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

DIVISION OF
MARKET REGULATION

December 30, 1996

Mr. Raymond J. Hennessy
Vice President
New York Stock Exchange, Inc.
20 Broad Street
New York, New York 10005

Dear Mr. Hennessy:

This letter is in response to the comments that we have received concerning the treatment of mortgage backed agency securities for purposes of calculating net capital under the net capital rule, Rule 15c3-1, under the Securities Exchange Act of 1934.[1]

I. INTRODUCTION

Paragraph (c)(2)(vi)(A) of the net capital rule sets forth the method for calculating the value, for net capital purposes, of a broker-dealer's proprietary positions in U.S. government securities. Securities issued under the sponsorship of the United States or any agency thereof, including mortgage backed agency securities, are U.S. government securities for the purposes of calculating haircuts under the net capital rule.[2] In calculating haircuts under subparagraph (c)(2)(vi)(A), the net capital rule imposes a smaller haircut for offsetting positions in mortgage backed agency securities and government securities under prescribed circumstances.

The net capital rule recognizes that longer term interest rate securities tend to be more volatile in price than shorter term interest rate securities. Therefore, subparagraph (c)(2)(vi)(A) of the net capital rule imposes higher haircuts on interest rate securities with longer remaining maturities than it does on similar securities with shorter remaining maturities. Presently, mortgage backed agency securities are placed into paragraph (c)(2)(vi)(A) on the basis of their remaining maturity. However, Salomon Brothers Inc. ("Salomon") represents that the volatility in the price of mortgage backed agency securities does not necessarily increase as their remaining maturity lengthens because whereas government securities return principal only at maturity, mortgage backed securities may return principal over the life of the security. Salomon represents that this amortized repayment of principal, as well as anticipated prepayments of the entire principal, has a significant effect on the price volatility of these securities that should be reflected in the net capital rule's treatment of these securities.

1/ 17 C.F.R. § 240.15c3-1 (1996).

2/ See, New York Stock Exchange Interpretation Handbook at 179.

II. REQUEST

Because mortgage backed securities are placed into paragraph (c)(2)(vi)(A) based on their remaining maturity, Salomon argues that the net capital rule may impose a greater than necessary charge on a position in mortgage backed agency securities that a broker-dealer considers to be appropriately hedged using a Treasury security with a shorter maturity. Conversely, it is possible that a broker-dealer's positions in mortgage backed agency securities and Treasury securities with equal remaining maturities may not act as a hedge, yet those positions would be treated as a hedge for purposes of the net capital rule, and the broker-dealer would incur little or no capital charge on that mortgage backed agency security position. Salomon believes that instead of using maturity, broker-dealers holding offsetting positions in mortgage backed agency securities and government securities should be able to consider a proper hedge for net capital purposes to be one where the duration of the mortgage backed security approximately equals the duration of the government security.

However, Salomon did not request no action relief to use duration as the basis for determining haircuts on mortgage backed agency securities because it believes that using duration as a basis for calculating haircuts for these securities would be too difficult to implement and monitor. Instead, pending a comprehensive reanalysis of the net capital rule by the Commission, Salomon represents that the market price of a mortgage backed agency security relative to its par value is an appropriate alternative for measuring and determining duration for the purpose of slotting the security into an appropriate haircut category of subparagraph (c)(2)(vi)(A).

Salomon represents that a mortgage backed agency security with a high coupon rate will experience a significant amount of prepayment of principal and, consequently, will tend to have a short duration. In addition, a mortgage backed agency security with a high coupon rate also generally trades at a significant premium over its par value. For example, Salomon represents that a thirty year mortgage backed security trading at $108 with a par value of $100 generally has a duration equal to a government security with nine to twelve months remaining maturity. Accordingly, Salomon proposes the treatment described below for mortgage backed agency securities. Salomon's proposal does not depend on duration or a prepayment model; instead, the market prices of mortgage backed agency securities are used to reflect the market's expectation of future prepayments and price volatility.

III. RESPONSE

Based on the discussion above, the Division will not recommend enforcement action to the Commission if a broker-dealer, in computing its net capital, applies the haircuts described below to the pass-through mortgage securities, as defined below, held in its proprietary and other accounts.

