SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-18417; File No. S7-855]

Net Capital Requirements for Brokers and Dealers; Amended Rules

AGENCY: Securities and Exchange Commission.

ACTION: Adoption of amendments to net capital rule.

SUMMARY: The Commission is amending portions of the net capital rule. The amendments will lower the required minimum percentage of net capital to aggregate debit items under the alternative method of computing net capital. The amendments will also affect the computation of net capital under either the basic method or the alternative method.

EFFECTIVE DATE: May 1, 1982.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Division of Market Regulation (202) 272-2372, 500 N. Capitol Street, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: In October 1980, the Commission proposed for comment a number of far-reaching amendments to its net capital rule for brokers and dealers ("the Concept Release").[1] Those amendments would have substantially reduced the amount of liquid capital required to be maintained by those firms which have elected the alternative method of computing net capital. In a companion release, the Commission proposed for comment new haircut schedules for debt securities.[2] In the Concept Release, the Commission also solicited comment on a broad range of questions regarding the financial responsibility standards for brokers and dealers in its reexamination of the scope, adequancy and necessity of those rules. The Commission received thoughtful and helpful comments from self-regulatory organizations, industry groups and from several brokers and dealers. In light of these comments, the Commission has determined to modify its initial proposal and to adopt the amendments described below. The Commission has also issued three associated releases which deal with subsidiary questions relating to the net capital rule.

I.

Capital standards based upon liquidity for brokers and dealers have been in effect since at least 1934 when the Securities Exchange Act was adopted. Section 8(b) of the original Act made it unlawful for a member of a national securities exchange to allow "in the ordinary course of business as a broker" its aggregate indebtedness to all other persons to exceed such percentage of the net capital employed in the business (but not exceeding in any case 2000%) as the Commission may by rules prescribe as necessary or appropriate. The primary purposes of this section was to prevent a broker from operating on a "shoestring."[3] Because of inherent limitations in the wording of Section 8(b), it never was more than a general standard of conduct for the securities business.

In 1938, Congress enacted Section 15(c)(3) of the Securities Exchange Act which authorized the Commission to adopt financial responsibility standards for brokers and dealers. In 1942, the Commission adopted Rule X-15C3-1 which incorporated the aggregate indebtedness standards of Section 8(b). The rule exempted from coverage members of national securities exchanges whose rules and practices imposed minimum capital requirements more comprehensive than those of the Commission. In succeeding years, the Commission was generally satisfied with the financial responsibility program. During the years 1967-1970, however, the securities industry underwent an unprecedented financial and operational crisis. That crisis is extensively detailed in the Commission's Study of Unsafe and Unsound Practice of Brokers and Dealers[4] which the Commission was called upon to prepare for the Congress under Section 11(h) of the Securities Investor Protection Act of 1970. Referring to the operational crisis of the late 1960's, the Study exposed the structural weaknesses of an industry which could not withstand "the stresses and strains placed upon it by events of virtual hurricane force."[5] Out of this period emerged a number of legislative and administrative proposals designed to prevent recurrence of the resulting problems.

The first major development was the passage of the Securities Investor Protection Act of 1970 which was designed to give investors who dealt with brokers and dealers additional protections for their funds and securities, in the event of the insolvency of a broker or dealer. Therein Congress provided additional authority to the Commission to adopt rules relating to the acceptance of custody and use of customer securities and the carrying and use of customers' deposits and credit balances. Pursuant to this authority, the Commission adopted Rule 15c3-3 which requires a broker or dealer to have and maintain possession or control of all fully-paid and excess margin securities carried by it for the account of customers and to use customers' funds or customers related funds only in "safe" areas of its business of its business related to financing customer transactions and to deposit in a separate bank account any such funds not so used.

In the meantime the Commission also adopted Rule 17a-13 which requires quarterly counts of securities by brokers and dealers in their possession or control, in order to establish a minimum standard as to the location of securities for brokers and dealers. The Commission also improved its early-warning system to require a broker or dealer to report immediately any net capital violation or the lack of current books and records. The Commission, in addition, revised its reporting provisions to provide for more detailed surveillance of brokers and dealers and to coordinate effectively the examination programs of the Commission and the self-regulatory organizations.

Finally, the Commission, responding to Congressional concern, substantially reformed its net capital rule. The Commission eliminated the exemption in its prior net capital rule for all members of national securities exchanges and made virtually all registered brokers and dealers subject to the Commission's capital requirements.[6] The reformed rule continued the basic liquidity concept under which the securities industry had operated for many years. That concept requires a firm to have and maintain designated minimum amounts of liquid assets in relation to its aggregate indebtedness. In addition, the Commission introduced an alternative method to measure the capital adequacy of brokers and dealers. The alternative method linked the capital requirement of a broker or dealer

[1] Securities Exchange Act Release No. 17208 (Oct. 9, 1980), 45 FR 69915 (Oct. 22, 1980).

[2] Securities Exchange Act Release No. 17209 (Oct. 9, 1980), 45 FR 69911 (Oct). 22, 1980) ("the Haircut Release").

[3] *See, for example,* House Hearings on H.R. 7852 and 8720, 73rd Cong., 2nd Sess. (1934) at 87.

[4] *See* Securities and Exchange Commission, *Study of Unsafe and Unsound Practices of Brokers and Dealers,* H. Doc. No. 92-231, 92nd Cong., 1st Sess. (1971) [hereinafter cited as "Unsafe and Unsound Study"].

[5] *Id.* at 11.

[6] Section 15(c)(3) of the Act was amended by the Securities Acts Amendments of 1975 to require the Commission, by September 1, 1975, to establish minimum financial responsibility requirements for all brokers and dealers.

to its customer related business as measured by the requirement of Rule 15c3–3. These reforms were significant steps in the Commission's continuing efforts to structure its rules to provide adequate protection for customers' assets while recognizing the industry's need for flexibility in efficiently allocating capital resources.

