests, and insurance products for IDS Life Insurance Company and IDS Life of New York. Marketing does not hold the funds of investors or customers at any time.

The NASD conducted an examination of Marketing during the week of October 26, 1981. In reviewing Marketing's computation of net capital and aggregate indebtedness, the NASD questioned its accounting treatment of certain capital

lease assets and capital lease obligations. At that time Marketing had \$409,712 in long-term leases for automobiles and training center leasehold improvements which it treated as capital assets in computing its net capital. Relying on subparagraph (c)(2)(iv) of Rule 15c3-1, Marketing fully offset these capital lease assets by the corresponding capital lease obligations on the automobiles and training center leasehold improvements, thereby treating the dollar

value of the capital leases as an allowable asset. In addition, Marketing excluded these capital lease obligations from its computation of aggregate indebtedness. The NASD disallowed Marketing's net capital treatment of its capital leases on the basis that the capital lease obligations (fixed liabilities) were not adequately secured by the capital lease assets.

Marketing presently has leases for automobiles and intends to enter into additional leases for telephones and new equipment. Marketing believes that its previous accounting treatment of capital lease assets and the corresponding capital lease obligations complies with the terms of subparagraphs (c)(2)(iv) and (c)(1)(viii) of Rule 15c3-1. Accordingly, Marketing requests that the Commission take no action if Marketing offsets its capital lease assets against the corresponding capital lease obligations to the extent of the lease asset in the computation of net capital and exclude the capital lease obligations from the computation of aggregate indebtedness.

Subparagraph (c)(1)(viii) provides that "(f)ixed liabilities adequately secured by assets acquired for use in the ordinary course of the trade or business of a broker or dealer" shall be excluded from "aggregate indebtedness." Likewise, subparagraph (c)(2)(iv) provides that "fixed assets and assets which cannot be readily converted into cash" need not be deducted from net worth in computing net capital to the extent of "any indebtedness excluded in accordance with subdivision (c)(1)(viii)" of the Rule.

It has been the consistent view of the Division that capital leases should be treated as purchases of assets which collateralize a financing loan. The liability representing the present value of the future lease payments is treated as indebtedness (a fixed liability) collateralized by the assets. Accordingly, the lease liabilities may be excluded from aggregate indebtedness and the capital leases need not be

deducted from net worth in computing net capital if the assets are either "acquired for use in the ordinary course of the trade or business of a broker or dealer," or the lessor's sole recourse for nonpayment of the liability is limited to the leased property.

The terms "assets acquired for use in the ordinary course of the trade or business of a broker or dealer" were intended to include only those assets which were essential to the conduct of a brokerage business generally. The purpose of the provision was to allow brokers and dealers leverage to finance the purchase of building(s) actually used in the conduct of the brokerage business, and equipment and furniture essential for the general conduct of a brokerage business. The special capital treatment accorded "[f]ixed liabilities adequately secured by assets acquired for use in the ordinary course of the trade or business of a broker or dealer" was intended to carve only a very narrow exception to the liquidity requirements of the net capital rule (Rule 15c3-1).

Thus, it is the view of the Division that automobiles used by a broker-dealer in its business are not generally essential to the conduct of a brokerage business. Accordingly, automobiles cannot be treated as allowable assets pursuant to subparagraph (c)(2)(iv) of Rule 15c3-1 unless they collateralize a sole recourse liability. Similarly, capital lease obligations secured by the automobiles cannot be excluded from aggregate indebtedness under subparagraph (c)(1)(viii). However, telephones and other office equipment used by the broker or dealer in its securities business can be treated as allowable assets under subparagraph (c)(2)(iv) of the Rule, provided they "adequately secure" a related liability. Likewise, the capital lease obligations "adequately secured" by the telephones and office equipment may be excluded from aggregate indebtedness under subparagraph (c)(1)(viii) of Rule 15c3-1.

If you have any further questions, please do not hesitate to contact us.

