

SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549

DIVISION OF MARKET REGULATION

Mr. Jeffrey C. Bernstein

Co-Chairman Compliance Committee

International Operations Association Securities Industry Association

c/o Bear, Stearns & Co. Inc.

2 Broadway New York, New York 10004

Dear Mr. Bernstein:

This is in response to your April 17, 1989 letter on behalf of the Compliance Committee of the International Operations Association Division of the Securities Industry Association. Specifically, you ask that Rule 15c3-3 and Rule 17a-13 under the Securities Exchange Act of 1934 (17 C.F.R. §§ 240.15c3-3, 240.17a-13, respectively) be interpreted to recognize foreign settlement dates as to foreign issued and settled securities for purposes of the "Formula For Determination of Reserve Requirement For Brokers and Dealers Under Rule 15c3-3" ("Reserve Formula") (17 C.F.R. § 240.15c3-3a) and the quarterly securities count required by Rule 17a-13. You also request relief from the provision of Rule 15c3-3 that requires exclusion from the Reserve Formula of fails to deliver outstanding over thirty (30) calendar days.

I.

We understand the pertinent facts prompting your request to be as follows:

To comply with the provisions of Rules 15c3-3a and 17a-13, broker-dealers have developed extensive computer programs that are able to recognize only two dates for any transaction: trade date and settlement date. These computer systems must use the actual settlement dates of securities transactions so that appropriate entries in the stock records and general ledgers can be made and to provide the cashiering and money management departments with correct and timely information. Any other date used for settlement date would inhibit severely the

cashiering and money management departments from performing their functions in an efficient, economical, and timely manner.

The international securities market, however, is characterized by diverse settlement periods and procedures. Some countries have similar or more rapid automated securities settlement procedures than those found in the United States, while other countries' settlement systems are substantially slower than those in the United States. The manual securities settlement procedures that are used, such as physical delivery of certificates and multiple clearing agents, are relatively inefficient and result in high fail rates. Additionally, settlement delays, often in excess of sixty days, are prevalent in many countries due to the limitations of their securities settlement systems.

A. Settlement Date

1. Reserve Formula - Rule 15c3-3a

Paragraph (e)(1) of Rule 15c3-3 requires every broker-dealer to maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers" ("Special Reserve Bank Account") in which the broker-dealer must deposit cash or qualified securities in amounts computed in accordance with the Reserve Formula set forth in Exhibit A to Rule 15c3-3. Additionally, broker-dealers are required by paragraph (e)(3) of Rule 15c3-3 to make weekly computations to determine, in conformity with the Formula, the amount required to be deposited in the Special Reserve Bank Account.

To compute the Reserve Formula, broker-dealers must identify fails to receive, fails to deliver, stock loans, and stock borrows that are attributable to customer accounts. Where it is impractical or unduly burdensome to determine whether failed to receive contracts and failed to deliver contracts relate to proprietary accounts or customer accounts or whether securities loaned and securities borrowed are for proprietary purposes or are customer related, the broker-dealer may make an appropriate allocation on a conservative basis. Broker-dealers making such allocations are required to make and maintain records of each such allocation on a settlement date basis. The allocation procedure requires the use of stock records.

Defining settlement date for Reserve Formula purposes as five business days past trade date would require broker-dealers to make extensive changes to their computer systems to enable them to recognize three dates: the trade date, the date five business days after the trade date, and the actual settlement date for foreign issued and settled securities transactions. You state that, given the current available technology, such a change to broker-dealers' computer programs would be extremely expensive and would not achieve any measurable increase in customer protection.

2. Securities Count Rule - Rule 17a-13

Paragraph (b)(2) of Rule 17a-13 requires certain broker-dealers at least once in each calendar quarter to:

account for all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive, failed to deliver, subject to repurchase or reverse repurchase agreements or otherwise subject to [the broker-dealer's control or direction but not in the firm's physical possession by examination and comparison of the supporting detail records with the appropriate ledger control accounts.

Paragraph (b)(3) of Rule 17a-13 requires certain broker-dealers to:

verify all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive, failed to deliver, subject to repurchase or reverse repurchase agreements or otherwise subject to the broker-dealer's control or direction but not in the firm's physical possession, where such securities have been in said status for longer than thirty days.

You assert that broker-dealers encounter the same operational problems conducting their quarterly counts of foreign issued and settled securities as discussed above in connection with Rule 15c3-3a.

Accordingly, you request that the settlement date used for purposes of compliance with the requirements of Rule 15c3-3a, the Reserve Formula, and Rule 17a-13 be defined as "the customary settlement cycle in the foreign country" or, if the settlement cycle is on a "seller's option basis," no more than thirty (30) days from the trade date.

