



D. VISION OF  
MARKET REGULATION

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

*Arbitrage Positions*

January 25, 1989

Mr. Edward R. Venit  
Kelly Drye & Warren  
1330 Connecticut Avenue, N.W.  
Washington, D.C. 20036

Dear Mr. Venit:

In your letter dated May 16, 1988 you ask for the net capital rule treatment of a short common stock position offset by a long bond position convertible into an equal amount of the short common stock.

We understand the facts to be as follows: Your firm represents Baring Securities, Inc. ("Baring") which computes its net capital requirement under the alternative method, pursuant to subsection (f) of Rule 15c3-1. Baring holds a "long" position in certain bonds convertible at will into common stock of the issuer. Baring has also sold "short" a certain number of shares of the company which issued the convertible bonds. Therefore, the long convertible bond position is partially hedged by the short stock position.

Baring is carrying both its long bond and its short stock positions at 100% of market value, with the resulting gain or loss reflected in retained earnings. Baring has computed the haircut on the unhedged portion of the convertible bond position pursuant to subsection (f)(3) of Rule 15c3-1.

In your letter you pose two areas of concern. First, in order to reflect the economic loss that would be incurred if the bonds were put into conversion, Baring has taken a deduction on the hedged position equal to the difference in market value between the bonds and the common stock. Second, Baring also takes an undue concentration charge, pursuant to subsection (f)(3)(iii) of Rule 15c3-1, on the market value of the entire bond position.



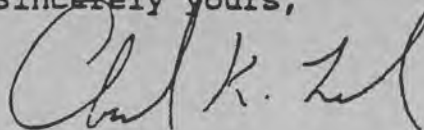
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With regard to the deduction on the hedged position, it is the position of the Division of Market Regulation that Baring's calculation of the market value deduction is correct. Alternatively, Baring may treat its long position in the convertible bonds and its short position in the underlying stock as two individual unhedged positions. If Baring were to elect to proceed in this alternative manner, it would be required to determine separate haircuts for both the long position in the convertible securities and the short position in the underlying securities.

Subparagraph (f)(3)(iii) of Rule 15c3-1 requires an undue concentration charge under the alternative method of computing net capital, where the broker-dealer holds certain securities which are long or short in its proprietary accounts which have a market value of more than 10 percent of its tentative net capital. In your letter, you indicate that Baring is unsure whether the undue concentration charge should be calculated on the basis of the market value of the entire bond position or only the unhedged portion. You indicate that Baring is presently following the more conservative approach by calculating the undue concentration charge on the basis of the market value of the entire bond position. You argue however, that the undue concentration charge should be based only on the market value of the unhedged position because this figure more closely reflects the firm's true market risk in the position.

Based on the circumstances indicated above, the Division of Market Regulation will recommend no action to the Commission if Baring calculates its undue concentration charge on the basis of the market value of the unhedged portion of its securities holding and does not reduce its net worth by any undue concentration charge on the hedged portion of the convertible bond position. The Division's position in this regard does not constitute a conclusion of law and is confined to the facts as you have represented them to us. Any material change therein may warrant a different result and should be brought to the Division's attention.

Sincerely yours,



Arvind K. Lal  
Staff Attorney