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

DIVISION OF
MARKET REGULATION

November 19, 1991

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

Re: Federal Funds Sales

Dear Mr. Preston:

In your letter dated September 21, 1989, you request that broker-dealers who engage in loans to depository institutions of immediately available funds (commonly referred to as "sales of Federal funds"), held in connection with the clearance of securities may be permitted to do so without being required to deduct the amount of the transaction from net worth in calculating net capital under Securities Exchange Act Rule 15c3-1 (17 C.F.R. § 240.15c3-1).

I understand the pertinent facts to be as follows: In connection with a broker-dealer's securities operations, a firm will occasionally have excess funds at the end of the trading day, left in its clearing account maintained at its clearing bank. Generally, excess funds accrue in the clearing account because it is difficult for a broker-dealer to anticipate its exact funding needs for the day. You have advised us that the only practical overnight investments for these excess funds are Federal funds swaps or sales.

In a Federal funds sale, a broker-dealer sells excess cleared funds in its clearing account to a depository institution. The funds are available for use by the broker-dealer the next banking business day and are functionally equivalent to demand deposits. The conversion from a demand deposit to a Federal funds sale allows the depository institution to pay interest on those funds on an overnight basis.[1]

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[1] See 12 C.F.R. § 204.2(a)(1)(vii)(D).

In computing net capital, Rule 15c3-1 requires a broker-dealer to make certain specified adjustments to net worth. Specifically, paragraph (c)(2)(iv) of the net capital rule requires a broker-dealer to deduct from net worth the value of assets which cannot be readily converted into cash, including all unsecured advances or loans and all unsecured receivables. The Division of Market Regulation (the "Division") has previously taken the position that a broker-dealer must deduct from net worth 100 percent of the value of a Federal funds sale.

You assert that Federal funds sales, the equivalent of demand deposits, are generally not treated as unsecured receivables where the deposit is located in a bank as defined in Section 3(a)(6) of the Securities Exchange Act of 1934 (the "Exchange Act"). Although Federal funds sales do not qualify for Federal Deposit Insurance Corporation insurance protection, you assert that they are otherwise similar to other types of bank investments, including demand deposits, certificates of deposit and bankers' acceptances. In any event, the insurance is limited to $100,000, an amount of small consequence compared to the size of most Federal funds sales by broker-dealers.

Because the transaction is similar to a demand deposit, you assert that broker-dealers should be permitted to engage in Federal funds sales to the clearing bank where the funds are located or to another bank. You point out that broker-dealers often maintain clearing accounts at more than one bank. For example, if a broker-dealer's account at one clearing bank contained an excess of Federal funds, and that bank had no need for a Federal funds sale, a broker-dealer would be able to sell the surplus Federal funds to another of its clearing banks. You assert that no additional risk would be created by this arrangement, and the broker-dealer would be able to obtain the most favorable rate of return on its funds.

You also argue that broker-dealers may engage in economically identical transactions, without incurring a deduction from net worth. You point out that broker-dealers may make a Eurodollar or other offshore demand deposit, time deposit or certificate of deposit, without deducting the amount from net worth provided the transaction is with a major money market financial institution and which is subject to the supervision of an authority of a sovereign national government.[2] Finally, you note that government securities broker-dealers registered with the Commission under Section 15C of the Exchange Act and subject

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[2] New York Stock Exchange Interpretation Handbook, Vol. I, 15c3-1(c)(2)(iv)(E)/06.

to the Department of the Treasury's financial responsibility rules are permitted to sell Federal funds to any depository institution without incurring a deduction from net worth.[3]

Based on the foregoing facts and circumstances, the Division will recommend no-action to the Commission if broker-dealers enter into loans with a depository institution for one business day of Federal funds held by a broker-dealer in connection with the clearance of securities on the day the loan is made (commonly referred to as "sales of Federal funds") without deducting the value of the transaction from net worth.

Sincerely,

Michael A. Macchiaroli
Assistant Director

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[3] See 17 C.F.R. § 402.2(d)(7).

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November 19, 1991

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

Re: Federal Funds Swaps

Dear Mr. Preston:

In your letter dated September 21, 1989, you request that broker-dealers who engage in swaps of Federal funds in the broker-dealer's bank clearing account with counterparties other than a bank be permitted to do so without being required to deduct the amount of the transaction from net worth in calculating net capital under Securities Exchange Act Rule 15c3-1 (17 C.F.R. § 240.15c3-1).

I understand the pertinent facts to be as follows: In connection with a broker-dealer's securities operations, a firm will occasionally have excess funds left in its clearing account maintained at its clearing bank. Generally, excess funds accrue in the clearing account because it is difficult for a broker-dealer to anticipate its exact funding needs for the day. You have advised us that the only practical overnight investments for these excess funds are Federal funds swaps or sales.

In a Federal funds swap, a broker-dealer swaps the excess funds contained in its clearing account with a counterparty in exchange for a certified check. Normally, the counterparty to a Federal funds swap is another broker-dealer.

In computing net capital, Rule 15c3-1 requires a broker-dealer to make certain specified adjustments to net worth. Specifically, paragraph (c)(2)(iv) of the net capital rule requires a broker-dealer to deduct from net worth the value of assets which cannot be readily converted into cash, including all unsecured advances or loans and all unsecured receivables. With respect to Federal funds swaps, the question has been raised whether broker-dealers may engage in Federal funds swap transactions with counterparties in return for a certified check, without requiring the broker-dealer to incur a deduction from net worth in calculating net capital. You request that the allowable counterparties in Federal fund swaps should be expanded to include not only broker-dealers but other institutions, such as

clearing agencies, insurance companies or other companies that may have a need for the Federal funds. A broker-dealer would be able to seek out the party that has the greatest need for overnight funds and receive a higher rate of return on its funds, without having to lend overnight funds to its clearing bank at whatever rates were available in the Federal funds market.

Based on the foregoing facts and circumstances, the Division will recommend no-action to the Commission if broker-dealers engage in Federal funds swaps with registered broker-dealers or counterparties other than registered broker-dealers without deducting the value of the transaction from net worth if the broker-dealer receives a certified check drawn on a bank as defined in Section 3(a)(6) of the Securities Exchange Act of 1934 at the time of the release of the funds.

Sincerely,

Michael A. Macchiaroli

Michael A. Macchiaroli
Assistant Director