For the purposes of this letter, "pass-through mortgage securities" means any security issued under the sponsorship of the United States or any agency thereof that represents a pro rata interest or participation in the principal and interest cash flows generated by a pool of mortgage loans of which at least 95% of the aggregate principal is composed of fixed rate residential mortgage loans on one-to-four family homes, including five and seven year mortgage loans with balloon payments at maturity. Multifamily, adjustable rate, commercial, and mobile home mortgage loans shall not be considered pass-through mortgage securities under this letter.

1. Pass-through mortgage securities should be placed into the subcategories of Rule 15c3-1(c)(2)(vi)(A) in accordance with Table 1 based on their market value relative to par.

Table 1
Pass-Through Mortgage Securities

Category	**30 Year Pass-Throughs**	**15 Year Pass-Throughs**	**5 and 7 Year Balloons**
1(iv) 9 months but less than 12 months remaining maturity	> $108	NA	NA
2(i) 1 year but less than 2 years remaining maturity	> $105 but less than or = $108	> $103	> $102
2(ii) 2 years but less than 3 years remaining maturity	> $102 but less than or = $105	> $100 but less than or = $103	> $94 but less than or = $102
3(i) 3 years but less than 5 years remaining maturity	> $98 but less than or = $102	$100 or less	$94 or less
3(ii) 5 years but less than 10 years remaining maturity	$98 or less	NA	NA

2. In addition to the haircut under subparagraph (c)(2)(vi)(A) of Rule 15c3-1, a pass-through mortgage security offset, or hedged, against a U.S. government security (including futures contracts under subparagraph (c)(2)(vi)(A)(4) of Rule 15c3-1) or against another pass-through security is subject to an additional haircut on the hedged amount equal to the applicable percentages specified below in Table 2 or Table 3.[3]

Table 2
Haircuts on Hedged Amounts
of Pass-Through Mortgage Securities
Hedged Against Treasuries

Category	Deduction
1(iv)	0.75%
2(i)	1.00%
2(ii)	1.25%
3(i)	1.30%
3(ii)	1.35%

3/ For example, under the current net capital rule, a broker-dealer with a $1 billion long position in a 30 year pass through mortgage security priced below $98 and a $1 billion short position in a Treasury security with more than 5 but less than 10 years to maturity, the combined haircut would be: (6% x $1 billion long position) plus (4% x 1 billion short position) equalling $100 million. Under this no action letter, the pass through would be placed in the same category as the short treasury position and the haircut based on Table 2 would be: (1.35% x $1 billion) equalling $13.5 million.

Table 3
Haircuts on Hedged Amounts
of Pass-Through Mortgage Securities
Hedged Against Other Pass-Throughs

Category	Deduction
1(iv)	0.05%
2(i)	0.075%
2(ii)	0.10%
3(i)	0.15%
3(ii)	0.20%

3. A broker-dealer that elects to use this letter may, in lieu of the haircuts provided in Table 3 above, elect to separately compute haircuts for pass-through mortgage securities hedged with other pass-through mortgage securities pursuant to the applicable percentages specified in Table 4, provided that the hedged securities have the same coupon, the same stated maturity, and fall within the same category in Table 4.[4]

4/ For example, under Table 3 of this letter, a broker-dealer with a $100 million long position in a 30 year pass through mortgage security priced at $100 and a $100 million short position in a TBA pass through mortgage security with the same coupon and maturity also priced at $100, the haircut would be: (0.15% x $100 million) equalling $150,000. Under Table 4, the haircut would be (.125% x $100 million) equalling $125,000.

Table 4
Haircuts on Hedged Amounts
of Pass-Through Mortgage Securities
Hedged Against Other Pass-Throughs
With the Same Coupon and Maturity

Category	Deduction
1(iv)	.05%
2(i)	.075%
2(ii)	.10%
3(i)	0.125%
3(ii)	0.125%

4. The provisions of subparagraph (c)(2)(vi)(A)(5) of Rule 15c3-1 will apply to the haircuts calculated pursuant to this letter.

5. A broker-dealer may not offset pass-through mortgage securities against investment grade corporate debt securities under this letter, but it may continue to hedge investment grade corporate debt securities against other U.S. government and agency positions under subparagraph (c)(2)(vi)(F)(2).

You should be aware that this is a staff position with respect to enforcement only and does not purport to express any legal conclusions. This position is based solely on the foregoing description. Factual variations could warrant a different response, and any material change in the facts must be brought to the Division's attention. This position may be withdrawn or modified if the staff determines that such action is necessary for the protection of investors, in the public interest, or otherwise in furtherance of the purposes of the securities laws.

Sincerely,

Michael A. Macchiaroli
Associate Director