

NATIONAL ASSOCIATION OF SECURITIES DEALERS INC. 1735 K STREET, NORTHWEST
WASHINGTON, D.C. 20549

May 16, 1974

Mr. Lee A. Pickard, Director Division of Market Regulation Securities and Exchange
Commission 500 North Capitol Street Washington, D.C. 20549

Dear Mr. Pickard:

Since Rule 15c3-3 was adopted, the Association has received a number of technical questions from its members regarding the possession and control requirements and the mechanics of calculating the reserve formula under the Rule. In particular, questions often arise with respect to these matters in conjunction with the maintenance of margin accounts. While attempting to answer these questions, we became aware that there is a wide divergency of interpretations being rendered by the various self-regulatory organizations.

Therefore, in an endeavor to remove some of the confusion that currently exists, we have outlined a number of situations, which are not intended to cover all the areas of ambiguity, but are merely directed to those problems most commonly raised by our members and request that you respond to those questions at your earliest convenience.

Possession or Control

Pursuant to Paragraph (b) of the Rule 15c3-3, a broker-dealer is required to promptly obtain and then after maintain possession or control of a customer's fully paid and excess margin securities. Excess margin securities are defined as these securities whose value is in excess of 148 percent of the net debit balance in a customer's accounts.

Based on the above, the following questions have been raised.

1. Must a leading unit or round lot (normally 100 shares) be broken up to satisfy the possession and control requirements? If the answer is no, as has been indicated to us, the following questions are then raised.
2. If a customer's margin debit is secured solely by one round lot whose value is well in excess of the 140 percent guideline (i.e. \$3,000 debit securities value

\$10,000) should these securities be placed in customer segregation or may the broker-dealer designate such securities as collateral to support the customer's indebtedness?

3. If the round lot is segregated and not designated as customer's collateral, is the corresponding customer's debit balance deemed to be secured for the purpose of Item 10 of the reserve formula?
4. If a firm segregates all margin securities to avoid cashing problems, must it designate these securities which are excess margin and those which are not?

Reserve Formula -Note B(1)

1. If a firm determines to support a customer's margin debit and place all of the customer's margin securities in this segregation box, are the customer's debit balances and securities position charged in the determination of undue concentration pursuant to Note (B)?
2. If a broker-dealer determines to supported of its customers' margin debits and does not hypothecate nor lead customers' excess margin securities and, in fact, segregates all such securities, does Note (B) apply, and if so, is the broker-dealer required to designate such excess margin securities?
3. If all customers' margin and excess margin securities are segregated and are not used to support the margin debits, are these debits considered secured for the purpose of Item 10 of the formula?

Reserve Formula - General

1. If a broker-dealer makes a prepayment on a fail to receive for the account of a customer, possibly creating a contingent liability, is the balance in Item 4 of the formula reduced by an amount equal to the prepayment, or is it included until such time the securities are received?
2. Item 5 of the formula is intended to protect customers' positions until such time as short sales to customers are covered by the selling broker-dealer; therefore, should Item 5 reflect credits to a firm trading account created by

short sales to customers or the current market value of the resulting short position?

3. If the credit, created by a short sale to a customer, is reflected in Item 5 and such short sale is partially covered by the broker-dealer, should this item reflect the resulting decrease in the credit which may not truly reflect customer exposure, e.g. the price of the security has risen, or the current market value of the remaining short position?
4. If a broker-dealer ships securities free to under broker-dealer to satisfy a fail to deliver created by a customer transaction, is Item 12 of the formula reduced by an amount equal to the receivable based on the free shipment?

The Association again recommends and offers its assistance in the publication of a broker-dealer guide with respect to Rule 15c3-3 but in the meantime requests your prompt attention and reply to the above questions so that we may direct both our members and examining staff with regard to member compliance pursuant to the provisions of Rule 15c3-3.

Very truly yours,

Frank J. Wilson Senior Vice President Regulation

SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549

July 16, 1974

Mr. Frank J. Wilson Senior Vice President Regulation National Association of Securities Dealers, Inc. 1735 K Street, N.W. Washington, D.C. 20006

Dear Mr. Wilson:

In your letter of May 16, 1974 you raised a number of current questions related to the application of Rule 15c3-3 under the Securities Exchange Act of 1934 and request clarification thereof in order to eliminate certain ambiguities as to the interpretation of Rule 15c3-3. This letter intends to discuss and respond to the questions raised by your letter.

Possession or Control

Your first series of questions relate to the possession or control of fully paid or excess margin securities (i.e., the market value of those securities in excess of 140% of each customer's debit balance).