The Commission's present net capital rule requires that a broker's or dealer's "aggregate indebtedness" never be more than 1500% of its "net capital," as those terms are defined in the rule. Net capital essentially means the net worth of a broker or dealer reduced by prescribed percentages of the market value of securities owned by the broker or dealer ("haircuts") and reduced by other assets not readily convertible into cash, but including certain subordinated debt, i.e., net liquid assets. Aggregate indebtedness inlcudes all the money liabilities of a broker or dealer, except certain specifically described items. In essence, the rule requires a broker or dealer to cover each dollar of its liabilities with not less than one dollar and six and two-thirds cents of liquid assets.

The alternative method of computing net capital requires a broker or dealer to maintain minimum net capital equal to the greater of $100,000 or 4% of aggregate debit items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers under Rule 15c3–3 ("Reserve Formula"), 17 CFR 240.15c3–3a. The debit items in the Reserve Formula represent monies owed the broker or dealer in relation to customer transactions. The alternative method is founded on the concept that if the debit items in the Reserve Formula can be liquidated at or near their contract values, these assets, along with any cash required to be on deposit under the net capital rule, will be sufficient to satisfy all customer-related liabilities (which are represented as credit items in the Reserve Formula). As an additional safeguard, election of the alternative method requires a firm to reduce by 3% its aggregate debit items to provide, in essence, a bad debt reserve of firm capital to assure adequate resources to pay customer claims. Election of the alternative also requires that operational charges (stock record differences and suspense account items) be reflected in the Reserve Formula after seven business days, rather than after 30 business days, as permitted for those firms which have not elected the alternative method. These limitations, whether under the basic or the alternative method, allow a firm to increase its customer commitments only insofar as its net capital can support the increases.

Tables three through six of the Commission's Concept Release provide a financial profile of firms electing the alternative and basic methods of computing net capital. Most brokers and dealers utilize the basic method for complying with the net capital rule. As Tables three and four indicate, 139 of the 374 NYSE member firms conducting a public business as of December 31, 1979 were using the alternative method for the computation of net capital. These 139 firms accounted for 68% of the aggregate assets, 76% of the aggregate equity capital, and 81% of the aggregate revenues of the 374 NYSE firms conducting a public business. Of the classified NYSE member firms, all ten national full line firms elected the alternative capital approach, while 57 regional firms (48% of NYSE member firms classified as regional) utilized this method.[7]

Only 44 of the 2,066 brokers and dealers that conducted a public business as of December 31, 1979, and who were not members of the NYSE used the alternative method for computing net capital (*See* Tables five and six in the Concept Release). These 44 firms were, on average, substantially larger than the 2,022 firms using the basic method.

In this release, the Commission is adopting changes to the net capital rule which will affect not only the alternative method but also the basic method. Under the amendments, the net capital rule will still require, for the protection of customers, a cushion of liquid assets beyond the "net" amount of liquid assets needed to offset a broker's or dealer's liabilities.

The amendments will lower the ratio of required net capital to aggregate debit items. The amendments will also change the existing early warning levels. Finally, the amendments will modify the present treatment of certain items in the computation of net capital which will be applicable to firms using either the basic or alternative method. Other proposed amendments discussed in the companion releases will affect the treatment of certain debit items in the Reserve Formula, excluding those items from the computation of aggregate debit items, thereby further lowering the minimum net capital requirement under the alternative method.

The most significant issue before the Commission is whether the required ratio of net capital to aggregate debit items should be lowered from the present 4%. The Securities Industry Association (the "SIA") has recommended that the percentage be reduced to 2%. As a corollary, the SIA urges the Commission to lower the existing early warning levels, reasoning that otherwise there would be no effective lowering of the net capital required since prudent firms strive to stay above the early warning thresholds.

A. Lowering of the Percentage

Initially, the SIA proposed that the ratio of net capital applicable to item 10 debits be lowered from 4% to 2%. The "item 10 debits" are the debit balances in customers' cash and margin accounts or, more simply, the amount of money which customers owe the broker or dealer. The Commission proposed for comment a reduction to 3% and only as to the balances in margin accounts, not in cash accounts. The limitation as to margin accounts were premised on the theory that these accounts were adequately secured if in compliance with the maintenance margin rules of the appropriate self-regulatory organization.

The SIA in its comments to the Commission's proposal now recommends that the Commission reduce the minimum net capital requirement under the alternative method from 4% to 2% on all Reserve Formula debit items. It states that for the firms it observed it would require an inordinate operational effort to apply varying percentages to different debit items for purposes of computing net capital under the alternative method. In addition, for most firms, these remaining debits represent only a small portion of the total debits.

The Commission agrees with the SIA that any reduction in the required ratio should apply to all of the debit items. It is not, however, because the other debits are insignificant in amount. As to one large retail firm, those non-item 10 debits amounted to $207,000,000 or about 20% of its total debit items. Rather, for the sake of more simple calculations and manageability by all firms large and small, it is reasonable to extend the reduction to all debit items.

The main question before the Commission is whether the present ratio of net capital to aggregate debit items imposes an unwarranted requirement of liquid assets. This question is not easily

[7] National full line firms conduct a general securities business and have a nationwide branch office network. Regional firms, on the other hand, confine their activities to a more limited geographic area. For further information on classified NYSE member firms, *See* Chapter three Securities and Exchange Commission, *Staff Report on the Securities Industry in 1979*, September 1980.

answered. As the Commission said in its original proposal:

Initially, it must be noted that there is not necessarily any direct correlation between the 4% figure presently in the Rule and the amount of liquid capital required to protect customers. That figure was selected based on judgments inferred from the then-existing system.

Essentially, the SIA's arguments in support of its recommendations are two fold:

A. The debit items in the formula are by and large collectable.

B. The pivotal development has been the emergence of Rule 15c3–3, the Customer Protection Rule, as the centerpiece of the Commission's financial responsibility program.

Neither point, however, is entirely conclusive in determining whether the liquidity requirements of the net capital rule should be lowered.

Collectability of Debits

The SIA states that statistics it has obtained indicate that even a 2% minimum net capital requirement would be more than adequate to account for the risk posed by item 10 debits.

