



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

DIVISION OF  
MARKET REGULATION

March 10, 1992

Douglas G. Preston  
Attorney  
Securities Industry Association  
120 Broadway  
New York, NY 10271

Dear Mr. Preston:

This is in response to letters to the Securities and Exchange Commission ("Commission") dated July 6, 1989 and August 14, 1990 on behalf of the Securities Industry Association ("SIA"). Those letters request clarification as to the deductibility of commercial paper under the Uniform Net Capital Rule, rule 15c3-1 under the Securities Exchange Act of 1934.<sup>1</sup>

Paragraph (c)(2)(vii) of the Uniform Net Capital Rule requires that a broker-dealer deducts 100% of the carrying value of securities in its proprietary accounts whenever (i) there is no ready market for such securities, or (ii) the securities can not be publicly offered or sold because of statutory, regulatory or contractual arrangements or other restrictions.<sup>2</sup> Questions have been raised regarding whether commercial paper has a ready market, and, in particular, whether commercial paper that is privately placed should be treated the same way as publicly offered commercial paper. The questions have also arisen in connection with privately placed and publicly offered commercial paper in Puerto Rico because of the federal taxation regime applicable to income earned in that jurisdiction of the United States.

I. Commercial paper

Commercial paper is short-term, negotiable, unsecured promissory notes which have a fixed rate or are sold at a discount, which have maturity dates at the time of issuance, exclusive of days of grace, of nine months or less,<sup>3</sup> and which are of prime quality and of a type not ordinarily purchased by the general public.<sup>4</sup> Commercial paper is exempted from the registration requirement under the

<sup>1</sup> 17 C.F.R. § 240.15c3-1.

<sup>2</sup> 17 C.F.R. § 240.15c3-1(c)(2)(vii). *See* 17 C.F.R. § 240.15c3-1(c)(11)(i) (defining the term "ready market" as used in the Uniform Net Capital Rule).

<sup>3</sup> *See* 17 C.F.R. § 240.15c3-1(c)(2)(vi)(E). It should be noted that obligations payable on demand or having provisions for automatic "roll over" have been deemed excluded as not satisfying the nine-month maturity standard. Securities Act Rel. No. 4412 (September 20, 1961), 26 Fed. Reg. 9,158, 9,159 (September 29, 1961).

<sup>4</sup> *Id.*

Douglas G. Preston, Esq.  
Securities Industry Association  
March 10, 1992  
Page 2

Securities Act of 1933 ("Securities Act") if their proceeds have been used or are to be used for current transactions.<sup>5</sup>

The SIA asserts that commercial paper issues, which range in various maturities up to nine months, are highly liquid. Commercial paper outstanding in the United States exceeds \$500 billion,<sup>6</sup> with, according to the SIA, more than \$25 billion transacted daily. Moreover, as proof of the high liquidity of commercial paper, it is asserted that for presentation in financial statements prepared in accordance with generally accepted accounting principles many entities often include commercial paper in the caption "Cash and Cash Equivalents."

In the letter dated July 6, 1989, the SIA notes that, because the proceeds of the issue are not always used for current transactions, sometimes commercial paper is privately offered and, thus, exempted from registration under section 4(2) of the Securities Act ("4[2] commercial paper").<sup>7</sup> A broker-dealer holding 4(2) commercial paper is required, under section (c)(2)(vii) of the Uniform Net Capital Rule, to deduct 100% of the carrying value of such position in its proprietary account because the 4(2) commercial paper is a privately placed instrument which may not be publicly offered.<sup>8</sup>

The SIA asserts, however, that 4(2) commercial paper is virtually identical to commercial paper issued under section 3(a)(3) of the Securities Act<sup>9</sup> and that, therefore, it should be afforded the same treatment under the Net Capital Rule. According to the SIA, the fact that rating agencies treat all commercial paper the same way regardless of whether it is issued under section 3(a)(3) or 4(2) of the Securities Act is evidence that the registration exemption under which such commercial paper is issued has no effect on its liquidity. Moreover, it is asserted that the level of market liquidity of 4(2) commercial paper is evidenced by the fact that Federal Reserve Banks allow broker-dealers to obtain 100% collateral value on commercial paper regardless of whether it is issued under section 3(a)(3) or 4(2) of the Securities Act.

