NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST

WASHINGTON, D.C. 20006

March 07, 1980

Douglas S. Scarff

Director

Division of Market Regulation

Securities & Exchange Commission

500 No. Capitol Street

Washington, D.C. 20549

Dear Mr. Scarff:

On May 1, 1979, the staff of the Division of Market Regulation responded to a request by the Association seeking clarification as to whether subparagraph (c)(1)(iii) of Rule 15c3-1 (net capital rule) would permit an underwriter of investment company shares to exclude from "aggregate indebtedness", monies owed to investment companies, to the extent such liabilities were offset by receivables from other broker-dealers who had purchased shares of such investment companies. In this letter the staff of the Division opined that amounts payable to a mutual fund must be included in aggregate indebtedness.

It appears to us that the staff's position is based upon the technical distinctions between unsettled transactions which would commonly be understood to be "fails" and the transactions of an investment company principal underwriter which, while the same in essence, may not fit precisely within the traditional definition of the term "fail". In this connection, it is of interest to note that the term "fail" is not defined in Rule 15c3-1 although it is referenced throughout. We believe this position may not properly reflect the broader purposes of the net capital rule. We believe that for the reasons given below and, keeping in mind the overall purpose of subparagraph (c) (1) (iii) of the rule, and the similarity of the transactions in

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question to those to which the provision is primarily directed, the staff may wish to reconsider the position it expressed in its May 1, 1979 letter.

The primary differences between a traditional "fail to deliver" and a receivable from a broker-dealer on the books of an investment company principal underwriter, are:

(1) the investment company share transaction would not ordinarily be "delivery against payment" or C.O.D., and

(2) certificates may not be issued at all but rather the shares may be credited to the purchaser's account with the fund.

These differences, however, do not alter the essence of the transaction or the nature of the purchasing dealer's liability. The principal underwriter looks to the dealer for payment (just like an ordinary "fail" transaction) and, if payment isn't received, the shares purchased can be liquidated for the dealer's account and risk (just like an ordinary "fail" transaction).

As to the "payable" side of the transaction, the primary difference between the principal underwriter's payable to the investment company and a traditional "fail to receive" is that the investment company wouldn't ordinarily be a registered broker-dealer. (Of course this side of the transaction also would probably not involve certificates and even if it did, "delivery" would likely be made directly to the dealer or shareholder by the transfer/shareholder servicing agent of the fund.) We do not believe that a payable to, or possible delivery of certificates from, a company which is registered under the Investment Company Act of 1940, and which is subject to the pervasive scheme of regulation resulting therefrom, is so much different than a payable to a broker-dealer that additional capital must be maintained to carry the risk.

Another factor which is relevant to the staff's position is that net capital requirements as such have not been found by the Commission as necessary for investment companies (other than the requirements of Section 14 of the Act), even when such companies have precisely the same types of transactions with broker-dealers (or even with the public) as those in question. An investment company selling direct, i.e., without a principal underwriter (usually a no-load fund), may sell shares to a dealer in the same way as a principal underwriter for another company

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but need not be concerned about externally applied net capital requirements. Investment companies selling through principal underwriters therefore are at a competitive disadvantage to the extent that broker-dealers' net capital requirements restrict the ability of their underwriters to perform their distribution function.

We are neither suggesting that a net capital requirement for investment companies is necessary nor that the Commission or the staff should apply the net capital rule solely on the basis of competitive impact. We believe, however, that the operation of no-load funds described above argues against the necessity or desirability of applying the net capital rule to investment company principal underwriters in the manner required by the staff's May 1, 1979 letter.

The staff's May 1 letter did not express policy reasons for its position but, as noted above, was apparently based solely on the technical language of Rule 15c3-1. The staff may have been unaware that we had previously obtained an informal Commission staff opinion which was essentially in agreement with our position. This position was subsequently transmitted to an NASD member, which had in turn relied on such opinion in calculating net capital under the rule. We recognize that the staff is not required to provide a rationale for its views, beyond the specific language of the rule, however, in these types of circumstances, we believe an expression of the policy reasons for the staff's opinion are important. These reasons are particularly important when alternative approaches are available to effectuate the broad purpose of a rule.