The purpose of the net capital rule, however, is to ensure the ability of the broker or dealer promptly to pay its liabilities, particularly to customers. It requires the broker or dealer to be liquid at all times. When the Commission originally designed the Rule 15c3–3 formula it assumed that the debit items were fully collectable. It would have been inappropriate to allow the use of customer funds (the credits) to finance transactions which would result in uncollectable receivables. Thus, tying the net capital cushion to the collectability of these receivables mixes two concepts whose objectives are not entirely consistent. The capital cushion was designed to guard against the insolvency of a firm which could result from other losses.

The net capital rule establishes a minimum standard upon which customers and the industry can rely. Moreover, the liquidity cushion acts as a deterrent to the recurrence of those particular problems pointed out in the Unsafe and Unsound Study by dampening the degree of leverage a broker or dealer may achieve through its use of customers' assets.

Rule 15c3–3

The SIA also contends that the net capital rule is of lessened importance with the "success" of Rule 15c3–3. It states:

To leave the uniform Rule substantially unchanged would be to disregard both the full extent of the protections afforded customers by Rule 15c3–3 and the Commission's own aim of placing less reliance on the uniform Rule after gaining operational experience with Rule 15c3–3. At this advanced date, that experience indicates that Rule 15c3–3 has succeeded to the point that it has been ready for some time to shoulder more of the Commission's financial responsibility regulation mandate.

The Commission has often expressed its desire to consider alternatives to the liquidity concept in the net capital rule. However, the present Rule 15c3–3, by itself, is not an adequate financial responsibility test. There are serious theoretical and practical limitations to its substitution for the net capital rule. First, as to the possession and control requirements of Rule 15c3–3, there are pronounced delays between the time when a decision is made that a security must be in possession or control and the time it must actually be in possession or control. As to the formula, the computation is made only once a week and there is a ten-day period between one computation and the next required deposit. Beyond that, however, examinations by the Commission and self-regulatory organizations have found substantial and continuing violations of Rule 15c3–3 and an apparent lack of understanding of the rule among some brokers and dealers some eight years after the rule's adoption.

Finally, it should be noted that many of the firms that have been liquidated under SIPC proceedings did not make the required deposits as they approached financial difficulty.

While limitations of the regulatory framework suggest caution, there are other factors which have led the Commission to believe that a lowering of the minimum percentage requirement from 4% to 2% is appropriate. Since 1975, the year the present net capital rule was adopted, brokers and dealers have exhibited a willingness to commit their capital to back-office improvements. Brokers and dealers have improved their ability to handle, without bookkeeping or other operational difficulties, heavy trading volume. Their inability to do this in the 1968–1970 period was an important factor in the demise of many brokers and dealers. Moreover, most brokers and dealers that compute net capital using the alternative method clear significant portions of their business through clearing agencies which reduces their exposure to losses and increases their efficiency. In addition to these operational improvements, the Commission and self-regulatory organization surveillance programs have been upgraded and the NYSE and the NASD have indicated that they intend to improve their surveillance techniques further.

Perhaps of equal importance is that the early warning rules of the Commission and the self-regulatory organizations will be set significantly above the 2% minimum now adopted. Based on these factors and the protections of Rule 15c3–3, as well as the Commission concern that there should be no unwarranted capital requirements to protect investors, the Commission in its judgment believes that a reduction from 4% to 2% is appropriate. The reduction will enable firms to reallocate capital without creating undue risks to investors.

B. Early Warning Levels

Although the net capital rule presently requires a broker or dealer to maintain net capital equal to only 4% of aggregate debit items, the rule contains other provisions restricting certain aspects of the broker's or dealer's business, if its net capital falls below 7% of aggregate debit items.[8] In addition, Rule 17a–11 requires a broker or dealer to file prescribed reports with the Commission if its net capital falls below 6% of aggregate debit items.

Since prudent brokers or dealers maintain sufficient net capital to avoid falling below these early warning levels, it would provide no relief for those firms if the Commission lowered the basic requirement of 4% without adjusting these early warning levels. In the Concept Release, the Commission proposed that these levels be replaced with amounts equal to 175% and 150%, respectively, of the amount of minimum net capital required. The NYSE has advised the Commission that it proposes to lower its own early warning test set forth in the Rule 325(b) to 5% of aggregate debit items if the minimum level under the alternative method is lowered to 2%. This appears to be a reasonable accommodation which the Commission believes should be incorporated into its own early warning system. The 3% cushion should be sufficient to provide advance warning of a possible impending failure of a broker or dealer and adequate time to initiate corrective action. Thus, the capital lock-in provisions of Rule 15c3–1(e), the restrictions in Appendix D and the early warning reporting requirements of Rule 17a–11 will be amended to be set at levels of 5% of aggregate debit items.

[8] Some restrictions become effective only when the firm's net capital falls below 6% of aggregate debit items.

III

Minimum Requirement

Election of the alternative method, as discussed above, requires that a broker of dealer maintain net capital of at least $100,000. In the Concept Release, the Commission announced its intention to consider lowering the minimum from $100,000 to $25,000. This reduction, the Commission noted, would result in equivalent minimum net capital requirements for non-introducing brokers and dealers that carry customer accounts, whether they comply with the aggregate indebtedness test (the basic method) or the aggregate debit items test (the alternative method). The Commission noted that consideration should be given to lowering the minimum in stages, and proposed for comment a new minimum of $75,000 for brokers and dealers electing the alternative method. Further, the Commission stated that, if the reduction was adopted, it would monitor the impact through FOCUS data and the review of SIPC liquidations and periodic on-site examinations of brokers and dealers.

Upon further review, the Commission has determined not to lower the minimum at this time for brokers and dealers electing the alternative method. The Commission notes that the $100,000 requirement has been substantially eroded by inflation.[9] The minimum level of required net capital was set originally because the alternative method's percentage requirements are based on customer-related receivables rather than liabilities. Thus, it was feared that a firm could expand its liabilities without limitation, thereby jeopardizing its solvency. The Commission sees no reason to alter its views on this matter.