John C. Bryce

Staff Attorney

cc:

William J. Gaynor

Chicago Regional Office

Gerald F. Cuny

Sincerely,

NASD Chicago District Office

Darrell Proctor

NASD

INVESTORS DIVERSIFIED SERVICES, INC. • IDS TOWER • MINNEAPOLIS, MINNESOTA
55402

KEVIN P. HOWE VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL (612)
372-3142

Mr. Nelson S. Kibler, Director Office of Financial Responsibility Division of Market
Regulation Securities and Exchange Commission 500 North Capitol Street
Washington, D. C. 20549

June 11, 1982

Dear Mr. Kibler:

We are writing to you on behalf of IDS Marketing Corporation (Marketing) to request a no-action position regarding the treatment of capital lease assets under the Net Capital Rule, 17CFR ~ 240.15c3-1 (1981). Marketing requests that the SEC staff indicate that "no action" be taken if Marketing treats certain long-term leases as capital assets and offsets such capital lease assets by the corresponding capital lease obligations when computing net capital and aggregate indebtedness under the provisions of the Net Capital Rule.

Marketing is a wholly owned subsidiary of Investors Diversified Services, Inc. (IDS). Both IDS and Marketing are registered broker-dealers and members of the National Association of Securities Dealers (NASD). (Marketing's SEC Broker-dealer file number is 8-16791; IDS' SEC Broker-dealer "file number is 8-340). Marketing provides logistical and administrative services to the IDS sales force, trains new representatives, provides advanced product knowledge and marketing techniques to veteran representatives, and acts as branch manager for IDS' Life of New York, a

wholly owned subsidiary of IDS Life Insurance Company. It also sells investment company securities for IDS and its associated investment companies, oil and gas and real estate limited partnerships, and insurance products for IDS Life Insurance Company and IDS Life of New York. In the course of its business activities, Marketing does not at any time hold any funds of investors or customers.

As a registered broker and dealer in securities, Marketing must meet "net capital" requirements as defined in the Net Capital Rule (Rule). (IDS has received an exemption from the Rule.) The NASD conducted an examination of Marketing during the week of October 26, 1981. In reviewing the computation of net capital and aggregate indebtedness, the NASD staff questioned Marketing's accounting treatment of certain capital lease assets and capital lease obligations. Marketing had \$409,712 of long-term leases for automobiles and training center leasehold improvements which it treated as a capital asset for the purpose of net capital computation. Marketing offset these - capital lease assets by the corresponding capital lease obligations of the automobiles and training center leasehold improvements to the extent of the lease asset. Accordingly, Marketing excluded the capital lease obligations of automobiles and training center leasehold improvements from its computation of aggregate indebtedness.

The NASD interpretation of the Rule was that the lease obligations of certain leases capitalized by Marketing were not adequately secured by capital lease assets. For these leases the lessor potentially had recourse beyond recovery of the leased assets. The NASD interpretation stated that such capital lease assets should not be offset by the corresponding capital lease obligations. The NASD interpretation had the effect of reducing Marketing's net capital and increasing its aggregate indebtedness. Previous NASD examinations had not questioned Marketing's accounting treatment of similar capital lease assets and the corresponding capital lease obligations for the purpose of net capital and aggregate indebtedness computation. However, it was not clear whether the NASD had focused on the issue in the previous examinations. Although Marketing did not agree, it revised its treatment of capital lease assets and corresponding capital lease obligations when computing net capital and aggregate indebtedness to be consistent with the NASD interpretation of the Rule. Subsequently, IDS assumed the lease obligation for the training center leasehold improvements •

