Company Act of 1940 (15 U.S.C. 80a–8), is an American Depository Receipt of a foreign issuer whose securities are registered under section 12 of the Act, or is a stock of an issuer required to file reports under section 15(d) of the Act (15 U.S.C. 78o(d)).

* * * * *

(4) Daily quotations for both bid and asked prices for the stock are continuously available to the general public,

(5) There are 300,000 or more shares of such stock outstanding in addition to shares held beneficially by officers, directors, or beneficial owners of more than 10 per cent of the stock,

(6) The minimum average bid price of such stock, as determined by the Board, is at least $2 per share, and

(7) The issuer has at least $1 million of capital, surplus, and undivided profits.

* * * * *

Final Regulatory Flexibility Analysis

The initial regulatory flexibility analysis indicated that because the proposals to amend OTC List criteria involved a mixture of relaxing and tightening changes, it was not easy to judge the overall impact on small domestic entities—primarily those small-sized corporations whose stocks are traded in the over-the-counter market.

No comments were received which would lead the Board to conclude that the adoption of these amendments would have a significant economic impact on a substantial number of small entities.

By order of the Board of Governors of the Federal Reserve System, May 12, 1982.

William W. Wiles,

Secretary of the Board.

[FR Doc. 82–13492 Filed 5–19–82; 8:45 am]

BILLING CODE 6210–01–M

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

15 CFR Part 931

Improving Coastal Management in the United States

Correction

In FR Doc. 82–13359, appearing at page 21009, in the issue of Monday, May 17, 1982, make the following correction:

On page 21024, in the first column, remove the heading Subpart C—[Removed] appearing after the table of Contents for Subpart D;

On page 21024, in the first column, before paragraph 1., add:

§ 931.140 through § 931.152 (Subpart L) [Removed]

BILLING CODE 1505–01–M

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–18737; File Nos. S7–855, 856, 922 and 923]

Net Capital Requirements for Brokers and Dealers

AGENCY: Securities and Exchange Commission.

ACTION: Adoption of Amendments to net capital rule.

SUMMARY: The Commission is amending parts of its net capital and customer protection rules for broker-dealers. The amendments will alter the haircuts under the net capital rule on most debt securities, preferred stock and redeemable securities of certain registered investment companies. The amendments will also affect the treatment of securities borrowing and fails to deliver by brokers-dealers under both rules. Finally, the Commission is adopting a new provision in the net capital rule designed for a unique class of broker-dealer generally known as municipal securities broker's brokers.

EFFECTIVE DATE: June 25, 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 January 1982, the Commission announced the adoption and proposal of amendments to the net capital and customer protection rules that, taken together, would significantly revise the capital requirements for broker-dealers.[1] The amendments as adopted or proposed for comment represented the Commission's conclusion, following a comprehensive examination of the financial responsibility requirements applicable to broker-dealers and the capacity of the securities industry to avoid operational and financial problems encountered in the "Paperwork Crisis" of the late 1960's, that those capital requirements could be revised without creating undue risks to investors.

The amendments that were adopted by the Commission in January 1982, generally, reduced by half (from 4% to 2%) the percentage requirement of net capital for those broker-dealers which have elected the alternative method of calculating net capital, allowed the use of revolving subordinated loans, moderated the treatment of short securities differences and allowed elimination from the Reserve Formula[2] of securities borrowed from customers under certain circumstances. The amendments that were proposed in January 1982 included changes in the percentage deductions ("haircuts") from the market value of certain securities in the proprietary accounts of broker-dealers in computing capital requirements; changes in the treatment of municipal securities that have no ready market; changes in the treatment of fail to deliver contracts that allocate to fail to receive contracts ("matched fails") under the Reserve Formula; and changes in the time period before a deduction must be taken for fail to deliver contracts. The Commission also proposed to amend the customer protection rule to change the treatment of securities borrowed by broker-dealers from persons other than brokers, dealers, or municipal securities dealers under the possession or control requirement of that rule. The effective date of the amendments that were adopted by the Commission in January 1982 was delayed until May 1, 1982.

Following the Commission's actions in January 1982, self-regulatory organizations and the Commodities Futures Trading Commission (the "CFTC") have taken action affecting the capital requirements of many broker-dealers. The New York Stock Exchange (the "NYSE") adopted a rule proposal reducing the early warning levels, thereby reducing, as a practical matter, the net capital required of member firms. The Board of Directors of the National Association of Securities Dealers, Inc. (the "NASD") has approved a substantially similar rule and has submitted that rule to its membership for approval. The CFTC has proposed for comment amendments that would substantially parallel the amendments to the net capital rule adopted by the Commission.

The Commission is adopting the amendments proposed in January 1982, modified, as discussed below, to account for certain of the comments received. The Commission, however, declines to revisit at this time, as several commentators suggested, certain issues considered in January 1982. In view of the significant reduction in overall

[1] Securities Exchange Act Releases Nos. 18417–18420 (Jan. 13, 1982), 47 FR 3512 (Jan. 25, 1982).

[2] 17 CFR 240.15c3–3a.

capital requirements, the Commission has determined not to revisit the liquidity concept of the net capital rule as applied to the treatment of exchange seats and unsecured receivables (which are now treated as not readily convertible into cash).[3] The Commission will, however, continue to explore alternatives with the securities industry. The Commission believes that a balance must be struck by increasing deductions for some of the items in the net capital calculation to reflect the changing economic and market conditions.

The Commission has received thoughtful and helpful comments from the securities industry in its efforts to update the financial responsibility rules. The Securities Industry Association (the "SIA"), some of its members, the various self-regulatory organizations, broker-dealers and others have assisted in the analysis of relevant issues by supplying data, views and recommendations appropriate to the Commission's undertaking. The Commission believes that the success of its public dialogue with the securities industry in this matter, which began in 1979, is evident in the rules as adopted today. The Commission hopes this dialogue will continue as other issues of public concern are explored.

I

The Haircuts

A broker-dealer arrives at its net capital by deducting from its net worth (calculated in accordance with generally accepted accounting principles)[4] the value of assets not readily convertible into cash, and also certain percentages of the market value of securities carried in its accounts. The amount of the haircuts for debt securities (including short term notes) depends on the nature of the issuer, the time to maturity of the security and, for securities of non-governmental issuers, the ratings of nationally recognized statistical rating services. In general, the haircuts for debt securities were designed to take into account the historical market fluctuations of each type of instrument and its associated market.

Relatively recent events in the debt market have caused the Commission to question the adequacy of the present haircut provisions for debt securities generally. Interest rates rose to unprecedented heights in the 1979–80 period, causing precipitous declines in the values of already issued debt instruments. The Commission is concerned that individual firms have an adequate capital cushion to cover potential market risks in light of the volatility of the current markets.

In Securities Exchange Act Release No. 17209,[5] the Commission proposed for comment amendments to the haircut schedules for Government securities, municipal securities and nonconvertible debt securities. Also, in an effort to make its financial responsibility rules more compatible with sound business practices, the Commission solicited comment on the degree to which the haircut provisions should deal with hedges among various classes of debt instruments. Through the comment process the Commission expected to develop criteria for hedging which would be objective, clear and easily determinable.