In conclusion, we respectfully request that the staff of the Division of Market Regulation reconsider its view that an investment company principal underwriter may, pursuant to subparagraph (c)(1)(iii) of Rule 15c3-1, exclude from aggregate indebtedness, payables to investment companies which are offset by receivables from broker-dealers for shares purchased, in the same way as traditional "fails to receive" may be offset against "fails to deliver".

If you think it would be helpful, we would be pleased to meet with you to discuss these points in greater detail at your convenience.

Sincerely,

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Frank J. Wilson

Senior Vice-President and

General Counsel

FJW/nb

cc: S. Mendelsohn

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

June 28, 1978

Mr. Frank J. Wilson

Senior Vice-President and

General Counsel

National Association of Securities Dealers, Inc.

1735 K Street Northwest

Washington, D.C. 20006

Dear Mr. Wilson:

This is in response to your letter of March 7, 1980, requesting that the Division of Market Regulation reconsider its position taken in a letter to the NASD dated May 1, 1979, regarding the inclusion of amounts payable to a mutual fund in a broker-dealer's aggregate indebtedness computation under Rule 15c3-1 of the

1934 Act (17 CFR 240.15c3-1).

In that letter, the NASD requested clarification as to whether subparagraph (c)(1)(iii) of Rule 15c3-1 would permit an underwriter of investment company shares to exclude from aggregate indebtedness monies owed to investment companies to the extent that such liabilities were offset by receivables from other broker-dealers who had purchased shares of such investment companies. The Division responded

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that amounts payable to a mutual fund must be included in a broker-dealer's aggregate indebtedness computation regardless of whether such liabilities were offset by related receivables.

In your letter of March 7, 1980, and in subsequent conversations on this matter, you indicate that the Division's position in the May 1, 1979, letter was based on technical distinctions between unsettled transactions commonly understood to be "fails" and transactions of an investment company principal underwriter which may not fit precisely within the traditional definition of the term "fail". You point out that the Commission in Securities Exchange Act Release No. 16750 (April 16, 1980); 19 SEC Docket 1224 (the "Listrom case"), recognized the similarity between "fails" and transactions of an investment company principal underwriter and allowed "free shipments" of mutual fund shares to be treated as fails under Item 12 of the reserve formula under Rule 15c3-3.

Based in part on this analogy in the Listrom case, you request that the Division reconsider its view that an investment company principal underwriter may not, pursuant to subparagraph (c)(1)(iii) of Rule 15c3-1, exclude from aggregate indebtedness payables to investment companies which are offset by receivables from broker-dealers for shares purchased, in the same way as traditional "fails to receive" may be offset against "fails to deliver" under this provision.

As I am sure you are aware, Rules 15c3-1 and 15c3-3, although both obviously designed to promote customer protection, are different rules with different objectives. The primary purpose of Rule 15c3-3 is to ensure that customer funds and securities are protected and that customer funds are used only in proper areas of the broker-dealer's business, i.e., to finance customer debits. Rule 15c3-1, on the other hand, was designed to ensure that a broker-dealer had sufficient liquid assets to meet his current indebtedness and to prevent a broker-dealer from incurring indebtedness far in excess of his net capital. To this end, the uniform net capital rule contains a net capital ratio concept which prohibits a broker or dealer from incurring aggregate indebtedness in excess of 1500% of its net capital.

The net capital ratio concept was originally espoused in former Section 8(b) of the Securities Exchange Act of 1934 which prohibited a broker or dealer from incurring aggregate indebtedness in excess of 2000% of its net capital. Examination of the

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legislative history of this provision reveals that the creation of the ratio standard was the Congressional response to its desire to prevent brokers from incurring indebtedness far in excess of their capital as was done prior to the stock market crash of 1929. In enacting Section 8(b), Congress wanted to make certain that broker-dealers did not operate on a shoestring, with unlimited leverage.