Marketing presently has leases for automobiles and intends to enter into additional leases for telephones and new equipment. Marketing believes that the NASD interpretation of the Rule is wrong and that it should be able to use its previous accounting treatment for capital lease assets. Marketing's previous accounting treatment followed the provisions of the Rule. The Rule's definition of "net capital" includes several adjustments to net worth. Subdivision (c) (2) (iv) (A) authorizes the deduction of fixed assets and assets which cannot be readily converted into cash /less any indebtedness excluded in accordance with subdivision (c) (1) (viii)/. Pursuant to subdivision (c) (2) (iv) (A), Marketing deducted the capital-lease assets (less the corresponding capital lease obligations) from its net worth. Furthermore, the Rule's definition of "aggregate indebtedness" provides for several exclusions. Specifically, 15c3-1 (c) (1) (viii) excludes certain fixed liabilities which are secured by assets from aggregate indebtedness. The Rule states that to qualify for exclusion under the definition of aggregate indebtedness, the assets must either be "acquired for use in the ordinary course of the trade or business of a broker or dealer" or the lessor's sole recourse must be limited to the leased property. Marketing's leases for automobiles and training center leasehold improvements were acquired for use in the ordinary course of the business of Marketing and/or the capital lease assets represented fixed liabilities which were secured by collateralized assets. By allowing exclusions of fixed liabilities from aggregate indebtedness, the definitions of net capital and aggregate indebtedness as set forth in the Rule support Marketing's accounting treatment of capital lease assets and the corresponding capital lease obligations.

Marketing's accounting treatment is in compliance with the provisions of the Statement of Financial Accounting Standards No. 13, "Accounting for Leases" (FASB 13), issued by the Financial Accounting Standards Board in November, 1976. Prior to the effective date of FASB 13, Marketing treated such leases as operating leases with rental payments expensed in the current accounting period. The provisions of FASB 13 are effective for leasing transactions entered into on or after January 1, 1977. FASB 13 identifies the criteria which must be met for a lease to be classified as a capital lease by a lessee and also identifies accounting and reporting requirements of a lessee with respect to capitalized leases. (Due to the complexity of the rules, we prefer not to go into the specifics of FASB 13.) Pursuant to FASB 13,

Marketing's long-term leases for the automobiles and training center leasehold improvements met the criteria for classification as a capitalized lease. As a result, Marketing treated such capital lease assets and the corresponding capital lease obligations according to the provisions of FASB 13 and the Rule.

Moreover, the SEC staff affirmed this line of reasoning in response to a NYSE request in 1979 (NYSE Release No. 79-4 dated 3/79 is attached as Exhibit A). The NYSE requested that capitalized leases be treated as purchases of assets which collateralize a financing loan. The staff response indicated that the liability, which represents the present value of future lease payments, should be treated as indebtedness collateralized by the asset. To receive this favorable treatment under the Rule, the SEC staff stated that the assets subject to the capitalized leases must be "acquired for use in the ordinary course of the trade or business of a broker or dealer" or the lessor's sole recourse must be limited to the leased property.

The American Institute of Certified Public Accountants' Audits of Brokers and Dealers in Securities contains an example of the computation of net capital and aggregate indebtedness in accordance with the Rule (See Exhibit B). This treatment also offsets capital lease assets against the corresponding capital lease obligations when computing net capital and excludes the capital lease obligations from aggregate indebtedness. Peat, Marwick, Mitchell & Company, Marketing's independent accountants, support such treatment.

Based on the foregoing, Marketing should be able to reinstate its previous accounting treatment of capital lease assets and the corresponding capital lease obligations when computing net capital and aggregate indebtedness. The provisions of the Rule support Marketing's previous accounting treatment and the SEC staff has indicated approval of similar accounting treatment. Marketing should be able to offset its capital lease assets against the corresponding capital lease obligations to the extent of the lease asset in the computation of net capital and exclude the capital lease obligations from the computation of aggregate indebtedness. Marketing requests that the SEC staff issue a no-action letter formally indicating approval of Marketing's previous accounting treatment of capital lease assets and capital lease obligations under the Rule.

If you need any additional information, please call the undersigned at (612) 372-3142.

Sincerely,

KPH/jb

Attachments

cc Gerald F. Cuny

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