As discussed in its October 1980 Release, data provided to the Commission tended to confirm doubts as to the adequacy of the present haircut provisions. The data were compiled from records accumulated by brokerage firms in the ordinary course of dealing in debt securities. In one of its January 1982 Releases,[6] the Commission reproposed for comment the haircuts on debt securities and proposed for comment a rather sophisticated hedging schedule as to Government securities. It also proposed for comment changes in haircuts for preferred stock and for redeemable securities of certain registered investment companies.

A. Government Securities

Haircut Schedules. The net capital rule currently requires, in the case of a security issued or guaranteed as to principal or interest by the United States or any agency thereof, deductions from net worth equal to a percentage of the net long or short position in each category described in subparagraph (A) of the haircut provisions of the rule. There is no deduction for securities having less than one year to maturity. The deduction for securities having one year but less than three years to maturity is 1 percent; that for securities having three years but less than five years to maturity is 2 percent; that for securities with five years or more to maturity is 3 percent.

The data submitted to the Commission by the SIA in 1979 indicated that these haircuts were inadequate in measuring the risk in carrying the securities, particularly those securities with less than one year to maturity and those with five years or more to maturity. That data showed that the majority of monthly changes in market value were greater than the existing haircuts and that, for some months, the month-end to month-end price movements were considerably greater than the existing haircuts. For example, in 26 of the 49 months in the survey, Treasury bills maturing in 6 months moved in price between one tenth of 1% to over 1%. In one month, Treasury bills maturing in nine months moved 1.50% and in February 1980, 1.90%. Finally, in 39 of 49 months, Treasury bills maturing in 12 months moved between one tenth of 1% and 2.51% (February 1980). In each case, however, the rule required no haircut.

The data for bonds with 2 years, 5 years, 10 years, 20 years and 30 years to maturity showed the same discrepancies between the haircuts and the price fluctuations as securities having 1 year or less to maturity. For example, in 3 different months within a 6 month period, Treasury bonds maturing in 30 years declined substantially: 7.06% in February 1980, 8.82% in January 1980 and 9.16% in October 1979. Yet, the required haircut for these securities is only 3%. Based largely on these data and other data later submitted to the Commission, the Commission proposed in its January 1982 Release to alter the haircuts on Government securities.

In an effort to recognize more realistic hedging approaches by brokers-dealers, the Commission also proposed for comment a sophisticated hedging provision as initially presented by the SIA and modified by the Commission. The computation process includes the "weighting" of subcategory haircuts in determining the overall haircut for the category. Permitting only a partial offset of haircuts among subcategories within each category is necessary to account for the increasing fluctuation in prices and yields as the differences in dates to maturity of the long and short positions increase. At the same time, however, permitting a partial offset of haircuts among subcategories recognizes that the market risks of holding both positions are historically less than the total deduction that would be required with respect to each position if the haircut schedule did not permit hedging of securities in different subcategories. Thus, for example, a long position consisting of $1 million of three month Treasury bills does not entirely offset a short position consisting of $1 million in six month Treasury bills, but the haircut required on both positions is less than

[3] The Commission understands, however, that the staff has issued an interpretation allowing a broker or dealer to net receivables from and payables to another broker or dealer for net capital purposes.

[4] This means, among other things, using the accrual method of accounting.

[5] Securities Exchange Act Release No. 17209 (Oct. 9, 1980), 45 FR 69911 (Oct. 22, 1980).

[6] Securities Exchange Act Release No. 18418 (Jan. 13, 1982), 47 FR 3521 (Jan. 25, 1982).

the sum of the haircuts required if the positions were viewed separately.

The hedging formula also prescribes a safety factor that is a percentage of the lesser of the aggregate net long or short positions within each category. By including the safety factor in the haircut computation for each category, the computation takes into consideration the degree to which the various security positions act as hedges for each other. Since the haircuts for the subcategories reflect only the manner in which the market value of the individual security positions within a particular subcategory fluctuate, the safety factor adds a measure of how the market value of the subcategories vary with each other.[7] The SIA determined that the safety factor for the haircut schedule based on an analysis of 30-day price fluctuations would be 48%. For ease of computation and to provide an added measure of safety in the case of portfolios with a heavy concentration in a particular subcategory, the Commission has increased the safety factor to 50%.

The Commission also included in the proposed amendments a provision whereby a broker-dealer can elect to recognize some cross category hedges. Under that provision, an electing broker-dealer could exclude the market values of a long or short security from one category and one from another category provided that such securities have maturity dates: (1) Between 9 months and 15 months and within 3 months of one another; (2) Between 2 years and 4 years and within 1 year of one another; or (3) Between 8 years and 12 years and within 2 years of one another. The electing broker-dealer, however, would be required to include the net market value of the two securities in the category for the security with the longer date to maturity.

Moreover, the Commission proposed to amend the Government securities haircut provisions to permit brokers-dealers to exclude long or short positions in Government securities that are hedged by certain futures contracts.[8] To qualify, the futures contract must be traded on a regulated market and must provide for the delivery of a Government security with a maturity date that would be within a specified range of the maturity date of the long or short Government securities position that the broker-dealer seeks to exclude.

Finally, the Commission proposed, as an alternative to the principal haircut procedure, a simplified procedure for computing applicable haircuts to satisfy the concerns of commentators that the rule continue to provide a simple and direct method for computing required deductions from net capital. That procedure would require an electing broker-dealer to apply the percentage deduction provided in the schedule to the value of each net long or short position in Government securities in the 12 subcategories, and would prohibit any hedging between subcategories or adjacent categories. By netting long or short positions within subcategories, however, the rule would continue to permit some risk-reducing hedges by electing brokers-dealers.

The Commission received few comments regarding the proposed amendments. Most who commented stated that the haircuts on Government securities should not be increased except as to those having a maturity of less than one year. Indeed, the SIA recommended that the haircuts be decreased for all Government securities having a maturity of more than one year, except in two subcategories. The commentators contend that the markets for these securities (and presumably they are referring to Treasury notes and bonds) are highly liquid. They assert that a weekly volatility analysis is more appropriate than the monthly volatility analysis relied upon by the Commission because the average inventory turnover in the market among dealers in Government securities is 1.5 days. They state that the proposed haircuts will cause firms to reduce unnecessarily their Government securities inventory. This, in turn, will diminish the industry's ability to serve the unprecedented demand for liquidity and stability in the Government securities market.

With respect to hedging, although the commentators commended the Commission for incorporating a hedging framework in the proposed rule, they suggest that the Commission's proposed hedging mechanism did not go far enough. They contend that it would be consistent with the goal of providing relief for hedged positions to permit netting among securities in different subcategories (within the same category). In addition, they assert that further netting with futures, forwards and "ratio trading" should be allowed.

Bear Stearns, a reporting government dealer,[9] submitted its own proposal. The proposal would set up 12 categories of maturity ranges, similar to those in the Commission's proposal, but would substantially alter the hedging provisions. Bear Stearns, in its proposal, presumes that all Government securities have some relationship to one another. Therefore, Bear Stearns contends that the rule should allow a dealer to reduce its haircut by netting one category against any of the other 12 categories including those in the shortest maturity band against those in the longest maturity band.