IV

Short Securities Differences

Paragraph (c)(2)(v) of the uniform net capital rule requires brokers and dealers to deduct from net worth in computing net capital the market value of all short securities differences [10] that are unresolved for seven business days after discovery and the market value of long securities differences [11] where such securities have been sold by the broker or dealer before they are adequately resolved (less any reserves established therefor). Generally, the broker or dealer discovers these differences by performing a "box-count" and reconciling the results of the "box-count" with its books and records as required by Rule 17a–13.

Paragraph (c)(2)(v) of the net capital rule was promulgated in response to the industry's poor performance in the resolution of short securities differences during the "Paperwork Crisis" of 1968–70.[12] It was designed to provide an incentive to brokers and dealers to resolve short securities differences within a short time after discovery before the differences became impossible to trace. Potentially, if the securities are not located, the broker or dealer will be obligated to buy the missing securities in the open market to make delivery.

The Commission has determined that requiring a 100% deduction for unresolved short securities differences after seven business days is no longer warranted, although it should not be inferred that maintenance of current and accurate records and of adequate internal controls is being de-emphasized. As has recently been demonstrated, a broker or dealer can still encounter the same kind of recordkeeping problems that undermined many brokers and dealers from 1968 to 1970. It appears to the Commission from data submitted [13] that short securities differences are largely resolved over a period of time, although the data received relate to firms which have not failed. The scaling of deductions for short securities differences reflects more accurately the experience of brokers and dealers and, at the same time, adequately provides the necessary safeguards and incentives.

Furthermore, the early deduction may inhibit corrective action by a broker or dealer suffering severe and sudden operational problems. A broker or dealer faced with such a situation may be compelled to assign its personnel to research particular short securities differences in order to avoid potential capital charges rather than assign its personnel perhaps more productively to correct the underlying problems which gave rise to the operational problems.

While the NYSE recommended a different scaling than now adopted,[14] the Commission has determined to adopt a scaling that is compatible with the requirements of Rule 15c3–3(h) which generally requires broker-dealers to "buy-in" all unresolved short securities differences by at least the 45th calendar day after the discovery date. Forty-five calendar days is equivalent to approximately 30 business days. Under the scale proposed by the NYSE, if the broker or dealer is in compliance with Rule 15c3–3(h), the full capital charge would not be meaningful because the broker or dealer would have been required to buy in the short securities difference by the 28th business day or long before the 45th business day, the day on which a 100% deduction would be required under the NYSE scale. Consistent with Rule 15c3–3(h), the outer limits of the Commission's scale will be set at 28 business days. Since 28 business days is equal to approximately 40 calendar days, a broker or dealer would be required to have liquid assets equal to the short securities differences five days prior to the 45th calendar day, the day by which the broker or dealer would be required to "buy-in" short securities differences under Rule 15c3–3(h). The time periods specified in the scale (7, 14, 21 and 28 business days), will still provide a substantial incentive to brokers and dealers to review and eliminate their short securities differences. Finally, it appears prudent and less confusing to provide for equal increases of deductions from the market values of short securities differences at each successive level of the scale.[15]

In response to the need for flexibility to respond to sudden and unexpected occurrences, the amended rule provides

[9] The present value of $100,000 is about $65,000, as compared to 1975.

[10] "Short securities differences" occur where the securities record of a broker or dealer shows an obligation for a particular number of securities but which it is unable to locate.

[11] "Long securities differences" refer to situations where the "box-count" reveals securities in the broker's or dealer's possession or control, the owner of which is unknown.

[12] *See* Unsafe and Unsound Study at 100–104.

[13] The results of the study indicated that short securities differences and other unresolved items as reported by brokers and dealers in quarterly FOCUS filings from December 1979 through December 1980 ranged between $13.9 million and $100.7 million. Losses actually sustained during this period, however, were reported to be only $599 thousand.

[14] The NYSE proposed the following schedule:

Differences [1]	Number of business days after discovery
20 percent	10
40 percent	20
50 percent	30
100 percent	45

[1] Percentage of market value of short securities differences.

[15] The adopted scale is as follows:

Differences [1]	Number of business days after discovery
25 percent	7
50 percent	14
75 percent	21
100 percent	28

[1] Percentage of market value of short securities differences.

that, under appropriate circumstances, the examining authority for a broker or dealer can provide limited relief from the requirements of the rule. This flexibility would afford customer protection and also provide an opportunity to rehabilitate the broker's or dealer's operations under the oversight of an independent third party.[16] The self-regulatory organization of course is expected to notify the Commission if it grants an extension without which the broker or dealer in whose favor the extension was granted would have been compelled to send telegraphic notice to the Commission pursuant to Section 17a–11 because not in compliance with the net capital rule.[17]

V

Subordinated Loans

Appendix D to Rule 15c3–1 sets forth the minimum and non-exclusive requirements for satisfactory subordination agreements. Among other things, no prepayment or any payment of a payment obligation may be made (except under the strictly defined limitations of paragraph (c)(5) of Appendix D) before the expiration of one year from the effective date of the subordination agreement. This provision was designed to insure the adequacy as well as the permanence of capital in the industry.

Over the years, it has been suggested by both the self-regulatory organizations and brokers and dealers that firms meeting certain criteria be permitted to make use of "Revolving Subordinated Loan Agreements." Under the terms of such agreements, brokers and dealers are permitted to make subordinated borrowings which can be repaid at any time without penalty. The agreements would conform in all other respects to the requirements of Appendix D.

