STUART BROTHERS

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January 14, 1976

Mr. Nelson S. Kibler

Assistant Director

Division of Market Regulation

Securities and Exchange Commission

500 North Capitol Street Washington, D.C. 20549

Dear Mr. Kibler:

Thank you for the opportunity to discuss with you the application of the Uniform Net Capital Rule to reverse repurchase agreements. I share your opinion that current market conditions provide sufficient time to review this question in detail.

The new interpretation regarding deficit charges on reverse repurchase agreements places an undue burden upon firms such as the New York Hanseatic Division of Stuart Brothers for the following reasons:

1. The New York Hanseatic Division is a division of a member firm of the New York Stock Exchange. A majority of the twenty-nine "recognized" U.S. Government Bond Dealers are either banks, non-registered dealers or non-guaranteed subsidiaries of member firms or registered broker/dealers. These dealers' operations in the reverse repurchase market are not affected by the new interpretation applicable to reverse repurchase agreements.
2. Risks to dealers' capital involved in reverse repurchase agreements are not the same as those involved in a long proprietary position. Transactions involving similar risks are accorded different treatment under the regulations than that proposed by the new interpretation on reverse repurchase agreements, as for example: a. transactions on a

"when issued" basis in government and federal agency securities, as well as other securities in connection with primary distributions, b. underwriting contracts that provide for delayed delivery subscriptions, c. the settlement of security transactions on a COD basis.

3. If the problem is really one of customer solvency or counter-party solvency, i.e., "know your customer", possibly other solutions might be more appropriate.

I would like to explain our thinking on each of the above points.

Most reverse repurchase agreements (RR/Ps) in U.S. Government and Agency securities are unique transactions not related to settlements of position trades. RR/Ps permit owners of securities to cover short- term cash deficiencies without altering overall portfolio strategy. Conversely, repurchase agreements (R/Ps) permit the temporary investment of surplus funds at a fixed interest rate for a fixed term without subjecting the invested funds to market fluctuations. Contrary to past practice where some RR/Ps and R/Ps Were negotiated at the par value of the underlying security, these transactions are now executed at market value and the majority run for thirty days or less. Most of these transactions are consummated with banks, major corporations and other substantial financial institutions. Thus, the bulk of these agreements are "current" and are with well capitalized counter-parties such as those listed in Rule 431 c2C of the New York stock Exchange. Thus, dealers have recognized the necessity to limit the customer risk to which the dealer might be subject under RR/P and R/P agreements.

Security prices can experience significant fluctuations over short periods. We have analyzed three recent movements of government security prices in relation to Federal Funds. The average of these movements is presented in the chart following:

Increase or Government Security Price Movement in Points Corresponding Decline in to Rate Movement in Federal Funds

Quotations Federal Funds	3 mo T. Bill	6 mo T. Bill	12 mo T. Bill	2 yr Note	4 yr Note	7 yr Note	15 yr Bond
0.10%	0.02	0.06	0.13	0.2	0.28	0.3	0.35
0.50%	0.11	0.3	0.66	1.01	1.38	1.48	1.76
1%	0.23	0.6	1.32	2.03	2.75	2.95	3.18

Two down movements and one up movement of over 100 basis points in Federal Funds occurred during 1975, as the Federal Reserve Open Market Committee reassessed its actions to promote economic recovery.

From the chart, it is obvious that, under the new interpretation, New York Stock Exchange members would be forced to confine RR/Ps to short-term securities. However, many portfolio holders prefer to give their business to those dealers who are in a position to execute RR/Ps regardless of the maturity of the security involved. Thus, a dealer attempting to limit his transactions to securities with maturities of two years of less would soon find himself at a competitive disadvantage. Further, even with a bona fide contract with a reputable customer who has contracted to repurchase securities at a fixed price upon the maturity of the RR/P, the dealer has no way to defend himself against deficit charges relating to market declines. A short sale of the security would only compound the risk, and a capital charge equal to that of an unsold proprietary position is inequitable. Charging the full market deficit against dealer net capital would have a significantly negative impact on dealer RR/P operations and give no credit for the fact that the dealer is protected by a contract that provides for the resale of the securities at a fixed and pre-established price at the maturity of the RR/P, nor does it give credit for the quality and marketability of U.S. Government securities or the financial standing of the counter-party. The best protection, therefore, is to keep transactions as "current" as possible.