The haircut for the netted categories would be determined by a predesigned formula which it represents is based on an historical analysis of the relationship of the securities in the two categories. The netting would involve a so-called hedging "ratio" which establishes the amount of the shorter-term position which must be maintained to provide an effective hedge against the longer-term position; *e.g.*, for every dollar of positions in category 3, two dollars of contrapositions in category 2 would be needed as an effective hedge.

The Commission acknowledges the responsible recommendations of the securities industry in the Commission's effort to adopt an appropriate haircut schedule for Government securities. Many broker-dealers have devoted substantial amounts of time to assist the Commission by compiling relevant data and by making alternate recommendations. The primary issues remaining for discussion are the basis for higher haircuts and the hedging formula.

The higher haircuts are prompted by the higher price volatility in the market for Government securities and the fact that the present haircuts do not adequately reflect the risks inherent in this increased volatility. The commentators do not dispute these facts. Instead, they contend that the use of the 30-day volatility data period in establishing the haircuts was not appropriate.

The Commission, however, believes that the 30-day period is appropriate since the rule was designed, among other things, to ensure a conservative measurement of the risks in holding positions. The rule cannot account for a particular broker-dealer's trading or hedging strategy. Moreover, the argument of the commentators presumes

[7] The safety factor was derived by analyzing the covariance coefficients of each security position to formulate the safety factor in terms of a percentage of the lesser of the aggregate haircut on the long positions or the aggregate haircut on the short positions within a given category.

[8] Exchange listed options on debt securities will be factored into the formula as the options begin trading. A separate haircut schedule as to the GNMA options has already been approved. *See* letter from the Division of Market Regulation to the Chicago Board Options Exchange, Inc., dated Sept. 29, 1981. The Commission continues to solicit comment and analysis on the impact of this development.

[9] A reporting dealer is one which submits reports to the Federal Reserve Bank of New York.

that the net capital rule is a "going concern" measure of liquidity, which overlooks the fact that the rule was designed to ensure that a firm can be liquidated to an equity. Hence the Commission must treat securities positions on a more conservative basis then a broker-dealer might view them in its everday operations.

Although the Commission believes that the haircuts should be raised as proposed in its release, it recognizes that there is a class of Government securities dealers, which report to the Federal Reserve Bank of New York, that should not be subject to the full impact of the increased haircuts, not only because these dealers turn over their inventory of Government securities within several days, but because they have undertaken certain affirmative obligations to the Federal Reserve System ("the System"). These reporting Government securities dealers must report on a regular basis their trading volume, positions and financing arrangements. They are also expected to participate in Treasury auctions and underwrite new issues of Treasury securities, particularly in troubled markets when there may be insufficient bids to meet the Treasury's cash needs. The dealers are also expected to make a market in certain new issues of Treasury securities. In sum, they are an essential part of the network through which United States monetary policy is maintained.

The Commission believes that these facts constitute sufficient reasons to lessen the haircuts for those reporting Government dealers that actually transact business with the System, provided they maintain a specified minimum net capital to ensure that their dealer activities do not impair the remainder of their business. Thus, the Commission has determined that such reporting Government securities dealers would be required to take only 75% of the haircut on Government securities positions, provided the dealer maintains in excess of $50,000,000 in tentative net capital.

Based on the comments and information before it, the Commission has determined to adopt the substance of the proposed hedging formula as modified to make it more compatible with actual securities industry trading strategies. As the Commission has previously noted, however, the rule cannot possibly reflect the most sophisticated hedging techniques of traders in Government securities. The hedging provisions will, however, be amended so that a broker-dealer will be deemed to be long or short the value of the security which is deliverable against a futures contract for a Government security where the broker-dealer has an open futures contract held in a proprietary account. The contract must be traded on a contract market as defined in the rules of the Commodity Futures Trading Commission.[10] The hedging formula will also be amended so that when a position in a lower haircut category is utilized to offset a position in a higher haircut category, the difference in the market value should remain in the category for the position with the greater dollar value. The January 1982 proposal would have required the net market value of the two securities to be included in the category with the longer date to maturity.

The hedging schedule proposed by Bear Stearns will be the subject of further study and analysis of the underlying assumptions and data. The Commission requests comment on that proposal from interested persons.[10a]

Repurchase, Reverse-Repurchase and Matched Repurchase Agreements

In Securities Exchange Act Release No. 18418, the Commission proposed to amend the net capital rule to clarify the treatment of repurchase, reverse-repurchase and matched repurchase agreements. In response to the proposal, the Commission received helpful comments from the NYSE, the SIA and others.

The NYSE suggested that the Commission continue to apply the tangible net asset test as established in informal staff advice.[11] The Commission agrees with the NYSE that the creditworthiness of the persons dealing with the broker-dealer is an important factor in determining whether to charge the entire deficit. There is, however, insufficient support for the $16,000,000 threshold figure as suggested by the NYSE. The Commission, therefore, declines to continue use of the tangible net asset test. The Commission notes, however, that in circumstances where the broker-dealer has reason to believe that a party to either a repurchase or reverse-repurchase agreement will not comply with its obligations under the agreement, the broker-dealer must treat the contract, for net capital purposes, as dishonored. Accordingly, in the case of a reverse-repurchase agreement, the broker-dealer must deduct the full deficit from net worth. In the case of a repurchase agreement which is part of a matched repurchase agreement, the broker-dealer must treat the security which is the subject of the agreement as a proprietary position and, as in the case of a repurchase agreement which is not part of a matched repurchase agreement, must deduct the appropriate haircut from net worth in computing net capital.

The Commission received other suggested changes to the rule which it believes should be incorporated into the proposed provisions. The rule will accordingly be amended to provide that, for those reverse-repurchase agreements that mature in 90 days or less, the entire deficit in an account or in related accounts that exceeds 5% of tentative net capital must be deducted from net worth. The original proposal would have aggregated the total deficits of all reverse-repurchase agreements with 90 calendar days or less to maturity and required their deduction from net worth if the total exceeded 5% of tentative net capital. The rule will be further clarified to indicate that it requires a deduction of only the loss (deficit in an account) and not a profit (gain in an account). Finally, because subparagraphs (c)(2)(iv)(F)(2)(ii) and (iv), as proposed in January 1982, could have been construed to require a deduction of an amount in excess of the total deficit in certain reverse-repurchase agreements, the provision will clearly state that the computing broker-dealer need not deduct more from net worth than the total deficit, in a reverse-repurchase agreement.

The Commission expresses its concerns about the high leverage achieved by a broker-dealer through repurchase agreements for which there is no net capital charge. The present rule amendment does not adequately address the problems raised by these transactions. Indeed, some may argue with great force that, as the time to maturity of a reverse-repurchase agreement decreases, the percentage of the deficit which must be charged should increase, not decrease. The Commission intends to continue studying the repurchase matters and requests information and comments from interested persons.

B. Municipal Securities

In its January 1982 Release, the Commission proposed to increase the haircuts for certain intermediate and long term municipal securities. The Commission also proposed for comment

[10] *See* 17 CFR 1.3 (1980).

[10a] Copies of Bear Stearns' proposal are available to interested persons at the Commission's Public Reference Room, 1100 L Street, NW., Washington, D.C.

