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

DIVISION OF
MARKET REGULATION

July 13, 2001

Ms. Cheryl M. Kallem
Chairperson
Capital Committee
Securities Industry Association
1401 Eye Street, NW
Washington, DC 20005-2225

Re: Net Capital Treatment of Failed to Deliver Contracts in Non-Marketable Securities Outstanding Less than 30 Business Days

Dear Ms. Kallem:

This is in response to your letter dated July 12, 2001, on behalf of the Capital Committee of the Securities Industry Association ("SIA"), in which you request that the Division of Market Regulation ("Division") not recommend enforcement action to the Securities and Exchange Commission ("Commission") if broker-dealers do not deduct the entire amount of failed to deliver contracts in non-marketable securities outstanding less than 30 business days when computing net capital under Rule 15c3-1 of the Securities Exchange Act of 1934.[1]

I understand the relevant facts to be as follows: Paragraph (c)(2)(ix) of Rule 15c3-1 requires broker-dealers to deduct from the contract value of each failed to deliver contract that is outstanding five business days or longer the percentages of the market value of the underlying security that would be required by application of the deduction required by paragraph (c)(2)(vi) of Rule 15c3-1 (the "aged fail deduction"). The aged fail deduction must be increased by any excess of the contract price of the failed to deliver contract over the market value of the underlying security or reduced by any excess of the market value of the underlying security over the contract value of the failed to deliver contract, but not to exceed the amount of such deduction.

In your letter, you represent that the aged fail deduction is excessive when applied to foreign and domestic securities treated as non-marketable under paragraph (c)(2)(vii) of Rule 15c3-1, and does not reflect the risk that a counterpart will perform on its obligations. You also represent that losses from such contracts have been minimal because of risk management processes used by broker-dealers to monitor and manage risk associated with aged fails. Further, you represent that failed to deliver contracts in non-marketable securities generally result from differences in clearance and settlement systems, rather than from a counterpart's failure to perform.

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[1] 17 CFR 240.15c3-1 (2001).

In lieu of the aged fail deduction, you propose that broker-dealers not be required to deduct 100 percent of the value of failed to deliver contracts in non-marketable securities but that the charge be staggered over a period of time similar to that in paragraph (c)(2)(v) of Rule 15c3-1.

Based on the foregoing, the Division will not recommend enforcement action to the Commission if broker-dealers do not deduct 100 percent of the value of each failed to deliver contract in non-marketable securities that is outstanding five business days or longer but instead apply the following schedule:

Days Failed to Deliver Contract is Outstanding	Percentage Deduction
5 to 14 business days	15 percent
15 to 21 business days	50 percent
22 to 28 business days	75 percent
29 business days or more	100 percent

In addition, broker-dealers must increase the amount of the deduction set forth above by any excess of the contract price of the failed to deliver contract over the market value of the underlying security or reduce the deduction by any excess of the market value of the underlying security over the contract value of the failed to deliver contract, but not to exceed the amount of such deduction. Further, broker-dealers relying on the schedule set forth in this letter must have the ability to demonstrate to appropriate staff of the Commission or the broker-dealer's designated examining authority that the firm has an adequate process for monitoring risk associated with aged fails.

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

Sincerely,

Michael A. Macchiaroli
Associate Director

cc: Ms. Susan DeMando, NASD Regulation, Inc.
Ms. Elaine Michitsch, New York Stock Exchange, Inc.

Securities Industry Association
1401 Eye Street, NW • Washington, DC 20005-2225 • (202) 296-9410, Fax (202) 296-9775
www.sia.com, info@sia.com

July 12, 2001

Michael A. Macchiaroli
Associate Director
Division of Market Regulation
Securities and Exchange Commission
Mail Stop 5-1
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Macchiaroli:

Based on recent discussions and correspondence with you, the SIA's Capital Committee requests that the Division of Market Regulation not recommend any enforcement action if broker-dealers compute capital charges on aged fail to deliver transactions involving non-marketable securities in the manner prescribed below:

The Securities and Exchange Commission ("SEC")'s Rule 15c3-1(c)(2)(ix) generally requires that, after a fail to deliver transaction has remained unsettled for a specified period, a broker-dealer must take a capital charge based upon the extent to which the security's contract price exceeds its market value in addition to a haircut on the underlying security as prescribed within SEC Rule 15c3-1(c)(2)(vi).

As a result broker-dealers are frequently required to take substantial capital charges for aged fail to deliver transactions in foreign and domestic securities treated as non-marketable under SEC Rule 15c3-1, (or interpretations thereof), as the haircut required is stipulated as 100% of the market value of the underlying security. Delays in the settlement of these transactions are usually a result of differences in settlement systems, cycles and clearance practices between markets, rather than due to counter-party failure to perform. These transactions are collateralized with determinable exposure and based on our experience broker-dealer losses have been *de minimis* due to the failure to consummate aged fail to deliver transactions. The framework for capital charges has not changed to reflect the globalization of capital markets and advances in technology that have led to more integration and efficiency in these markets. Technology has also afforded broker-dealers more effective means of monitoring and reducing the inherent risk in these transactions. The prohibitive capital treatment of these transactions has precipitated the shifting of certain activities to offshore entities, away from US regulatory scrutiny.

In light of the above facts, the Committee feels it is prudent at this time to adopt a phased in approach to the capital charge for aged fail to deliver transactions on non-marketable securities based upon the broker-dealer's ability to demonstrate an adequate process for monitoring risk associated with aged fails.

The charge to capital would consist of a haircut on the underlying security, as indicated below, increased by any excess of the contract value over the market value of the underlying security or decreased by any excess of the market value of the underlying security over the contract value (not to increase capital) on the transaction.

Haircut Calculation:
15% after 5 business days
50% after 14 business days
75% after 21 business days
100% after 28 business days

We look forward to discussing this proposal with you at your earliest convenience. If you have any questions regarding the above please contact me at (347)643-4746 or George Kramer, the Committee's staff adviser at (202) 296-9410.

Very truly yours,

Cheryl M. Kallem /S/ GKramer

Cheryl M. Kallem
Chair, SIA Capital Committee

cc: Elaine Michitsch, New York Stock Exchange, Inc.