With limitations, the suggestion appears not to contravene the net capital rule's objectives. The NYSE has suggested criteria which appear to be appropriate. Accordingly, Appendix D to Rule 15c3–1 will be amended to permit any broker or dealer to prepay any borrowings arising out of a Revolving Subordinated Loan Agreement which could be prepaid at any time upon approval by the designated examining authority so long as:

1. The intended prepayment, along with other intended repayments and scheduled repayments of capital during the succeeding six months would not result in a capital ratio greater than 900% (if the broker or dealer is on the basic method) or a net capital percentage less than 6% of aggregate debit items (if the broker or dealer has elected the alternative method), or net capital less than 200% of the minimum dollar requirement (under either method); and

2. Pre-tax losses during the latest three month period equaled less than 15%[18] of current excess net capital.[19]

VI

Liquidity Concept

There are several additional proposals advocated by the SIA which would substantially lower the net capital requirements and which the Commission believes are not consistent with the liquidity concept of the net capital rule and therefore should not be wholly adopted, at least at this time.[20]

A. Exchange Memberships

The SIA has recommended that the current value of a firm's exchange seat, less appropriate haircuts, be includable in a firm's net capital. Under the present rule, the value of an exchange membership is considered a non-liquid asset which must be deducted from a firm's net worth. The SIA in its initial report argued that exchange memberships should be included in net capital because they are easily marketable.

The Commission, in its Concept Release, asked for additional comment on this recommendation noting that "though in most cases they may be readily sold at some price, because of the priorities set forth in exchange rules, it is not certain what amount of the proceeds would benefit customers."

In responding generally, the SIA noted the success of Rule 15c3–3 as the centerpiece of the Commission's financial responsibility program and then stated,

> This in turn indicates that the liquidity concept, and with it the notion that assets are properly allowable only to the extent that they will unconditionally inure to the benefit of customers upon liquidation, can be deemphasized. Rather, the question becomes to what extent a particular asset contributes to a level of financial viability sufficient to assure the completion of transactions among professionals (footnote omitted). In this light, the priority rules governing the disposition of the proceeds from the sale of exchange memberships are, if anything, a factor in favor of their allowance for purposes of the Rule.

The SIA submitted historical data which focuses on the fluctuation in value of exchange memberships, rather than their ready liquidity. The SIA concluded that this data demonstrated that it was unnecessary to deduct the entire value of an exchange membership in terms of the purposes of the net capital rule and that their present treatment under the net the net capital rule was both overcautious and presented particular difficulties for those smaller firms which commit a high portion of their net worth to exchange memberships recommendation to specify a 33⅓% haircut on exchange memberships.

Historically, the value of exchange memberships have not been included in a firm's net capital. The Securities Exchange Act, as originally enacted provided in Section 8(b) that firms must exclude only two items from net capital—fixed assets and *the value of exchange memberships*. This exclusion has continued into the present net capital rule. Further, two major exchanges did not allow member firms to include the value of memberships under their own rules concerning the computation of net capital.[21]

To allow the inclusion of exchange memberships in a firm's net capital would deemphasize the net capital rule's liquidity concept, the essential characteristic of the rule. Because of the substantial reduction in the required percentage of net capital for firms electing the alternative method, already discussed, the Commission does not believe that it would be appropriate to reduce the liquidity requirements further.

B. Receivables

Consistent with the concept of liquidity, Rule 15c3–1(c)(2)(iv) requires a broker or dealer in computing net capital to deduct from net worth "assets

[16] No proposal was made concerning long securities differences, and the Commission is unaware of any reason to change that provision.

[17] It should be noted that the provisions of Rule 17a–13 are not being amended.

[18] The NYSE recommended that 5% should be the criteria.

[19] The appropriate SRO must of course assure itself that the borrowings and repayments are being made for legitimate business purposes.

[20] In the Concept Release, the Commission solicited public comment on the SIA's recommendation that, for purposes of the Reserve Formula, a firm short position that allocates to a customer debit should be treated in the same manner as a firm long position that allocates to a customer credit. Currently, where a firm short position allocates to a customer debit both sides must be included in the Reserve Formula, whereas if a firm long position allocates to a customer credit, both sides are excluded from the Reserve Formula. The Commission stated the exposure inherent in a short sale to customers—that the broker or dealer selling short to a customer may be required to borrow securities in order to meet its delivery requirement under Rule 15c3–3. No comments have been received to negate this objection and the Commission knows of none. Accordingly, the interpretation will not be changed.

[21] *See* NYSE Rule 325 (June 1, 1975) and Chicago Board of Options Exchange Rule 13.3 (1973).

which cannot be readily converted into cash." Included in this category are most unsecured receivables, 100% of which must be deducted from net worth. Certain unsecured receivables, however, need be deducted only after a period of time specified in the net capital rule.

The SIA has recommended that underwriting receivables and investment banking receivables (otherwise known as "syndicate receivables") be given treatment similar to that accorded commissions receivable from other brokers and dealers under the net capital rule. In addition, the SIA has recommended that other unsecured receivables be allowed as liquid assets to the extent that they generate tax accruals.

The Commission has determined to allow inclusion of the receivables but only to the extent they generate tax liabilities which have not been paid.

While the data supplied by the SIA appears to demonstrate the high collectability of underwriting and investment banking receivables, their ultimate collectibility does not alone warrant amending the net capital rule to threat such unsecured receivables as allowable assets.

From the standpoint of liquidity, the question is first whether an asset is readily convertible into cash; this is an all important consideration since the purpose of the rule is to ensure that a broker or dealer has on hand at all times sufficient liquid assets to satisfy customer claims promptly.

As the Commission stated in the Concept Release,

> With certain limited exceptions, unsecured receivables have not been treated as readily convertible into cash because they may not be readily collectable on the initiative of the broker or dealer. If the broker's or dealer's debtor disputes the claim, or simply does not pay, court action and its attendant delays may be the only recourse.

The SIA's data have not demonstrated otherwise.

Although most unsecured receivables are not deemed by the net capital rule to be readily convertible into cash, the rule is somewhat inconsistent in recognizing other unsecured receivables as readily convertible into cash. This results largely from the fact that, in adopting the uniform net capital rule, the Commission annexed provisions from the various net capital rules of the self-regulatory organizations which accepted these unsecured receivables as liquid. Whatever the cause for these exceptions to an otherwise clear policy, the Commission does not view it as a reason to extend the exceptions any further.