[11] The net asset test ($16,000,000) is used to determine the extent to which a deduction should be taken for a deficit with respect to a reverse-repurchase agreement. *See*, NYSE, Interpretation Handbook: Regulation Surveillance 139–40 (1980).

a modified version of the "presumed marketability" test devised by the NASD as an alternative to the ready market test now in effect for all other securities.[12]

In response to the proposals, the Commission received many thoughtful comments from members of the industry, certain industry groups, self-regulatory organizations and others.[13] Although the Commission was not soliciting comment with respect to the appropriateness of the specified percentage deductions,[14] most comments received questioned the appropriateness of the deductions. In addition, a number of comments disputed the necessity for the presumed marketability test.

1. Haircuts on Municipal Securities

The Commission proposed to increase the haircuts for municipal securities having at least two but less than five years to maturity from 3% to 5% and for municipal securities having five or more years to maturity from 5% to 7%.

The need for the increased haircuts was based largely on data supplied to the Commission by industry sources which indicated that the existing haircuts for municipal securities were not adequate to cover price fluctuations in the municipal bond market in recent years. The data were supplied by broker-dealer firms dealing in municipal debt securities and included data over a 49 month period from February of 1976 through February of 1980. Prices were extracted from the Bond Buyer Municipal Index ("BBI"). Among other things, the data showed that municipal bond prices moved 8.58 percent in October 1979 and 11.05 percent in February 1980.

Most commentators opposed the Commission's proposal to raise haircuts on municipal securities.[15] The SIA conceded that recent volatility in the municipal securities marketplace justified increases in the haircuts for municipal securities. On the basis of the relative price movements of 30 municipal bonds, however, the SIA recommended haircut increases more modest than those recommended by the Commission. More specifically, the SIA proposed that the haircut for municipal bonds with at least two but less than five years to maturity be increased from 3% to 3.5%, that a separate haircut category be created for municipal bonds with at least five but less than ten years to maturity and that the haircut be 5% and, finally, that the haircut for municipal bonds with at least ten years to maturity be increased from 5% to 5.5%.

As to the justification for the proposed increases, some commentators questioned the Commission's use of the BBI as a means of demonstrating volatility in the municipal securities marketplace. These commentators suggested that, since the BBI is only a general indicator of the price movements of municipal securities,[16] it alone is not sufficient to justify the increases proposed. The PSA argued that a 30-day time period to measure price fluctuations is inappropriate since, according to a survey of 50 PSA members, the average turnover of inventory among those members is 12 days in periods of high volatility.

The PSA also argued that the Commission, by narrowly focusing on volatility, ignored important self-correcting mechanisms [17] which help to maintain the financial integrity of firms during volatile period. Due to the anticipated adverse impact of the Commission's proposal as outlined below, the PSA, as well as the MSRB, believes that a greater justification for the proposed increases is necessary.

As to the impact of the proposed haircut increase many commentators pointed out that such increases will reduce the ability of municipal securities firms to carry inventory and will therefore impair liquidity in the secondary market.[18] They argue that impairing liquidity in the secondary market will ultimately raise the borrowing cost of issuers of municipal securities. Moreover, many regional firms, as well as the PSA, commented that the proposed increases in haircuts discriminate against smaller firms and will have anti-competitive effects in the industry.

The PSA suggested that the Commission withdraw its proposal to increase the haircuts for municipal securities or at least adopt more moderate increases for these securities. The PSA, as well as the MSRB, also suggested that the Commission create additional haircut categories for municipal securities which would, in their view, more clearly reflect the realities of the municipal securities marketplace.

The arguments as to increased haircuts do not adequately deal with the extended periods of sharp volatility in the municipal securities marketplace since 1979. It should be noted that the present haircut schedule was devised in a period when municipal securities prices were subject to significantly less fluctuation. The Commission believes the contention as to the appropriateness of the 30-day volatility analysis does not address all of the areas of Commission concern dealing with inventory risk. The Commission has set forth reasons in its January Release for use of a 30-day period. In addition, the Commission believes it is not possible for any municipal securities dealer to determine with precision how long it will have to maintain a position in inventory. Every dealer of course, seeks to turn over its inventory as rapidly as possible. In any event, estimates by various broker-dealers that they hold positions for an average of 12 business days during periods of high volatility is neither determinative nor persuasive in this context.

The 30-day period is useful because it represents a reasonable margin of safety for liquidation of inventory positions which cannot be duplicated by an estimated turnover rate. Haircuts are designed to measure future risk. Moreover, the net capital rule does not assume the "going concern" nature of the broker-dealer. It attempts to ensure that the firm will liquidate to an equity at a particular point in time and provides a cushion to protect investors against unanticipated adverse events.

In addition, the commentators' concerns with respect to use of the BBI

[12] The Commission, due to the lack of sufficient information to formulate an appropriate provision, declined, at least for the present, to distinguish between rated and unrated municipal securities for purposes of applying haircuts under the rule.

[13] The Commission received comments from, among others, 32 members of the municipal securities industry.

[14] *See* Exchange Act Release No. 18418, 47 FR 3521 (Jan. 25, 1982) at 3521.

[15] Many comments were also received from a specialized type of municipal broker-dealer known as a brokers' broker. Unlike other members of the municipal industry, the brokers' brokers were concerned, not with the level of the increased haircuts or the presumed marketability test but, rather, with the Commission's proposals regarding fails to deliver and fails to receive. That matter is discussed later in this release.

[16] The BBI is a general indicator of historical price movements in the municipal bond market. It is based, not on actual price movements of actual securities, but rather, is derived from averages of estimates made by market professionals of the yield levels at which a specified list of issuers could sell 20-year maturity new issues generally.

[17] For example, the PSA points out that, in response to volatile markets, firms will make substantial downward adjustments in inventory and dealers will maintain greater spreads.

[18] The PSA pointed out that, at the end of the fourth quarter of 1980, municipal dealers doing a public business and carrying customer accounts held an aggregate of $2.373 billion in municipal securities. The PSA went on to point out that, assuming that 75 percent of this aggregate amount had maturities of two years or more, the additional amount of capital required to support their inventory would be approximately $36 million if the haircut levels are raised as proposed. The removal of $36 million of capital, the PSA argues, would reduce the positioning capacity of municipal securities dealers by approximately $600 million, assuming an average 6 percent haircut.

are somewhat misplaced. In determining volatility in the municipal securities marketplace in connection with amendments adopted herein, the Commission relies, not only on the BBI, which is widely used by broker-dealers to detect historical movements in municipal securities, but also on data supplied by the SIA, as well as data obtained from a municipal bond evaluation service. These data traced the price movements of actual issues of municipal securities and led to the same conclusion as the BBI data.

Finally, an impact analysis reveals that the effect of the proposed changes in municipal securities haircuts on the securities industry as a whole will be modest. While, as expected, municipal securities dealers dealing primarily in municipal securities will be disproportionately affected by the proposed increases,[19] the Commission's impact analysis showed that these firms carried more excess net capital proportionately than the rest of the securities industry.[20] As a result, the overall net capital position of municipal securities dealers should not be significantly impaired.[21]

It appears to the Commission that most of the higher haircuts as to municipal securities will be absorbed by the larger NYSE firms which have elected the alternative method of computing net capital. Because of the recent reduction, from 4% to 2%, of the percentage of net capital required to be maintained by those firms electing the alternative method of computing net capital and because of other adjustments to the financial responsibility rules which, overall, will reduce by hundreds of millions of dollars the required level of net capital for those firms, the Commission believes that it would be imprudent to ignore the recent steep increases in volatility in the municipal marketplace. Accordingly, the Commission believes that an increase in the level of haircuts for municipal securities is entirely justified.

