

DIVISION OF MARKET REGULATION

December 22, 1987

Mr. Michael J. Simon

Vice President - Associate General Counsel

National Securities Clearing Corporation 55 Water Street

New York, New York 10041

Dear Mr. Simon:

This responds to your letter dated October 2, 1987, written on behalf of the National Securities Clearing Corporation (NSCC") wherein you request a no-action position from the Division regarding NSCC's Reconfirmation and Pricing Service ("RECAPS"). In particular, you request that the Division take no enforcement action to the Commission if NSCC's members treat the RECAPS settlement date as the date of the fail for purposes of the Commission's net capital rule (17 CFR §240.15c3-1) and the customer protection rule (17 CFR §240.15c3-3) under the Securities Exchange Act of 1934.

We understand the pertinent facts to be as follows:

NSCC has developed a system to reconfirm and reprice securities transactions which were originally compared but have failed to settle in a timely fashion. NSCC has once previously conducted this fail clearance system, better known as RECAPS, on a pilot basis. The RECAPS pilot reconfirmed and repriced fails in municipal securities transactions for a limited group of participants. By letter dated June 11, 1987, this Division took a no-action position concerning only the net capital treatment of fails processed through the RECAPS pilot.

Essentially, the Division treated the RECAPS settlements as a new date for purposes of paragraph (c)(2)(ix) and (e)(2)(iv)(E) of the Commission's net capital rule, 17 CFR §240.15c3-1.

NSCC has now filed with the Commission a proposed rule amendment seeking to adopt an expanded version of the RECAPS service. NSCC It intends to expand the RECAPS service to allow all NSCC members to participate and by accepting fails in

other securities transactions besides municipals. NSCC will run the RECAPS system on a periodic basis as its members indicate a need. Currently, NSCC anticipates running the system no more often than quarterly.

The operation of the proposed permanent service will remain basically unchanged from the pilot. Members submit their fails into RECAPS on a day determined by NSCC. On the following day, the trade resolution procedure occurs for uncompleted submissions. On the second day following submission, NSCC issues final contract sheets and settlement instructions.

The manner of settlement for a reconfirmed transaction depends on whether the underlying securities have become eligible for NSCC's Continuous Net Settlement ("CNS") System. For CNS eligible securities, the transaction will settle in the CNS System on a day specified by NSCC, probably two days after the issuance of settlement instructions, with the difference between the contract price and the current market price also settling on that day. For non-CNS eligible securities the transaction will settle pursuant to balance orders, or receive and deliver tickets issued by NSCC, with money differences settling at NSCC on the same day. As in the pilot, NSCC will not guarantee the repricing service under RECAPS. Accordingly, NSCC may reverse a credit given to a participant if the contra party to the repriced transaction fails to make the corresponding payment.

The Commission's net capital rule imposes on registered broker-dealers certain deductions from net worth for "aged" fail to deliver or "aged" fail to receive securities transactions. A fail becomes aged when it remains unsettled for more than a specifically prescribed period of time past settlement date. The customer protection rule also imposes additional requirements on registered broker-dealers with aged fails. First, it requires a broker-dealer under certain circumstances to buy-in fail to receives outstanding more than thirty (30) calendar days. Second, it requires a broker-dealer in computing the reserve requirement to include as a credit the market value of all customers' fail to receives, rather than the contract value of such fails outstanding more than thirty (30) calendar days if the market value of the underlying securities exceeds the contract value of the fail. Furthermore, a broker-dealer must exclude as a debit the contract value of all customers' fail to delivers where such fails have become older than thirty (30) calendar days.

Based upon the foregoing representations regarding RECAPS, the Division will raise no question nor recommend any enforcement action if a broker-dealer participating in NSCC's RECAPS service treats the RECAPS settlement date as the date of the fail under paragraphs (c)(2)(ix) and (c)(2)(iv)(E) of the Commission's net capital rule, and paragraphs (d)(2) and (e) and Exhibit A of its customer protection rule. For purposes of computations under these provisions, the contract value of each fail should be the RECAPS's price of the contract rather than original price of the trade.

You should understand that this is a staff position on enforcement only and does not purport to be a legal conclusion on this matter. The Division's position is necessarily confined to the facts as you have represented them to us; any material change may warrant a different result and should be brought to the attention of the Division. This position is further conditioned upon NSCC keeping the Division fully informed of the results of each run of the RECAPS service. The information that NSCC should supply to the Division must at least consist of (1) the names of the participating members, (2) the number of fails submitted by each participant, (3) the number of submissions matched and unmatched for each participant, and (4) the net cash adjustment either debit or credit for each participant.

Please contact the undersigned if you have any further need of assistance on this matter.

Sincerely,

Michael T. Dorsey

Attorney-Advisor

cc: Martin Robby Michael T. Dorsey Attorney-Advisor New York Stock Exchange, Inc.
Thomas Cassella National Association of Securities Dealers, Inc.

Mr. Michael A. Macchiaroli

Assistant Director

Division of Market Regulation Securities and Exchange Commission

450 Fifth Street, N.W. Washington, D.C. 20549

Dear Mike:

October 2, 1987

As we discussed, attached is the no-action request for RECAPS. It is substantively identical to the earlier letter with the addition of a request for no-action with respect to Rule 15c3-3. We currently plan to run RECAPS again on November 20. Thus, I'd appreciate it if you could get a response back to me at least a week before that (November 13th). If you have any questions, please give me a call. Thanks for your help.