The SIA claims, moreover, that investors generally distinguish between commercial paper issues on the basis of the characteristics of the issuer, the maturities and the rates offered and not on the particular registration exemption under which the commercial paper is issued. In fact, the SIA asserts, that the interest rates and the secondary market bids and asks are identical for each type of commercial paper with the same maturity date, regardless of whether they were issued under section 3(a)(3) or 4(2) under the Securities Act. It is asserted that the fact that the market imposes no discount on the 4(2) paper provides further evidence that the credit and market risks are identical for

---

<sup>5</sup> 15 U.S.C. § 77c(a)(3). The current transaction standard is not satisfied where the proceeds are used for the discharge of existing indebtedness. Securities Act Rel. No. 4412, 26 Fed. Reg. at 9,159.

<sup>6</sup> Federal Reserve Bank of New York Rel. No. 1923 (February 12, 1992).

<sup>7</sup> 15 U.S.C. § 77d(2).

<sup>8</sup> 17 C.F.R. § 240.15c3-1(c)(2)(vii).

<sup>9</sup> 15 U.S.C. § 77c(a)(3).

Douglas G. Preston, Esq.  
Securities Industry Association  
March 10, 1992  
Page 3

each type of paper. The SIA states, therefore, that the liquidity of 4(2) commercial paper is on a par with the liquidity of commercial paper issued under section 3(a)(3) of the Securities Act.

## II. Section 936 market

The securities market in Puerto Rico relies on the tax credit provided by section 936 of the Internal Revenue Code ("section 936")<sup>10</sup> for qualifying income earned in Puerto Rico. As a result of this beneficial tax treatment, mainland businesses operating in Puerto Rico have been able to accumulate substantial amounts of funds which are channelled to private and public sector borrowers through the purchase of commercial paper.

To qualify for the tax credit provided by section 936, a large percentage of a business' income must be derived from sources within a possession of the United States, including Puerto Rico. For purposes of section 936, a business' investment income must be "attributable to the investment in such possession (for use therein) of funds derived from the active conduct of a trade or business in such possession, or from such investment."<sup>11</sup> Accordingly, many of the financial instruments sold in Puerto Rico are designed to comply with the requirements of section 936, thus allowing purchasers to take advantage of the tax credit under section 936. As a result of this situation, many financial instruments sold in Puerto Rico have a very limited market outside Puerto Rico.

The SIA claims that the 936 market is a fairly liquid securities market within Puerto Rico with total investments of approximately \$13 billion. This market, moreover, involves many foreign and domestic financial institutions who often guarantee the obligations sold to lenders by issuing unconditional letters of credit that serve to back the payment of principal and interest.

## III. Conclusion

Based on the above facts, the Division of Market Regulation will not recommend to the Commission that enforcement action be taken, if broker-dealers apply the guidelines set forth below when determining haircut treatment under the Uniform Net Capital Rule for their proprietary positions in commercial paper.<sup>12</sup>

---

<sup>10</sup> 26 U.S.C. § 936.

<sup>11</sup> 26 U.S.C. § 936(d)(2)(B).

<sup>12</sup> The purpose of this letter is to provide guidance regarding the classification of certain proprietary positions in commercial paper under subparagraph (c)(2)(vi)(E) of the Uniform Net Capital Rule, 17 C.F.R. § 240.15c3-1(c)(2)(vi)(E). A broker-dealer may elect to include the market value of other proprietary positions in money market instruments and commercial paper with the haircut taken under the appropriate section of the Uniform Net Capital Rule, provided there is a ready market for such positions.