B. Fails to Deliver vs. Fails to Receive

Rule 15c3-3a allows broker-dealers to exclude both the debit and credit for securities failed to deliver that allocate to securities failed to receive of the same quantity and issue if the failed to deliver contract is not older than thirty (30) calendar days. Securities failed to deliver are excluded from the Reserve Formula if the failed to deliver contract is older than thirty (30) calendar days, no matter to what they allocate. Foreign securities often are characterized by high fail rates due to the inability of broker-dealers to "buy-in" or borrow foreign securities failed to receive and the settlement procedures employed in many foreign countries (which often involve the physical delivery of certificates).

You request permission for a broker-dealer to include in the Reserve Formula aged failed to deliver contracts that allocate to failed to receive contracts or other includable items as long as the security is a foreign issued and settled security, the failed to deliver contract is not older than 120 calendar days, and the broker-dealer reduces the debit item on a mark-to-market basis by the appropriate proprietary haircut charge.

II.

Based on the above, the Division will not recommend any action to the Commission if, for purposes of the Rule 15c3-3 Reserve Formula and paragraphs (b)(2) and (b)(3) of Rule 17a-13, broker-dealers treat the settlement date of foreign issued and settled securities as the customary settlement cycle in the particular country. In those instances where the settlement cycle is on a "seller's option basis," the settlement date must be a date no more than thirty (30) days from the trade date.

A broker-dealer using a foreign settlement date shall maintain in its records a schedule of the current settlement cycle of each country in which it trades and must file a written notice with its designated examining authority stating the broker-dealer's intention to apply this definition of settlement date to foreign security transactions.

Additionally, the Division will recommend no action to the Commission if a broker-dealer, in computing its Reserve Formula pursuant to Rule 15c3-3, includes as a debit item foreign issued and settled failed to deliver securities contracts

outstanding more than thirty (30) days past the customary settlement date that allocate to either failed to receive contracts or other includable credits if:

(1) the aged failed to deliver security is a foreign issued and settled equity security traded on an exchange or a foreign issued and settled debt security in Australia, Austria, Belgium, Canada, Denmark, the Federal Republic of Germany, Finland, France, Hong Kong, Italy, Japan, Luxembourg, Malaysia, Mexico, the Netherlands, New Zealand, Norway, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland, and the United Kingdom;

(2) the broker-dealer reduces the aged failed to deliver on a mark-to-market basis thirty (30) days after the customary settlement date by an amount computed in accordance with paragraph (c)(2)(ix) of Rule 15c3-1 under the Securities Exchange Act of 1934 (17 C.F.R. § 240.15c3-1), the net capital rule. For purposes of this calculation, broker-dealers are not required to apply paragraph (c)(2)(vii) of Rule 15c3-1; and

(3) the failed to deliver security contract is not outstanding more than sixty (60) calendar days past the customary settlement cycle in the foreign country or, if the settlement cycle is on a "seller's option basis," more than ninety (90) days from the trade date.

You should understand that the positions expressed herein are staff positions with respect to enforcement only and do not purport to express any legal conclusions on these matters. The Division's positions necessarily are confined to the facts as represented herein. Any material change in these conditions must be brought immediately to the Division's attention.

The Division expects to monitor this program to assure that the procedures outlined function in a manner consistent with the objectives of Rule 15c3-3 and Rule 17a-13.

Sincerely,

Michael A. Macchiaroli

Assistant Director

cc: Edward Kwalwasser New York Stock Exchange, Inc. John Pinto National Association of Securities Dealers, Inc.

April 17, 1989

Mr. Michael A. Macchiaroli

Assistant Director

Division of Market Regulation

Securities and Exchange Commission

450 Fifth Street, N.W. Washington, DC 20546

Dear Mr. Macchiaroli:

This letter is written on behalf of the Compliance Committee of the International Operations Association (the "IOA")* regarding the definition of settlement date for foreign issued, foreign settled security transactions included in the computation of the Reserve Formula pursuant to Rule 15c3-3 of the Securities Exchange Act of 1934 (the "Act") or subject to the procedures enumerated in Rule 17a-13 of the Act, and the treatment of foreign issued, foreign settled securities failed to deliver older than 30 calendar days in the Reserve Formula.

This is the third no-action request letter written on behalf of either the IOA or the SIA regarding the treatment of foreign issued, foreign settled security transactions under Rules 15c3-1, 15c3-3 and 17a-13.