The risk entailed in RR/Ps is no greater than that involved in offsetting delayed delivery contracts, COO deliveries and offsetting transactions in securities on a -When issued" basis. In each case there may be significant [Original Text Unreadable] in the price of a security prior to actual delivery, and the volume of such, [Original Text Unreadable] in a particular security, especially in governments, is significant. COD transactions permit deliveries of up to thirty-five days. "When issued" contracts in government and agency securities are often for periods of three weeks. Delayed delivery for optional delivery contract periods have extended to six months. In view of the similarity of risk between these transactions and RR/Ps, namely, will the customer live up to his obligation when due, RR/Ps should be treated in a manner comparable to that of the other three types discussed.

We recognize that concern for undisciplined growth of RR/P transactions risks is warranted. However, it appears that the nature of the risk is one of customer solvency, rather than that of a position or market risk. Alternative solutions to this "customer problem" might include the following:

1. A requirement that all RR/Ps be executed for an amount equal to or less than the market value of the underlying security,
2. No charge for capital deficiencies due to market fluctuations on RR/Ps of thirty days or less, as these transactions are of recent date and are executed at market prices;
3. Some exemption for RR/Ps with customers regulated by other Federal or State regulatory authorities or with customers with substantial capital resources;
4. It is unlikely that all of the counter-parties on dealer RR/Ps would become insolvent simultaneously. But it is [Original Text Illegible] possible that a small percentage of counter-parties might not be in a position to complete an RR/P contract, particularly if such a contract were long-term. Therefore, some charge might be applied to RR/Ps in excess of thirty days. Such a formula might be:

10% of the market deficit for RR/Ps 31-60 days' maturity;

25% of the market deficit for RR/Ps with maturity in excess of 61 days.

The above suggestions might represent a more equitable treatment of capital charges on RR/Ps to government bond dealers who are either member firms or registered broker-dealers and permit them to continue to operate as registered broker-dealers in these transactions. The suggestions are consistent with the objectives enumerated in the Introduction to the Uniform Net Capital Rule, Section II, items 3 and 5. We have discussed the contents of this letter with the New York Stock Exchange and would welcome the opportunity to discuss the above points with you and other interested parties in greater detail at your convenience.

Very truly yours,

NEW YORK HANSEATIC DIVISION OF STUART BROTHERS

Ernest M. Grunebaum

EMG:lmn

cc: Ms. Marsha A. O'Bannon Mr. Howard Spindel New York Stock Exchange

March 29, 1976

Mr. Ernest M. Grunebaum

Stuart Brothers 55 Broad Street New York, New York 10004

Dear Mr. Grunebaum:

Thank you for your letter of January 14, 1976 in which you suggest alternative solutions for treating reverse repurchase agreements rRRP·) under Rule 15c3-1 (17 CFR 240.15c3-1) under the Securities Exchange Act of 1934 ("the Act").

We understand the pertinent facts to be as follows: an RRP transaction enables a broker or dealer to lend cash and to receive securities which would collateralize the cash loan; the cash loan is an amount equal to the market value of the collateral received; and the collateral consists of U.S. Government and Agency securities; the RRP transactions are with banks, and major corporations.

Under present staff interpretation any deficit between the amount of the loan on the part of the broker or dealer and the market value of the collateral would be a deduction from net worth in determining net capital under Rule 15c3-1.

You further state that deducting the full market deficit from net worth would have a significant negative impact on dealer RRP operations and would not recognize the fact that the dealer is protected by a contract that provides for the resale of the securities back to the party from who they were received at a fixed end pre-established price at the maturity of the RRP. You also note that the majority of such contracts are for short periods of time and that the risk is primarily a credit risk of the purchaser.

Based on the facts set forth in your letter, the Division will raise no question where a broker or dealer applies the following deductions to the deficit related to RRP transactions in U.S. Government and Agency securities, provided that at the time such transactions were effected, the cash loan was an amount not greater than the market value of the collateral received:

(1) 30 days or less to maturity -0%

(2) 31 to 60 days to maturity -50%

(3) 61 days or more to maturity-100%

If you have further questions, please contact us.

Sincerely,

Nelson S. Kibler

Assistant Director