You have asked whether a trading unit or round lot must be broken up to satisfy possession or control requirements of Rule 15c3-3? While paragraph (b)(1) of the rule requires a broker-dealer to obtain and thereafter maintain possession or control of all fully paid and excess margin securities, the rule is also cognizant of the fact that normal operations in the securities business will sometimes make accomplishment of this requirement difficult or result in undue or unreasonable operational burdens for the broker-dealer in the present environment. The Division has therefore taken the position where less than a full unit of trading is required to be in possession or control no action pursuant to paragraph (d) of the rule will be required and delivery of trading units will not be precluded if a deficiency of less than a trading unit will result. If a deficiency exists, of course no further deliveries can be accomplished.

Next you inquire as to whether a margin debit secured by a round lot whose excess margin value is substantially in excess of 140% be required to be placed in possession or control? While the Division's basic position is that a broker-dealer may pledge customers margin securities in units of trading quantities without reference to the requirement to reduce to possession or control quantities of less than a trading unit, we believe the rule requires that where such excess margin value is material or substantial a broker-dealer should take appropriate corrective action. In this connection we note that Securities Exchange Act Release No. 9922 permits a broker-dealer to revise his selection of securities in margin accounts representing collateral for customers margin indebtedness.

Third, you inquire whether if a round lot of securities is in possession or control and not designated as customers' collateral the corresponding customers debit balance is deemed secured for the purpose of Item 10 of the Reserve Formula ("Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection").

It is our view that the determination of whether a debit balance is secured and therefore includable in Item 10 of the Reserve Formula is not effected by whether

the broker-dealer pledges, loans or holds such securities in his possession or control.

Finally, you inquire if a broker-dealer reduces all margin securities to possession or control, whether it must designate those which are excess margin and those which are not.

It is our view that where all securities in a margin account are reduced to possession or control all such securities will be deemed excess margin securities for purposes of Rule 15c3-3.

Reserve Formula - Note (B)(1)

Regarding Note (B)(1) of the Reserve Formula you ask if a firm determines to finance either one customer's or all customers' margin indebtedness with other than customer margin securities and places all margin securities in possession or control must these securities be considered in determining an undue concentration pursuant to Note (B)(1).

The Division interprets the rule to require that the undue concentration and exclusive provisions of Note (B) (1) apply on securities deemed margin securities to the extent of 140% of the debit balance carried; however, while such debit balances may not be financed by bank loans or stock loans, they may be supported by customer credit balances which require the protections which Note (B)(1) is intended to afford.

You also ask, with reference to margin and excess margin securities, which the broker-dealer has determined to place in possession or control and not use to finance customers' debit balances, whether such debits are considered secured for purposes of Item 10 of the Formula.

As we noted in response to an earlier question the determination of whether margin debits are secured is not effected by the fact that such securities have been pledged or loaned or placed in possession or control by the broker-dealer.

Reserve Formula - General

You also raise the question of a broker-dealer's prepayment of a fail to receive from another broker-dealer which may result in an unsecured short position where such

location is not an omnibus account with another broker-dealer which conforms to the requirement of Section 4(b) of Regulation T or a control location designated as permissible by the Commission pursuant to subparagraph (c)(7) of Rule 15c3-3. You inquire whether the amount in Item 4 of the Reserve Formula is to be reduced by the amount of such prepayment or retained as a credit item in the Formula.

Since the customers' securities are still failed to receive, the customer is exposed to the extent of the market value of the securities failed to receive and in our view such amount should be retained as a credit item in the Formula and no contra debit item is includable in the Formula for the money receivable from the broker-dealer failing to deliver. Where, however, the prepaid short position is located in what is deemed a valid control location pursuant to subparagraph (c)(7) of Rule 15c3-3, the credit item may be excluded in computing the Formula.

You inquire whether Item 5 of the Formula should reflect the current market value of the short position remaining uncovered or the amount of the credit to the firm trading account in cases where a broker-dealer's short sale to a customer in a firm trading account is either uncovered or partially covered.

It is our view that Item 5 should reflect the market value of such short positions since short positions in proprietary accounts should be continually market to the market as such market value most accurately reflects the actual customer exposure involved.

Lastly, you inquire whether a free shipment to another broker-dealer to satisfy a fail to deliver created by a customer transaction results in a reduction of Item 12 of the Reserve Formula. It is the Division's view that such free shipments result in the creation of an unsecured receivable or debit which is not properly includable as a debit item in the Reserve Formula as an offset to customers credit balances or other related obligations to customers.

Should you have any further questions, I or my staff would be happy to assist you.

Sincerely,

Nelson S. Kibler Assistant Director Office of Broker-Dealer Financial Responsibility
and Securities Transactions

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