In the first letter, dated April 29, 1988, we discussed problems broker-dealers were experiencing in complying with the "buy-in" requirements of paragraphs (d) and (m) of Rule 15c3-3. In that letter, we discussed the varying settlement periods and procedures in foreign countries. We explained that in some countries, the "regular way" settlement date is sooner than in the United States while in other countries, like the United Kingdom, Spain, France and Italy, the settlement periods are substantially longer. Some countries have rapid automated procedures, while some still have manual settlement procedures. These manual procedures, which involve physical delivery of certificates, re-issuance and re-registration of certificates, and

multiple clearing agents, are inefficient and result in high fail rates. It is these high systematic fail rates which leave broker-dealers with capital charges that exceed the level of risk involved.

The Commission's no-action letter dated June 16, 1988 granted broker-dealers certain relief by allowing that in lieu of the buy-in requirements of paragraphs (d) and (m) of Rule 15c3-3 a broker-dealer (in addition to other requirements), 30 days after settlement date, may take proprietary haircut charges for those securities pursuant to Rule 15c3-1 reduced (or increased) by the equity (or deficit) in the transaction on a mark-to-market basis. Settlement date for these purposes is considered the customary settlement cycle in the foreign country except where settlement is on a seller's option basis, in which case the settlement date for these purposes will be considered to be a day not more than 30 days from trade date.

In the second letter, dated November 9, 1988, we discussed the deductions a broker-dealer is required to take in connection with failed to deliver and failed to receive contracts involving foreign issued, foreign settled securities in accordance with paragraphs (c)(2)(ix) and (c)(2)(iv)(E) of Rule 15c3-1. We requested that settlement date for these purposes be consistent with how settlement date was treated in the Commission's no-action letter dated June 16, 1988 described above.

Realizing that the Commission is concerned that the risk, imposed by certain large unsettled transactions with a single counterparty involving undelivered foreign securities, may not be adequately addressed under the current procedures, we suggested the imposition of a concentration charge during the period from trade date until the aged fail to deliver or fail to receive charge is required to be taken.

We understand that the staff is currently reviewing our no-action request letter and we hope to have a positive response in the near future.

In order to further expedite the interpretation process relating to the handling of foreign issued, foreign settled security transactions in the various financial responsibility rules we would like to discuss the settlement date of these transactions in connection with the Reserve Formula and Rule 17a-13.

Reserve Formula

We strongly believe that settlement date for foreign issued, foreign settled security transactions included in the Reserve Formula must be consistently defined as the customary settlement cycle in the foreign country.

The preparation of the weekly Reserve Formula is a very time consuming and complicated process. Broker-dealers have developed very expensive and sophisticated computer programs in order to comply with the regulations. For most broker-dealers it is impractical or unduly burdensome to determine which fail to receive or fail to deliver contract relates to proprietary accounts versus customer accounts and which stock loan and borrow transactions are on account of proprietary or customer transactions. Therefore, an allocation procedure is allowed.

The NYSE Interpretation Handbook clearly states that when it is impractical or unduly burdensome to make this determination an allocation is permitted as long as it is made on a conservative basis to accomplish maximum protection for customers based on guidelines referred to in the Handbook. This allocation procedure is basically the same at each broker-dealer since it must always start at the same place, the settlement date stock record.

In a letter dated April 23, 1986 to Mr. Michael Helmick, the then Chairman of the American Institute of Certified Public Accountants' Stock Brokerage Auditing Sub-Committee, you stated that "in any event, the broker or dealer must maintain the securities record required by Rule 17a-3(a)(5) on a settlement date basis. Additionally, the broker or dealer must compute the formula set forth in Rule 15c3-3a on a settlement date basis".

The computer systems now being used or anticipated to be used for the near future recognize only two dates for a given transaction. They are: trade date-the date the trade was executed; and settlement date-the date the transaction is to be paid for and the securities delivered. The settlement date that is used in the computer systems must be the actual date the transaction will settle in order to allow the system to make appropriate entries in the stock record and general ledger systems and to provide the cashiering and money management departments with correct and timely information. Any other date used for the settlement date will severely inhibit the cashiering and money management

departments from performing their functions on an efficient, economical and timely basis.

If the Commission insists that the settlement date for purposes of the Reserve Formula must be no longer than five business days past trade date, then broker-dealers would be required to make extensive changes to their computer systems to enable it to recognize a third date in connection with foreign security transactions. This date would only be used as the settlement date for the Reserve Formula. We believe that, given the current available technology, such a change to the broker-dealer community computer programs would be extremely expensive and would not achieve any measurable increase in customer protection.