Tax Offsets

The current treatment of receivables and corresponding accrued tax liabilities under the net capital rule subjects brokers and dealers to what appears to be a "double deduction." The rule does not allow a broker or dealer to add back actual tax liabilities (in contrast to deferred tax liabilities) to net worth even if the tax liability relates to a receivable which must be deducted from net worth in computing net capital. The Commission did not allow such offsets because current tax liabilities must be paid by the broker or dealer regardless of whether the asset to which the tax relates has been converted into cash.

In retrospect, the Commission believes that this treatment, while justified on a strict liquidity basis, seems unnecessary to protect the solvency of a broker or dealer. Accordingly, a broker or dealer will not be required to deduct from net worth receivables to the extent such receivables are offset by corresponding tax liabilities. Such tax liabilities, however, would have to be reflected as a liability and included in computing the broker's or dealer's aggregate indebtedness.

C. Free Shipments

Currently, Rule 15c3–1(c)(2)(iv)(B) provides that receivables arising out of "free shipments" of mutual fund shares need be deducted from net worth in computing net capital only if such receivables are outstanding more than seven business days. The NASD has requested that the Commission extend the time period during which receivables arising out of free shipments of mutual fund shares are considered "good assets" in computing net capital to 30 calendar days. In support of its proposal, the NASD points out that investment company share liquidations present little risk in view of Section 22(e) of the Investment Company Act of 1940 which provides that the proceeds of a mutual fund redemption must be paid within seven days of the tender of such securities. Moreover, the NASD believes that the seven business day processing period for mutual fund redemptions currently provided for in the rule is unrealistic and ignores current business practices. According to a study conducted by the NASD, on the average, a mutual fund redemption is settled in 18.9 calendar days.

It appears to the Commission that a period of 16 business days to allow for mutual fund redemption is appropriate. This period is based upon a study of the NASD data. Sixteen business days (or approximately 22 calendar days) exceeded the average number of days it took to "settle" mutual fund redemptions (18.9 according to the NASD) by approximately three days. Accordingly, Rule 15c3–1(c)(2)(iv)(B) will be amended to require a deduction from net worth for receivables arising out of free shipments of mutual fund shares after 16 business days rather than 7 business days as currently provided for in the rule.

Statutory Basis and Competitive Considerations

Pursuant to the Securities Exchange Act of 1934 and particularly Sections 15(c)(3), 17(a), and 23(a) thereof, 15 U.S.C. 78*o*(c)(3), 78*q*(a) and 78*w*(a), the Commission is amending § 240.15c3–1 and § 240.17a–11 in Chapter II of Title 17 of the Code of Federal Regulations in the manner set forth below. The Commission believes that any burden imposed upon competition by the amendments is necessary in furtherance of the purposes of the Act, and particularly to implement the Commission's continuing mandate under Section 15(c)(3) thereof, to provide minimum safeguards with respect to the financial responsibility of brokers and dealers.

Text of Amendments

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

In accordance with the foregoing, 17 CFR Part 240 is amended as follows:

1. In § 240.15c3–1, paragraph (a) is revised; (c)(2)(i)(E) added; (c)(2)(iv)(B) and (v), (e) and (f)(1)(i) and (2) revised and paragraph (g) removed to read as follows:

§ 240.15c3–1 Net capital requirements for brokers and dealers.

(a) No broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 1500 percentum of his net capital, except as otherwise limited by the provisions of paragraph (a)(1) of this section, or, in the case of a broker or dealer electing to operate pursuant to paragraph (f) of this section, no broker or dealer shall permit his net capital to be less than 2 percent of aggregate debit items as computed in accordance with § 240.15c3–3a of this chapter, or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater, except as otherwise limited by paragraph (f) of this section, and every broker or dealer shall have the net capital necessary to comply with the following conditions, except as otherwise provided for in paragraph (f) of this section.

* * * * *

(c) * * *

(2) * * *

(i) * * *

(E) Adding to net worth any actual tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section.

* * * * *

(iv) * * *

(B) *Certain unsecured and partly secured receivables.* All unsecured advances and loans; deficits in customers' and non-customers' unsecured and partly secured notes; deficits in special omnibus accounts maintained in compliance with the requirements of 12 CFR 220.4(b) of Regulation T under the Securities Exchange Act of 1934, or similar accounts carried on behalf of another broker or dealer, after application of calls for margin, marks to the market or other required deposits which are outstanding 5 business days or less; deficits in customers' and non-customers' unsecured and partly secured accounts after application of calls for margin, marks to the market or other required deposits which are outstanding 5 business days or less, except deficits in cash accounts as defined in 12 CFR 220.4(c) of Regulation T under the Securities Exchange Act of 1934 for which not more than one extention respecting a specified securities transaction has been requested and granted, and deducting for securities carried in any of such accounts the percentages specified in paragraphs (c)(2)(vi) or (f) of this section or Appendix A (17 CFR 240.15c3–1a); the market value of stock loaned in excess of the value of any collateral received therefor; receivables arising out of free shipments of securities (other than mutual fund redemptions) in excess of $5,000 per shipment and all free shipments (other than mutual fund redemptions) outstanding more than 7 business days, and mutual fund redemptions outstanding more than 16 business days; any collateral deficiencies in secured demand notes as defined in Appendix D (17 CFR 240.15c3–1d);

* * * * *

(v)(A) Deducting the market value of all short securities differences (which shall include securities positions reflected on the securities record which are not susceptible to either count or confirmation) unresolved after discovery in accordance with the following schedule:

Differences [1]	Numbers of business days after discovery
25 percent	7
50 percent	14
75 percent	21
100 percent	28

[1] Percentage of market value of short securities differences.

(B) Deducting the market value of any long securities differences, where such securities have been sold by the broker or dealer before they are adequately resolved, less any reserves established therefor;

(C) The designated examining authority for a broker or dealer may extend the periods in (A) above for up to 10 business days if it finds that exceptional circumstances warrant an extension.