Douglas G. Preston, Esq.  
Securities Industry Association  
March 10, 1992  
Page 4

**A. Commercial Paper**

Commercial paper, whether or not exempted from the registration requirement under section 3(a)(3) of the Securities Act, may be deemed to have a ready market under subparagraph (c)(7) of the Uniform Net Capital Rule and not subject to a deduction of 100% of its carrying value, if the following conditions are met:

1. The commercial paper is not traded flat or in default as to principal or interest.
2. The commercial paper is not issued by a parent or an affiliated company of the broker-dealer.
3. The commercial paper is rated in one of the two highest categories by at least two of the nationally recognized statistical rating organizations ("NRSROs").

If at any time, any of the two ratings is reduced below the two highest categories the broker-dealer will deduct from net worth, when computing net capital, 15% of the carrying value of the commercial paper. Any time after the thirtieth day subsequent to the date when any of the two ratings is reduced below the two highest categories, there shall be a deduction from net worth equal to 100% of the carrying value of the position.

4. The commercial paper is the subject of a commercial paper program which:
  - (a) is administered by an issuing and paying agent bank and there exists a dealer willing to make a market in said commercial paper, or
  - (b) is administered by a direct issuer pursuant to a direct placement program.

**B. Section 936 Market**

Commercial paper, whether or not exempted from the registration requirement under section 3(a)(3) of the Securities Act, which is sold in Puerto Rico for the section 936 market, may be deemed to have a ready market under subparagraph (c)(7) of the Uniform Net Capital Rule and not subject to a deduction of 100% of its carrying value, if the following conditions are met:

1. The commercial paper is not traded flat or in default as to principal or interest.
2. The commercial paper is not issued by a parent or an affiliated company of the broker-dealer.
3. The purchase of the commercial paper by a corporation that is allowed a tax credit pursuant to section 936, constitutes, either (i) an investment under section 936(d)(2) of the Internal Revenue Code for the purpose of deriving "Qualified Possession Source Investment Income," or (ii) an investment in an

Douglas G. Preston, Esq.  
Securities Industry Association  
March 10, 1992  
Page 5

"eligible activity" under section 6.2.4 of Regulation Number 3582 of the Commissioner of Financial Institutions of the Commonwealth of Puerto Rico and, in either instance, the principal and interest owed as a result of the commercial paper obligation are payable in the Commonwealth of Puerto Rico.

4. The commercial paper is rated investment grade by at least two NRSROs, or is absolutely and without condition guaranteed as to principal and interest by an institution whose commercial paper is rated in one of the two highest grades by at least two NRSROs.

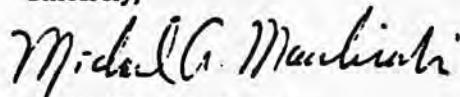
If at any time, any of the two ratings is reduced below the two highest categories the broker-dealer will deduct from net worth, when computing net capital, 15% of the carrying value of the commercial paper. Any time after the thirtieth day subsequent to the date when any of the two ratings is reduced below the two highest categories, there shall be a deduction from net worth equal to 100% of the carrying value of the position.

5. The commercial paper is the subject of a commercial paper program which:
  - (a) is administered by an issuing and paying agent bank and there exists a dealer willing to make a market in said commercial paper, or
  - (b) is administered by a direct issuer pursuant to a direct placement program.

This is a staff position concerning enforcement action and it does not represent any legal conclusions. This position is based solely on the foregoing description and factual variations might require a different response. This position may be withdrawn or modified if the staff determines that such action is necessary in the public interest, for the protection of investors, or otherwise, in furtherance of the purposes of the securities laws.

If you have any questions regarding these matters, please do not hesitate to contact Julius R. Leiman-Carbia at (202) 272-2824.

Sincerely,



Michael A. Macchiaroli  
Assistant Director

cc: Thomas R. Cassella, Vice President  
Financial Responsibility  
National Association of  
Securities Dealers, Inc.  
1735 K Street, N.W.  
Washington, DC 20006

Raymond J. Hennessy, Vice President  
Member Firm Regulation  
New York Stock Exchange, Inc.  
20 Broad Street 21<sup>st</sup> floor  
New York, NY 10005