The term "aggregate indebtedness" is deemed by the rules to mean "the total money liabilities of a broker or dealer arising in connection with any transaction whatsoever..." (emphasis added). The concept is not one based on risk which requires the analysis of each liability independently but, rather, is one based on the fact that the broker-dealer has aggregate contractual obligations of a measurable sum upon which he is expected to perform. Aggregate Indebtedness is an all-inclusive concept and, for that reason, the exemptions therefrom should be construed narrowly. What the Commission said in rejecting the view that overnight bank loans should be excluded from aggregate indebtedness is relevant here:

"This concept of appraising a broker's or dealer's liquidity and financial condition by measuring his net capital against his aggregate indebtedness achieves viability only to the extent that "aggregate indebtedness" provides a rational and substantially accurate measurement of all the liabilities incurred by brokers and dealers."

Securities Exchange Act Release No. 12482 (May 26, 1976), pp.9-10; 9 SEC Docket 722, 725.Paragraph (c)(1)(iii) of Rule 15c3-1 provides an exclusion from aggregate Indebtedness for:

"(iii) Amounts payable against securities failed to receive which securities are carried long by the broker or dealer and which have not been sold or which securities collateralize a secured demand not pursuant to Appendix (D), 17 CFR 240.15c3-1d or amounts payable against securities failed to receive for which the broker or dealer also has a receivable related to securities of the same issue and quantity thereof which are either fails to deliver or securities borrowed by the broker or dealer;"

Although not specifically defined in Rule 15c3-1, the "fail to receive" and "fail to deliver" concepts have always been thought of as existing between brokers and dealers. As the Commission stated in its Special Study of the Securities Markets:

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"'Fails to deliver' is a technical term that means the failure of a broker-dealer to deliver a certificate in proper form at the agreed settlement date to another broker-dealer. The term is not used to indicate the late delivery of a security to a customer by a broker-dealer.... The securities 'failed to receive' account, conversely, indicates the dollar amount of purchased securities which have not been delivered to the broker-dealer at settlement date by other broker-dealers. (Securities and Exchange Commission, Report of Special Study of Securities Markets, Doc. No. 95, Pt. 1, 88th Cong., 1st. Sess., 416 (1963))".

Also, the American Institute of Certified Public Accountants in its industry audit guide defines "fail to receive" as:

"Securities which the purchasing brokerage concern has not yet received from the selling brokerage concern at the settlement or clearance date. (American Institute of Certified Public Accountants, Audits of Brokers and Dealers in Securities. (1973), P. 199).

We know of no definition contrary to this and you have cited none. In any event, it is clear beyond doubt to what the Commission was referring.

In stating that receivables arising out of free shipments of mutual funds may be included under item 12 of the reserve formula as fails to deliver, the Commission in Listrom did not directly analogize receivables and payables arising out of mutual fund transactions to "fails to receive" and "fails to deliver." It simply stated its view that, since redemption agents of mutual funds are required by statute to pay for properly tendered shares within seven days, receivables arising out of mutual fund transactions are secured in a manner similar to "fails to deliver."

In addition, even if the Commission had directly analogized receivables and payables arising in connection with mutual fund transactions to "fails to receive" and "fails to deliver", such analogy would not necessarily be controlling for purposes of Rule 15c3-1. As noted previously, the purpose of Rule 15c3-3 is to ensure that customer funds and securities are protected and that customer funds are used only in proper areas of the broker-dealer's business, i.e., to finance customer debits. Since a receivable arising in connection with a mutual fund transaction is a customer debit, the Commission's determination that such

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receivables may be included under item 12 of the reserve formula was entirely consistent with the purpose and scope of Rule 15c3-3.

Rule 15c3-1, on the other hand, is a separate rule designed to insure that a broker-dealer has sufficient assets and does not incur indebtedness far in excess of its net capital. To classify amounts payable to a mutual fund as "fails to receive" such as you suggest, thereby excluding such liabilities from aggregate indebtedness, would only serve to dilute the net capital ratio concept and distort the purpose of the rule.

In sum, your arguments are inconsistent with the intention of the net capital rule. Whether or not the present exclusion of "fails to receive" which allocate to "fails to deliver" from aggregate Indebtedness was a prudent exercise of Commission rulemaking, we cannot extend the meaning of those clearly understood words to circumstances obviously not contemplated by the exclusion. Should you have any other alternatives to solve this problem, we would be glad to discuss them with you.

I hope these answers are responsive to your questions. Please contact us if we can be of further assistance.

Sincerely,

Nelson S. Kibler

Assistant Director

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