Nonetheless, the Commission recognizes that it may not be appropriate to treat 5 year municipal bonds identically with 20 year municipal bonds for haircut purposes. Unfortunately, up to now, the Commission has not had sufficient data to justify creation of additional categories. After the January 1982 proposal, however, it obtained from the municipal securities industry additional data on price movements of selected municipal securities of intermediate maturity which allows the refinement of the category for municipal securities having 2 years or more to maturity.

On the basis of this additional data, the Commission has determined that applying a 7% haircut to all municipal securities having 5 years or more to maturity appears to be overly conservative. Municipal securities with 5 years to maturity generally exhibited less volatility than municipal securities with 20 years or more to maturity. Accordingly, the Commission is revising the percentage deductions to take account of this increased volatility of municipal securities as the length to maturity increases. The Commission is also revising the haircuts applicable to municipal securities having a maturity of 2 years or more based on the additional data.

These revisions will reduce the impact of the increased municipal securities haircuts on municipal securities dealers, who have inventory positions in such securities with maturities between 2 and 20 years.

2. Market Value of Municipal Securities

Rule 15c3–1(c)(2)(vii) requires broker-dealers to deduct from net worth in computing net capital 100% of the carrying value of securities in their proprietary or other accounts for which there is no "ready market." Under subparagraph (c)(11)(i) of the rule, a "ready market" includes a recognized established securities market where there exist independent bona fide offers to buy and sell. Recognizing the unique structure of the municipal securities marketplace, however, the Commission decided to suspend, by interpretation, application of the ready market provision to municipal securities pending development of appropriate marketability criteria for municipal securities.[22]

Since almost six years had lapsed since the interpretation was issued, the Commission, in Securities Exchange Act Release No. 17209, again requested comment regarding appropriate criteria to determine the market value of municipal securities for net capital purposes where the securities were the subject of quotations only by the computing broker-dealer.

In its January 1982 Release, the Commission proposed for comment a modified version of the presumed marketability criteria developed by the NASD as follows:

> Municipal securities dealers should value their municipal securities inventories at market, or if such values are unavailable, at cost for a period of 30 calendar days following settlement date. Thereafter, in the absence of further price or transaction data, a municipal firm would markdown or reduce the value of such positions by 5% per month until its capital value declined to 50% of its originally assigned value. At that point, the position would be valued at zero and considered a non-marketable security for net capital purposes.

Although the SIA endorsed the concept of presumed marketability, the PSA, the MSRB and many others who commented on this aspect of the Commission's proposal voiced their opposition to the adoption of a presumed marketability test.[23] Some commentators stated that the presumed marketability test was arbitrary, rigid and inappropriate for the municipal securities marketplace.[24] The MSRB stated that, because of the sheer volume and diversity of issues in the municipal marketplace,[25] formulas for determining the market value of municipal securities are not very useful.[26]

An accounting firm commented that adoption of the presumed marketability provision would result in municipal securities being valued differently for generally accepted accounting principles and net capital purposes. In their opinion, ability to hypothecate the

[19] Obviously, this is because the ratio of municipal haircuts to total net capital for sole municipal securities dealers is generally high relative to the rest of the securities industry.

[20] For year end 1981, the average NASD member had excess net capital equal to approximately 300 percent of required net capital while the average sole municipal securities dealer had excess net capital equal to approximately 470 percent of required net capital.

[21] As noted previously, for the year end 1981, the average municipal securities dealer had excess net capital in an amount equal to approximately 470 percent of required net capital. Even assuming that the municipal haircuts were raised to the level originally proposed in Securities Exchange Act Release No. 18418, excess net capital of these firms would still approximate 430 percent of required net capital.

[22] Securities Exchange Act Release No. 11854 (Nov. 20, 1975). In this release, the Commission requested public comment on developing market criteria for municipal securities.

[23] The PSA expressed its belief that the present practice of not applying the ready market provision to municipal securities has worked relatively well. The PSA believes that the broker-dealer quoting the security "maintains" the secondary market for issues and provides the necessary liquidity in the market. In the PSA's view, regional municipal dealers would be penalized by application of the ready market provision.

[24] The MSRB pointed out that there are many other ways of obtaining price verification for municipal securities. Unfortunately, none of them is satisfactory for issues which have no ready market.

[25] According to the MSRB there are approximately 47,000 issuers having 1,500,000 issues outstanding.

[26] In addition, the MSRB as well as an accounting firm, pointed out that adoption of the presumed marketability test may well induce firms to effect "accommodation trades" solely for the purpose of price validation. this, of course, would be fraudulent.

securities should be sufficient evidence of marketability.

As to the effects of adoption of the presumed marketability test, many commentators pointed out that the proposal discriminates against small regional dealers who may be the only market maker for a certain issue. As with the haircut proposal, they state that adoption of a presumed marketability test will reduce liquidity in the secondary market and raise the borrowing cost of issuers. In this regard, the MSRB states that the increased costs to regional firms may very well cause some of them to curtail their activities.

The Commission has in the past encouraged the industry to find a solution to the vexing problem of the valuation of municipal securities held in inventory for more than 30 days, which have no ready market in the usual sense. The problem remains that there are instances when the examining staffs of the Commission and the self-regulatory orgainzations have been unable to substantiate the valuation of specific municipal securities assigned by particular municipal dealers. More importantly, some broker-dealers were found to have capital problems after an examination because they were overvaluing securities which had no "ready market."

On the basis of information available to the Commission, it appears that, because of the relatively few issues that are held in inventory for substantial periods of time in excess of 30 days, the adverse effects of adoption of the presumed marketability test have been overstated. The presumed marketability test only comes into effect after 30 days and then only if the broker-dealer cannot establish the market value of the security involved, by reference to last sales data, legitimate quotes from other broker-dealers who are willing to buy the security or pledge of the securities under a bank loan to a bank lender.

In view of the comments received, however, the Commission has made some adjustments to the proposed test. More specifically, instead of being denied any value for inventory positions after the market value has declined to 50% of its originally assigned value, broker-dealers will be allowed to continue to reduce the value, for purposes of the rule, by 5% per month until the value reaches zero.[27]

The presumed marketability test, as revised, is as follows:

> Municipal securities dealers should value their municipal securities inventories at market, or if such values are unavailable, at cost for a period of 30 calendar days following settlement date. Thereafter, in the absence of further price or transaction data, a municipal firm would markdown or reduce the value of such positions by 5% per month until its capital value declined to zero. At that point, the position would be considered a non-marketable security for net capital purposes.