* * * * *

(e) *Limitation on withdrawal of equity capital.* No equity capital of the broker or dealer or a subsidiary or affiliate consolidated pursuant to Appendix C (17 CFR 240.15c3–1c) whether in the form of capital contributions by partners (excluding securities in the securities accounts of partners and balances in limited partners' capital accounts in excess of their stated capital contributions), par or stated value of capital stock, paid-in capital in excess of par, retained earnings or other capital accounts, may be withdrawn by action of a stockholder or partner, or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, sole proprietor or employee if, after giving effect thereto and to any other such withdrawals, advances, or loans and any Payments of Payment Obligations (as defined in Appendix D (17 CFR 240.15c3–1d) under satisfactory subordination agreements which are scheduled to occur within six months following such withdrawal, advance or loan, either aggregate indebtedness of any of the consolidated entities exceeds 1000 percentum of its net capital or its net capital would fail to equal 120 percentum of the minimum dollar amount required thereby or would be less than 5 percent of aggregate debit items computed in accordance with 17 CFR 240.15c3–3a, or, if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater or in the case of any broker or dealer included within such consolidation if the total outstanding principal amounts of satisfactory subordination agreements of the broker or dealer (other than such agreements which qualify as equity under paragraph (d) of this section) would exceed 70 percent of the debt-equity total as defined in paragraph (d). *Provided,* That this provision shall not preclude a broker or dealer from making required tax payments or preclude the payment to partners of reasonable compensation.

(f) * * *

(1)(i) A broker or dealer who is not exempt from the provisions of 17 CFR 240.15c3–3 under the Securities Exchange Act of 1934 pursuant to paragraph (k)(1) or (k)(2)(i) may elect not to be subject to the limitations of paragraph (a) of this section respecting aggregate indebtedness as defined in paragraph (c)(1) of this section and certain deductions provided for in paragraph (c)(2) of this section. *Provided,* That in order to qualify to operate under this paragraph (f), such broker or dealer shall at all times maintain net capital equal to the greater of $100,000 ($25,000 in the case of a broker or dealer effecting transactions solely in municipal securities) or 2 percent of aggregate debit items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3–3, 17 CFR 240.15c3–3a), or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater, and shall notify the Examining Authority for such broker or dealer and the Regional Office of the Commission in which the broker or dealer has its principal place of business, in writing, of its election to operate under this provision. Once a broker or dealer has determined to operate pursuant to the provisions of this paragraph (f), he shall continue to do so unless a change is approved upon application to the Commission.

(2) In the case of a broker or dealer who has consolidated a subsidiary pursuant to Appendix C (17 CFR 240.15c3–1c), such broker's or dealer's minimum net capital requirements shall be the sum of the greater of $100,000 or 2 percent of the parent broker's or dealer's aggregate debit items computed in accordance with 17 CFR 240.15c3–3a, or, if the parent is registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if

greater, and the total of each consolidated broker or dealer subsidiary's minimum net capital requirements. The minimum net capital requirements of a subsidiary electing to operate pursuant to paragraph (f) of this section shall be the greater of $100,000 or 2 percent of its aggregate debit items computed in accordance with 17 CFR 240.15c3–3a, or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated by the subsidiary pursuant to the Commodity Exchange Act and the regulations thereunder, if greater. Where the subsidiary which has been consolidated has not elected to operate pursuant to paragraph (f) of this section, its minimum net capital requirement is the greater of its requirements under paragraph (a) of this section or 6⅔ percent of its aggregate indebtedness.

* * * * *

2. In § 240.15c3–1d, paragraphs (b)(6)(iii), (7), (8)(i), (10)(ii)(B) and (c) (2) and (5) are revised to read as follows:

§ 240.15c–1d Satisfactory subordination agreements (appendix D to 17 CFR 240.15c3–1).

* * * * *

(b) * * *

(6) * * *

(iii) The secured demand note agreement may also provide that, in lieu of the procedures specified in the provisions required by paragraph (b)(6)(ii) of this section, the lender with the prior written consent of the broker or dealer and the Examining Authority for the broker or dealer may reduce the unpaid principal amount of the secured demand note. *Provided,* That after giving effect to such reduction the aggregate indebtedness of the broker or dealer would not exceed 1,000 percentum of its net capital or, in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3–1, net capital would not be less than 5 percent of aggregate debit items computed in accordance with 17 CFR 240.15c3–3a, or, if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater. *Provided, further,* That no single secured demand note shall be permitted to be reduced by more than 15 percent of its original principal amount and after such reduction no excess collateral may be withdrawn. No Examining Authority shall consent to a reduction of the principal amount of a secured demand note if, after giving effect to such reduction, net capital would be less than 120 percent of the minimum dollar amount required by 17 CFR 240.15c3–1.

(7) *Permissive Prepayments.* A broker or dealer at its option but not at the option of the lender, may, if the subordination agreement so provides, make a Payment of all or any portion of the Payment Obligation thereunder prior to the scheduled maturity date of such Payment Obligation (hereinafter referred to as a "Prepayment"), but in no event may any Prepayment be made before the expiration of one year from the date such subordination agreement became effective: *Provided, however,* That the foregoing restriction shall not apply to temporary subordination agreements which comply with the provisions of paragraph (c)(5) of this Appendix D. No Prepayment shall be made, if, after giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements then outstanding the maturity or accelerate maturities of which are scheduled to fall due within six months after the date such Prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such Prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 1000 percentum of its net capital or its net capital would be less than 120 percentum of the minimum dollar amount required by 17 CFR 240.15c3–1 or, in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3–1, its net capital would be less than 5 percent of its aggregate debit items computed in accordance with 17 CFR 240.15c3–3a, or if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, or its net capital would be less than 120 percent of the minimum dollar amount required by paragraph (f) of 17 CFR 240.15c3–1. Notwithstanding the above, no Prepayment shall occur without the prior written approval of the Examining Authority for such broker or dealer.