Sincerely,

Michael J. Simon

Mr. Michael A. Macchiaroli

Assistant Director

Division of Market Regulation Securities and Exchange Commission

450 Fifth Street, N.W. Washington, D.C. 20549

Dear Mr. Macchiaroli:

October 2, 1987

By letter dated April 20, 1987, ("April Letter") National Securities Clearing Corporation ("NSCC") requested the Division of Market Regulation ("Division") not to recommend enforcement action to the Securities and Exchange Commission ("Commission") if NSCC's members treat fails that have been reconfirmed and repriced through a one-time application of NSCC's Reconfirmation and Pricing Service ("RECAPS") as new fails for the purpose of Rule 15c3-1 ("Net Capital Rule")

under the Securities Exchange Act of 1934 ("Act"). By letter dated June 11, 1987, the Division granted the requested no-action position.

The purpose of this letter is to request that the Division extend the no-action position on a permanent basis and that the Division take a similar no-action position with respect to Rule 15c3-3 ("Customer Protection Rule") under the Act.

Description of RECAPS

The April letter, a copy of which is enclosed, contained a description of the one-time RECAPS pilot conducted in June, 1987. By rule filing number SR-NSCC-87-10, dated September 28, 1987, a copy of which also is attached, NSCC formally proposed adopting RECAPS as a permanent service of NSCC. It is anticipated that RECAPS will be run on a periodic basis, but no more often than quarterly. The next application of RECAPS tentatively is scheduled for November, 1987.

From an operational standpoint, only a few changes are being made in RECAPS as it moves from a pilot to a permanent service. The most important changes are that RECAPS now will be available to all NSCC participants, and that the service will be used for transactions in equity and other securities, in addition to municipal securities. RECAPS will continue to accept input of fails more than 15 days old on Friday evenings for comparison over the weekend. Once compared, the settlement for reconfirmed transactions will occur on either the following Monday or Tuesday, as described in the filing. Money settlement for the difference between contract price and current market price also will occur on that Monday or Tuesday as part of a member's daily money settlement.

Discussion

As described in the April Letter, pursuant to Paragraph (c)(2)(ix) of the Net Capital Rule, broker-dealers may have to deduct from their net capital a certain amount for each fail-to-deliver contract which is outstanding five business days or longer (21 business days or longer in the case of municipal securities). The amount depends on the appropriate haircut for the particular security and the difference between the contract price and the market price. Similarly, there is a potential capital charge for fail-to-receive contracts outstanding 30 days or longer under section (c)(2)(iv)(B) of the Rule.

These capital charges are reasonable and appropriate as the settlement date of the original contract becomes more remote and the market price moves from the contract price. However, once the parties to the transaction reconfirm their obligations to the trade and make whatever payment is necessary to update the price of the fail to the current market, it would appear to be appropriate to consider the date of the fail as the RECAPS settlement date for the purposes of the New Capital Rule.

NSCC requests, in effect, the same capital treatment for RECAPS transactions afforded other transactions when the contract price is updated to the current market. For example, in NSCC's CNS System, NSCC members are marked-to-the-market on a daily basis for trades that have been compared but do not settle on settlement day. Accordingly, CNS positions are not treated as aged fails under the Net Capital Rule. Similarly, RECAPS not only requires members to confirm their obligations to the trade, but requires that the trade be marked to the current market price.

Of course, unlike positions in CNS, the price of a RECAPS transaction will not be updated on a daily basis. Therefore, if members fail to settle the repriced RECAPS receive and deliver contracts, there may develop new aged fails subject to capital charges. NSCC, however, believes that the appropriate time to consider a RECAPS transaction as a "fail" is the RECAPS settlement date, and not the settlement date of the original transaction.

With respect to the Customer Protect Rule, similar policies guide in two specific provisions. First, under paragraph (d)(2) of that rule, a broker-dealer must "take prompt steps to obtain physical possession or control" of fully-paid or excess margin securities which it has failed to receive for more than 30 days. Second, with respect to the Formula for Determination of Reserve Requirement for Brokers and Dealers (the "Formula"), while a broker-dealer takes as a credit customers' securities failed-to-receive, there is a corresponding debit only for failed-to-deliver customer securities not older than 30 days, once the fail-to-deliver is aged 30 days or more, the debit drops from the Formula. This, in effect, requires the broker-dealer to deposit the amount of the fail in the Reserve Bank Account. Pursuant to the reasoning described above, NSCC believes that both fails-to-receive and fails-to-deliver reconfirmed and repriced through RECAPS should be considered new trades

as of the RECAPS settlement date for the purpose of these provisions of the Customer Protection Rule.

Conclusion

In accordance with the above, NSCC requests that the Division not recommend enforcement action to the Commission if NSCC's participants treat the RECAPS settlement day as the date of a transaction with respect to the fail-to-deliver and fail-to-receive provisions under the Commission's Net Capital and Customer Protection Rules. If you have any questions on this matter, please do not hesitate to contact me.

Sincerely,

Michael J. Simon

Vice President Associate General Counsel

MJS:lw

cc: Jonathan Kallman, Esq. Michael Dorsey, Esq. Angela Desmond, Esq. MSRB
Theresa Wright, NASD