C. Preferred Stock

The net capital rule currently requires in the case of cumulative, nonconvertible preferred stock a deduction of 20% of the market value of the greater of the long or short position. In its January 1982 Release, the Commission proposed to reduce from 20% to 10% the haircut for nonconvertible preferred stocks which are rated in one of the four highest categories by at least two of the nationally recognized statistical rating organizations. Under this proposal, all other issues of preferred stock would be treated as commonstock and receive a haircut of 30%. For firms using the alternative method, however, the haircut would be reduced to 15%.

This proposal resulted from a determination by the Commission that, since higher rated preferred stock presented little risk of non-payment of dividends when due, allowing preferential treatment to higher rated preferred stock more accurately reflected the degree of risk involved. At the same time, the Commission determined that, since the financial health of an issuer affects its ability to pay dividends on its preferred stock, lower rated preferred stock should be treated more like equity securities.

While the Commission received comments from the NASD and others endorsing the proposed revisions for preferred stock, it received no comments opposing the proposal. Accordingly, the Commission finds that the proposed treatment of preferred stock is a reasonable alternative to the present treatment of preferred stock and adopts the provision as proposed.

D. Securities of Certain Registered Investment Companies

In light of the proposed changes in the haircut schedules for certain debt securities, the Commission believed it appropriate to adjust the haircut provisions relating to redeemable securities issued by registered investment companies investing in such debt securities. In its January 1982 Release, the Commission proposed to amend the net capital rule to provide for (1) a deduction of 2% of the market value of the greater of the long or short position of redeemable securities of a registered investment company whose assets consist of investments restricted to certain debt securities with one year or less to maturity ("the 2% haircut") ("money market funds"); (2) a deduction of 7% of the greater of the market value of the long or short position of redeemable securities of a registered investment company whose assets consist of investments in long-term debt securities (other than corporate debt securities) with one year or more to maturity ("the 7% haircut"); and (3) a deduction of 9% of the market value of the greater of the long or short position of redeemable securities of a registered investment company whose assets consist of investments in long-term debt securities including nonconvertible debt securities ("the 9% haircut").[28]

In response to the proposal, the NASD commented that the permissible investments of a registered investment company qualifying for the lower 2% haircut are unnecessarily restrictive. More specifically, the NASD argued that, by restricting the permissible assets of the registered investment company to cash or securities or money market instruments with one year or less to maturity which are described in paragraphs (c)(2)(vi)(A) through (C) or (E) of the rule, the Commission may unintentionally be excluding securities of otherwise bona fide money market funds from the lower haircut provision.[29] In the NASD's view, this provision should be structured to make reference to any generally acceptable definition of a money market fund, perhaps one contained in another Commission rule.

Also in this connection, the NASD pointed out that it would be difficult for a broker-dealer to determine whether a certain investment company in whose securities the broker-dealer had invested qualified for the 2% haircut at any particular point in time. This is due to the fact that most broker-dealers have no effective means of determining

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[27] The wording of the presumption will also be altered to make clear that the valuation is for net capital purposes only and that a ready market for the securities can still be established if the securities are actually collateral for a bank loan. *See* Rule 15c3-1(C)(11)(ii).

[28] The Commission's also proposed to amend the rule to clarify that it applies only to "redeemable" securities of registered investment companies.

[29] For example, the NASD points out that paragraph (c)(2)(vi)(E) limits qualifying commercial paper to that rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations. The NASD goes on to point out that proposed Rule 2a-7 under the Investment Company Act recognizes that unrated instruments may be perfectly appropriate for a money market fund portfolio, subject to certain safeguards.

whether all of the assets of a particular investment company are restricted to the prescribed debt instruments with one year or less to maturity. As a solution, the NASD suggested that the Commission use a dollar weighted average maturity of the fund's portfolio as a means of determining whether a certain fund qualifies as a "money market fund" under the rule. The NASD points out that an average maturity figures are regularly published and readily available to broker-dealers and regulators.

The Commission recognizes that its original proposal as to the permissible investments of a registered investment company whose redeemable securities qualify for the lower 2% haircut may have been overly restrictive. Apparently, there are investments which are entirely suitable for investment companies commonly known as "money market funds" that may not come within the confines of a permissible investment as originally proposed by the Commission. Unfortunately, however, due to the rapidly changing nature of investment company activities, the Commission has as yet been unable to develop a comprehensive definition of a "money market fund." [30] Rather, the Commission, in reviewing registration statements of investment companies, has employed various criteria in determining whether a certain investment company is justifiably holding itself out to the public as a "money market fund."

Despite the lack of an explicit Commission rule, the Commission has determined to revise its proposal to provide that a broker-dealer may take the lesser 2% haircut on redeemable securities of a registered investment company which is commonly known as a "money market fund." This should alleviate the NASD's concern regarding the unintended exclusion of redeemable securities of otherwise bona-fide "money market funds" and should also provide broker-dealers and others with a degree of certainty in determining whether a particular investment company in whose securities the broker-dealer has invested qualifies as a "money market fund" under this provision.[31]

The Commission received no adverse comment regarding the proposed 7% and 9% haircuts for redeemable securities of registered investment companies which invest in long-term debt securities. In the Commission's view, these increased haircuts are necessary to reflect the increased volatility in the long-term debt market in recent years. Accordingly, the Commission is adopting the 7% and 9% haircuts as proposed and the 2% haircut as revised.

E. Nonconvertible Debt Securities

Rule 15c3-1(c)(2)(vi)(F) requires, in the case of nonconvertible debt securities having a fixed interest rate and fixed maturity date and that are rated in one of the four highest categories by at least two of the nationally recognized statistical rating organizations, haircuts ranging from 1% for those securities with less than one year to maturity to 7% for securities with five years or more to maturity.

In its January 1982 Release, the Commission, on the basis of available data, proposed to increase the haircuts on nonconvertible debt sucurities ranging from 2% for those securities with less than one year to maturity to 9% for those securities with five years or more to maturity. The Commission believed that it was appropriate to propose increased percentage haircuts in the schedule of maturities categories in order to reflect more accurately the volatility of nonconvertible debt securities.

In the same release, the Commission proposed amendments that would allow broker-dealers to reduce applicable haircuts on nonconvertible debt securities that are hedged by certain debt obligations of the United States or agencies thereof. The proposed amendments would permit a reduction in the applicable haircut on a nonconvertible debt securities position when hedged by a position in securities issued by the U.S. Government with certain dates to maturity and would eliminate the haircut otherwise applicable to the Government security. The Commission proposed these amendments to establish a basis for closer examination of the relationship among various securities positions and the extent to which market risks can be reduced through hedging strategies.

The Commission received few comments regarding the proposed amendments. All the commentators recommended that the Commission further refine the proposed amendments by permitting broker-dealers to hedge nonconvertible debt securities with Government securities futures and forward contracts. In addition, the commentators recommended that the Commission permit the hedging between two nonconvertible debt securities with similar maturity dates.

The commentators, however, did not provide the Commission with sufficient relevant data that would substantiate their claim that the aforementioned hedging strategies should be recognized by the Commission. The Commission is willing to address this matter in the future if it can obtain data upon which to make an informed decision. The Commission, therefore, specifically requests commentators to submit relevant data concerning the price spreads of nonconvertible debt securities that are hedged by either U.S. Government futures[32] or other nonconvertible debt securities with similar maturity dates. The Commission also invites commentators to submit relevant data on price spreads involving other hedging strategies so as to enable the Commission to establish hedging criteria that are objective, clear and easily determinable for reducing any required haircuts on nonconvertible debt securities.