(8) *Suspended Repayment.* (i) The Payment Obligation of the broker or dealer in respect of any subordination agreement shall be suspended and shall not mature if, after giving effect to Payment of such Payment Obligation (and to all Payments of Payment Obligations of such broker or dealer under any other subordination agreement(s) then outstanding which are scheduled to mature on or before such Payment Obligation) either (A) the aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital or, in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3–1, its net capital would be less than 5 percent of aggregate debit items computed in accordance with 17 CFR 240.15c3–3a or, if registered as a futures commission merchant, 6 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, or (B) its net capital would be less than 120 percent of the minimum dollar amount required by 17 CFR 240.15c3–1 including paragraph (f), if applicable. *Provided,* That the subordination agreement may provide that if the Payment Obligation of the broker or dealer thereunder does not mature and is suspended as a result of the requirement of this paragraph (b)(8) for a period of not less than 6 months, the broker or dealer shall thereupon commence the rapid and orderly liquidation of its business but the right of the lender to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of 17 CFR 240.15c3–1 and 240.15c3–1d.

* * * * *

(10) * * *

(ii) * * *

(B) The aggregate indebtedness of the broker or dealer exceeding 1500% of its net capital or, in the case of a broker or dealer which has elected to operate under paragraph (f) of 17 CFR 240.15c3–1, its net capital computed in accordance therewith is less than 2% of its aggregate debit items computed in accordance with 17 CFR 240.15c3–3a or, if registered as a futures commission merchant, 4% of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, throughout a period of 15 consecutive business days, commencing on the day the broker or dealer first determines and notifies the Examining Authority for the broker or dealer, or the Examining Authority or the Commission first determines and notifies the broker or dealer of such fact;

* * * * *

(c) * * *

(2) *Notice of Maturity or Accelerated Maturity.* Every broker or dealer shall immediately notify the Examining Authority for such broker or dealer if, after giving effect to all Payments of Payment Obligations under subordination agreements then outstanding which are then due or mature within the following six months without reference to any projected profit

or loss of the broker or dealer, either the aggregate indebtedness of the broker or dealer would exceed 1200% of its net capital or its net capital would be less than 120% of the minimum dollar amount required by 17 CFR 240.15c3–1, or, in the case of a broker or dealer who is operating pursuant to paragraph (f) of 17 CFR 240.15c3–1, its net capital would be less than 5% of aggregate debit items computed in accordance with 17 CFR 240.15c3–3a, or if registered as a futures commission merchant, 6% of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, or less than 120% of the minimum dollar amount required by paragraph (f) of 17 CFR 240.15c3–1.

* * * * *

(5) *Temporary Subordinations.* (i) For the purpose of enabling a broker or dealer to participate as an underwriter of securities or other extraordinary activities in compliance with the net capital requirements of 17 CFR 240.15c3–1, a broker or dealer shall be permitted, on no more than three occasions in any 12 month period, to enter into a subordination agreement on a temporary basis which has a stated term of no more than 45 days from the date such subordination agreement became effective. This temporary relief shall not apply to a broker or dealer if, at such time, it is subject to any of the reporting provisions of 17 CFR 240.17a–11 under the Securities Exchange Act of 1934, irrespective of its compliance with such provisions or if immediately prior to entering into such subordination agreement either (A) the aggregate indebtedness of the broker or dealer exceeds 1000 per centum of its net capital or its net capital is less than 120% of the minimum dollar amount required by 17 CFR 240.15c3–1, or (B) in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3–1, its net capital is less than 5% of aggregate debits computed in accordance with 17 CFR 240.15c3–3a or, if registered as a futures commission merchant, 7% of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, or less than 120% of the minimum dollar amount required by paragraph (f) of this section, or (C) the amount of its then outstanding subordination agreements exceeds the limits specified in paragraph (d) of 17 CFR 240.15c3–1. Such temporary subordination agreement shall be subject to all the other provisions of this Appendix.

(ii) A broker or dealer shall be permitted to enter into a revolving subordination agreement which provides for prepayment within less than one year of any or all of the Payment Obligations at the option of the broker or dealer upon the prior written approval of the Examining Authority for the broker or dealer. The Examining Authority shall not approve any Prepayment unless:

(A) If, after giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements than outstanding the maturity or accelerated maturities of which are scheduled to fall due within six months after the date such Prepayment is to occur pursuant to this provision or on or prior to the date on which the Payment Obligation in respect of such Prepayment is scheduled to mature disregarding this provision, whichever date is earlier) without reference to any projected profit or loss of the broker or dealer, either aggregate indebtedness of the broker or dealer would exceed 900 percentum of its net capital or its net capital would be less than 200 percentum of the minimum dollar amount required by 17 CFR 240.15c3–1 or, in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3–1, its net capital would be less than 6% of its aggregate debit items computed in accordance with 17 CFR 240.15c3–3a or if registered as a futures commission merchant, 7% of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, or its net capital would be less than 200% of the minimum dollar amount required by paragraph (f) of 17 CFR 240.15c3–1 and

(B) Pre-tax losses during the latest three-month period equaled less than 15% of current excess net capital.

* * * * *

3. In § 240.17a–11, paragraph (b)(2) is revised to read as follows:

§ 240.17a–11 Supplemental current financial and operational reports to be made by certain brokers and dealers.

* * * * *

(b) * * *

(2) If a computation made by a broker or dealer pursuant to § 240.15c3–1(f) shows, at any point during the month, that his net capital is less then 5 percent of aggregate debit items computed in accordance with § 240.15c3–3 Exhibit A: Formula for the Determination of Reserve Requirements, or that his total net capital is less than 120 per centum of the minimum net capital required of him, such broker or dealer shall file a report on Part II or Part IIA of Form X–17A–5 (§ 249.617 of this chapter) as determined in accordance with the standards set forth in §§ 240.17a–5(a)(2)(ii) and (a)(2)(iii), within 15 days after the end of each month thereafter until three successive months shall have elapsed during which his net capital is not less than 5 percent of aggregate debit items computed in accordance with § 240.15c3–3 Exhibit A, and his total net capital does not fall below 120 per centum of the minimum net capital required of him.

* * * * *

By the Commission.

George A. Fitzsimmons,

Secretary.

January 13, 1982.

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