A review of the actual computation leads us to believe that if settlement date for foreign issued, foreign settled security transactions in connection with the Reserve Formula was changed to no more than five business days past trade date, the only material difference would be a "blow up" of both sides of the formula. (Most foreign security transactions would be included in the Formula on a trade date basis since there is no way for a transaction to settle if we are required to report it and allocate it prior to the real settlement date). However, since we would be adding equal debits and credits in the Formula if we included these transactions prior to their foreign settlement date, there would be a 3% reduction in aggregate debits. We do not believe that increasing the amount of funds on deposit in the reserve bank account by 3% of these debit balances is a valid reason to create operational nightmares and materially increase costs to broker-dealers engaging in foreign securities transactions.

We recognize that by not including these transactions in the Reserve Formula until their foreign settlement date, we are reducing debits in the Formula and thereby, reducing the minimum net capital required for a broker-dealer operating under the alternative provisions of Rule 15c3-1. However, we do not believe that this should be of concern to the Commission since we have dealt with the capital adequacy requirements of foreign issued, foreign settled security transactions in our second letter to the Commission concerning the net capital charges of aged fail to deliver and fail to receive contracts.

Rule 17a-13

We would like to take this opportunity to request that you also clarify the definition of settlement date for foreign issued, foreign settled security transactions in connection with the requirements of Rule 17a-13.

Rule 17a-13 requires a broker-dealer to "account for all securities failed to receive or failed to deliver by examination and comparison of the supporting detail records with the appropriate ledger control accounts and to verify all securities.. failed to receive or failed to deliver where such securities have been in said status for longer than 30 days".

The Committee requests that for the same operational problems outlined above in connection with the Reserve Formula, settlement date for compliance with the provisions of Rule 17a-13 be defined as the customary settlement cycle in the foreign country.

Treatment of Aged Fails to Deliver in the Reserve Formula

Rule 15c3-3 allows a broker-dealer to exclude both the debit and credit for fails to deliver which allocate to fails to receive of the same quantity and issue provided the failed to deliver contract is not older than 30 calendar days. In addition, fails to deliver which allocate to includable items in the Reserve Formula (i.e. customer short positions, etc.) are excluded from the Reserve Formula if the failed to deliver contract is older than 30 calendar days.

As discussed in our previous letters, the inability of broker-dealers to buy-in or borrow foreign securities failed to receive and the manual settlement procedures employed in many foreign countries, which involve the physical delivery of certificates, result in high fail rates. These high fail rates are similar to the fails generated in the municipal and the U.S. Government security market places.

In a no-action letter to the NYSE and the NASD on August 12, 1988, the SEC staff granted relief for aged failed to deliver contracts involving municipal securities or securities issued or guaranteed by the United States or any of its agencies in the Reserve Formula.

For all the reasons described above and in our previous letters and for reasons similar to those provided in connection with your no-action letter on municipal and U.S. Government securities we request permission for a broker-dealer to include in

the Reserve Formula aged failed to deliver contracts which allocate to either failed to receive contracts or other includable items as long as the security is a foreign issued, foreign settled security, the failed to deliver is not older than 120 calendar days and the broker-dealer reduces the debit item by the appropriate proprietary haircut charge adjusted for any mark-to-market.

Conclusion

We therefore request that you advise us that you will not recommend enforcement action to the Commission if a broker-dealer in computing the Reserve Formula pursuant to Rule 15c3-3 and complying with the provisions of Rule 17a-13 defines settlement date for foreign issued, foreign settled security transactions as the customary settlement cycle in the foreign country except where settlement is on a seller's option basis, in which case the settlement date for these purposes will be considered to be a day not more than 30 days from trade date.

In addition, the broker-dealer will maintain in its records a schedule of the current settlement cycle of each country in which it trades and will file a written notice with a National Securities Exchange or a Registered National Securities Association which is its designated examining authority of its intention to apply this definition of settlement date to foreign security transactions.

We further request that you advise us that you will not recommend enforcement action to the Commission if a broker-dealer, in computing the Reserve Formula pursuant to Rule 15c3-3 includes as a debit item failed to deliver contracts older than 30 calendar days which allocate to either failed to receive contracts or other includable items if:

1. the aged failed to deliver security is a foreign issued, foreign settled security;
2. the broker-dealer reduces the aged failed to deliver value for purposes of the Reserve Formula by an amount computed in accordance with Paragraph (c)(2)(ix) of the net capital rule (Rule 15c3-1) (the appropriate haircut plus or minus the mark-to-market); and
3. the failed to deliver contract is not older than 120 calendar days.

We believe that this proposal is consistent with the policies and purposes of the Act and the national interest in assuring a competitive position in the international financial markets for U.S. broker-dealers and customers. We therefore request your expeditious consideration of this proposal.

We would be happy to further discuss this matter with you at your convenience.

Very truly yours,

Jeffrey C. Bernstein

Co-Chairman

IOA Compliance Committee

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