The Commission also invites comment on a recommendation by one broker-dealer that certain privately placed nonconvertible securities issued by large corporations without registration under the Securities Act be exempted from the provisions of paragraph (c)(2)(vii) of the net capital rule, which requires the deduction from net worth of 100% of the market value of securities which cannot be publicly offered or sold. The firm argues that these securities are marketable through an extensive institutional market.

On the basis of the foregoing, the Commission adopts the amendments as proposed which increase the haircuts on nonconvertible debt securities, but at the same time reduce the applicable haircuts on those securities that are hedged by positions in U.S. Government securities.

Borrowing and Lending of Securities by Broker-Dealers and Related Requirements

A. Introduction and Background

Brokers-dealers frequently borrow securities from institutions that are not ordinarily retail customers of the borrowing broker-dealer, but who are treated as customers of the borrowing

[30] Rule 434d of the Securities Act of 1933 (the "Act") makes reference to a "money market fund" for purposes of determining whether an advertisement is deemed to be a prospectus under Section 10(b) of the Act for purposes of Section 5(b)(1) of the Act. The rule does not, however, establish criteria that an investment company must meet in order to hold itself out to the public as a "money market fund."

[31] For purposes of this provision, a broker-dealer may rely upon the representations made by an investment company in its prospectus stating generally that its investment policy is to invest in money market instruments.

[32] The Commission will defer indefinitely any consideration of using forward contracts for hedging purposes under the net capital rule.

broker-dealer under the customer protection and net capital rules. Broker-dealers borrow securities, including U.S Government obligations, in order to complete short sales and to avoid fails to deliver to other broker-dealers or institutions due to delayed deliveries (fails to receive) by others. Securities are also borrowed to relend to other broker-dealers. The ability of broker-dealers to borrow and lend securities facilitates the smooth operation of the market for securities by reducing the level of incomplete transactions. The securities borrowing process also enables financial institutions to convert their securities portfolios into short term funds, thereby increasing the return to such institutions from these securities.

With the explosion of institutional and other trading activity over the last few years, the proliferation of trading strategies incorporating short sales of stock in combination with options, and the heightened activity of risk arbitrage and convertible arbitrage trading, there has been an enormous growth in broker-dealer requirements to borrow securities. December 1981 FOCUS filings by 392 NYSE member firms reported a total of over $8 billion in securities borrowed at year end.

Rule 15c3–3 under the Securities Exchange Act of 1934 requires, among other things, that a broker-dealer obtain and thereafter maintain possession or control of all fully paid or excess margin securities held for the account of customers.[33] For purposes of Rule 15c3–3, the term "customer" includes any person or entity, such as a financial institution, that lends securities to a broker-dealer, whether or not it maintains an investment or trading account with that broker-dealer. Thus, it would appear that the only securities available for lending would be securities that are held by the broker-dealer as collateral for margin accounts.

Although borrowing and relending securities from financial institutions and others could be viewed as violating Rule 15c3–3, the Commission staff has taken the position, on a no-action basis, that it will raise no question as to non-compliance with the possession or control requirement of Rule 15c3–3(b), provided the borrower provides a written agreement containing certain specific terms covering the securities subject to the loan. However, because the "Formula for the Determination of the Reserve Requirements of Brokers and Dealers" (the "Reserve Formula") of Rule 15c3–3 draws no distinction between securities held for the account of retail customers and securities obtained from persons pursuant to a collateralized loan, the market value of securities borrowed from others than retail customers, including financial institutions, are includable in the Reserve Formula.

In its January 1982 Release,[34] the Commission set forth a proposed amendment to exempt from the possession or control requirements those securities that are borrowed in accordance with the proposed amendment. The proposed amendment would allow the borrowing of customers' fully paid and excess margin securities, but would permit such borrowings only on transactions where there is a written agreement between the broker-dealer and the lender, which, in addition to other provisions:

(1) Requires that the written agreement entered into at the time of the loan specifically identify the securities to be loaned and the basis of compensation therefore,

(2) Requires 100% collateral, either in cash or in U.S. Treasury bills or notes,

(3) Requires, if the value of the borrowed security exceeds 105% of the value of the collateral, the delivery of additional collateral to satisfy the deficiency, and

(4) Requires the physical possession of the collateral be transferred to the lender or to his appointed agent.

In the same release, the Commission, as an interim measure, announced an interpretation of the customer protection rule which would reduce the reserve and net capital requirements of certain broker-dealers by excluding from the Reserve Formula debit and credit items that are related to securities borrowed from customers and financial institutions. To qualify for exclusion from the Reserve Formula, the securities must be borrowed pursuant to a written agreement and the broker-dealer must (1) deliver collateral in the form of cash or Government securities equal to at least 100 percent of the value of the securities; and (2) undertake to deliver additional collateral to satisfy the entire deficiency in the event that the market value of the securities exceeds by five percent the value of the collateral. Thus, securities borrowed in conformity with these requirements should be treated as if borrowed from a broker-dealer or municipal securities dealer. Furthermore, for purposes of allocating funds associated with these securities in the Reserve Formula, a broker-dealer may treat lenders of securities as being non-customers, so long as the broker-dealer complies with the requirement of proposed paragraph (b)(3) of Rule 15c3–3.

B. Discussion

In general, the majority of the comments received commended the Commission on its attempt to liberalize the conditions under which broker-dealers are permitted to borrow securities from customers as well as financial institutions. However, most of the commentators were critical of the conditions under which such borrowings would be permitted by the proposed rule as being too restrictive, fails to recognize fully general industry practice, and would create operational handicaps. Those commentators suggested that the proposal should, therefore, be reconsidered by the Commission. The commentators' primary concerns center around the Commission's refusal to expand the scope of acceptable collateral to include, among other things, irrevocable letters of credit. In addition, the majority of the commentators suggested that the Commission should reconsider the provisions that require: (1) Mark to the market; (2) transfer of actual possession of the collateral to the lender; and (3) a separate written agreement for each borrowing and lending transaction. In sum, the comments fall into two general classes, one relating to the written agreements and applicable disclosures and the second relating to the loan collateral, including delivery of additional collateral.

1. *Written Agreement and Notice Provisions.* Proposed Rule 15c3–3(b)(3)(i) requires that borrowers and lenders enter into a written agreement at the time of the loan identifying the securities to be loaned and the basis for compensation. Subparagraph (b)(3)(iii) requires that the agreement contain a provision disclosing that the securities lender may not be afforded protection under the Securities Investor Protection Act of 1970 ("SIPA") and therefore the collateral would constitute the first source of satisfaction of the borrower's obligation.

The commentators stated that most institutional lenders have written master agreements with the borrowing broker-dealers so that any given loan is covered not only by an established relationship but by a general contract specifying the terms of the loan, acceptable collateral and the rights of the lender in the event of default. Seldom, however, do these agreements identify the specific securities involved, and even where the compensation rates are specified, they are usually subject to renegotiation as warranted by changing

[33] *See* 17 CFR 240.15c3–3(b)(1).

