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

DIVISION OF
MARKET REGULATION

October 3, 1988

Mr. Joseph M. McDonough
Vice President Finance and Compliance
Power Securities Corporation
1355 S. Colorado Blvd.
Denver, Colorado 80222

Dear Mr. McDonough:

This is in response to your letter dated March 25, 1988, in which you, on behalf of Power Securities Corporation ("Power Securities"), raised several questions pertaining to the valuation and net capital treatment of certain short inventory positions. The securities are traded over-the-counter ("OTC") but are not (i) traded on the National Association of Securities Dealer's Automated Quotation System ("NASDAQ"), (ii) quoted in the National Quotation Bureau's "pink sheets," or (iii) regularly quoted in any other inter-dealer quotation system.

First, you inquire how short inventory positions in securities as described above are to be valued for purposes of financial statements and the Commission's net capital rule, Rule 15c3-1 (17 C.F.R. §240.15c3-1).

Broker-dealers are required to follow generally accepted accounting principles ("GAAP") in the preparation of their financial statements. The American Institute of Certified Public Accountants' in its "Audits of Brokers and Dealers in Securities" ("audit guide") states that marketable securities should be valued at current market value and securities with no ready market should be valued at fair value as determined by the management of the broker-dealer.

Market price is defined by the audit guide as usually meaning the last reported price at which a security has been sold. Where regular quotations for the securities in question are not available, the securities must be valued at fair value as determined by the firm's management. The audit guide states that the management's fair valuation procedures for securities that are not readily marketable should be designed to approximate the value that would have been established by market forces and "are generally a good faith estimate by management to determine the value of non-marketable securities." (p. 66) In establishing the value of non-marketable securities, we believe that, among other things, you should take into consideration the prices at which recent sales to your clients, customers, or others were made.

Next, you ask what is the appropriate reduction to be taken in your net capital computation for short inventory positions in the subject securities after the appropriate values have been established.

Although the appropriate deduction would appear to be 100% of the carrying value of the securities (the deduction found at subparagraph (c)(2)(vii) of the net capital rule for non-marketable securities), the Division will neither raise any question nor recommend any action if Power Securities in its net capital computation deducts from its net worth 40% of the fair value of its short positions in the subject securities. Power securities must also make the appropriate "undue concentration" deduction, as required by subparagraph (c)(2)(vi)(M) or (f)(3)(iii) of the rule, for any concentrated position it may have in the subject securities.

You should understand that the position expressed herein is a staff position with respect to enforcement only and does not purport to express any legal conclusion on this matter. The Division's position is necessarily confined to the facts as they are represented in this letter. Any changes therein may warrant a different position and should be brought to the Division's attention.

You should also review the Division's June 12, 1985, letter to Mr. John E. Pinto, Jr., of the National Association of Securities Dealers, Inc. In that letter, the Division stated that it would recommend no action if a broker-dealer applies subsection (c)(2)(vi)(K)(i) of the rule to certain of its pink sheet securities positions where it can show, first, there are three or more market-makers (other than the computing broker-dealer) in the pink sheets, even if the market makers do not display actual quotations and, second, the existence of bona fide inter-dealer trades within five business days before or after the date of valuation. (A broker-dealer may apply subsection (c)(2)(vi)(K)(ii) to its pink sheet positions if it can show there are one or two other market makers.) The trades must be of sufficient volume to justify a reasonable belief that the price used would support the liquidation of the entire position at or near that price. Furthermore, if the market place can absorb only a limited number of shares of a long security for which a ready market seems to exist, the non-marketable portion of that position is subject to a 100 percent deduction in the broker-dealer's net capital computation..

Sincerely,

Michael A. Macchiaroli

Michael A. Macchiaroli
Assistant Director