[34] Securities Exchange Act Release No. 18420 (Jan. 13, 1982), 47 FR 3534 (Jan. 25, 1982).

money rates, market conditions, expected duration of the loan, and the supply and demand for a specific security. These master agreements are normally executed at about the time of the initial transaction between the borrowing broker-dealer and the lender. However, sometimes the formal agreement is executed shortly thereafter. Thus, the commentators assert that there is no need for the agreements to specify each security loaned and the rates on each loan.

The commentators share the Commission's concern that the lenders be aware of their prospective status as "non-customers" for purposes of SIPA. They disagree, however, on the proposed means to accomplish this goal. Several broker-dealers maintain that mandatory disclosures regarding a lender's rights would only add unnecessary paperwork and expense and would not supply any relevant new information not known to the lender or the borrowing broker-dealer. One broker-dealer and the SIPA, on the other hand, proposed that the Commission adopt a rule which requires that the lender receive a notice from the borrowing broker-dealer contemporaneously with the first loan transaction between the parties. The notice would state that stock loan transactions are not customer transactions covered by SIPA and that the collateral would constitute the lender's primary source of satisfaction in case of default by the borrowing broker-dealer. Under this formulation, the borrowing broker-dealer would be responsible for conveying this information in a manner it determines appropriate.

The Commission agrees that there need be only one written agreement, which must be supplemented by a separate statement or confirmations specifying the securities actually loaned to the broker-dealer. The agreement to lend should be separate from other account agreements and should be executed at or before the first transaction. It should specify the rights and obligations of the parties in detail as to the borrowed securities, including applicable provisions dealing with mark to the market and the return of the borrowed securities. The written agreement should also set forth in bold type that the lender of the borrowed securities may not be protected by SIPA and that any collateral received by the lending entity may be its sole source of protection in the event of default by the broker-dealer. The Commission believes that the inclusion of this last statement will not create any substantial increase in paperwork for broker-dealers.

2. *Collateral Provisions.* Most of the commentators opposed all of the Commission's proposals as to the collateral delivery and mark to the market requirements. In essence, the commentators stated that a broker-dealer should be able to deliver to the lender whatever collateral the parties agree upon, including secured or unsecured irrevocable letters of credit. They also oppose the mark to the market provisions. They do so, not because marks to the market are not standard practice, but rather because, in their view, the lender should initiate the mark. That is to say, the customer should be on guard and protect its own interests. Finally, the commentators disagreed with the Commission's expressed concern as to the leverage inherent in the securities borrowing process.

The securities borrowed proposal was designed to curtail the leverage inherent in the securities borrowing process. Broker-dealers contend that this fear is illusory.

The Commission believes that the leverage in the securities borrowing process is undeniable. The commentators contend that if they use the funds retained from the process in a speculative manner, the net capital rule will require some charge. They also contend that obtaining cash through securities borrowing is not different than borrowing on an unsecured basis.

Neither point appears to completely answer the Commission's concerns. There are clearly instances where the broker-dealer will take no net capital charge for the use of money obtained from the securities borrowing process. In addition, as a general rule, broker-dealers do not borrow money on an unsecured basis for any extended period of time, except through subordinated loans. Finally, in many instances, the broker-dealer will have no balance sheet accountability for the securities borrowed if it provides no asset collateral in return for them.

While the Commission continues to believe that the securities lender should be given full cash (or its equivalent) collateral for the securities loaned, it does not want to restrict the business of borrowing and lending securities, some portion of which is used to complete legitimate short sales or fails to deliver. Therefore, the rule proposal will be revised so that if a broker-dealer delivers a letter of credit as collateral to the lending party, it must charge its net capital 1% of the market value of the securities borrowed. In effect, broker-dealers will be authorized (if Regulation T permits) [35] to deliver letters of credit, secured or unsecured.[36] The rule will still compel the firm to turn over the collateral physically to the lender and mark to the market. The definition of collateral will be broadened to include all forms of cash, Treasury bills or notes as well as letters of credit. The Commission also requests comments from broker-dealers, self-regulatory organizations and other interested members of the public discussing the impact the 1% surcharge will have on the securities borrowing business. The Commission will monitor the effects of the securities borrowing program for the next year and will at that time determine whether any alterations to the rules are necessary.[37]

III

Fails to Deliver

In Securities Exchange Act Release No. 18419, the Commission proposed for comment an amendment to a staff interpretation of Rule 15c3–3 which would allow a broker-dealer to exclude both fails to receive [38] and fails to deliver [39] which allocate to one another ("matched fails") from the Reserve Formula. The net capital rule would, however, be amended so that fails to deliver excluded by allocation would be subject to a capital charge of 1 percent of the contract value of the fail to deliver.[40] The Commission also

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[35] 12 CFR 220.6(h).

[36] The Commission notes that requests have been made that letters of credit be allowed to be used to secure primary capital contributions in the business of broker-dealers. While the Commission has not determined the issues, the staff has taken the position that promises to pay (or receivables on the broker-dealer's books) secured by letters of credit must be deducted from net worth in computing net capital. They otherwise have no value in determining the net capital of a broker-dealer.

[37] If customer margin securities are used as collateral for the letter of credit, the value of the securities borrowed must be entered as a credit in the Reserve Formula.

[38] A "fail to receive" arises when a buying broker-dealer has not taken delivery from the selling broker-dealer as of settlement date. A fail to receive is a liability which the buying broker-dealer must satisfy when the securities are delivered.

[39] A "fail to deliver" arises when the selling broker-dealer fails to deliver the certificates in proper form at the agreed upon settlement date to the buying broker-dealer. A fail to deliver is an asset since it represents monies due to the firm for sales of securities.

[40] The Commission's response in its letter to M.S. Wien & Co., Inc. dated July 15, 1976 (the "Wien letter") and in similar letters to other broker-dealers, as noted later in this release, will no longer be applicable and are withdrawn. Under the Wien letter, broker-dealers who do primarily a dealer business and who have substantial amounts of fails to receive versus fails to deliver which are not allocable to customers may under certain conditions

Continued

proposed to amend the net capital rule to reduce the time period before which a deduction under subparagraph (c)(2)(ix) of the rule must be taken for a fail to deliver.

A. Matched Fails

The commentators generally supported the proposal to exclude "matched fails" from the Reserve Formula. Many commentators, however, objected to the imposition of the 1 percent charge on excluded fails to deliver.

The NASD argued that the 1 percent capital charge is unduly harsh and unwarranted, particularly since a substantial number of their members had been netting their fails in reliance on a staff no-action letter without the additional burden of the 1 percent charge. The NASD also asserted that the 1 percent charge will not provide retail firms additional incentive to close-out fails to deliver. First, firms with retail business would still be able to operate with "dangerously low" minimum net capital by simply switching from the alternative to the basic method of computing net capital, thereby avoiding the 1 percent charge on excluded fails to deliver. Second, the net capital rule already provides such an incentive though the "aged fails to deliver" haircut provision, Rule 15c3–1(c)(2)(ix). The NASD maintained that this provision works well to reduce fails to a level commensurate with the capability of industry facilities to close-out and complete open trades. The NASD suggested that the Commission develop specific proposals to address the particular universe of firms which would be allowed to operate with lower minimum net capital absent the 1 percent capital charge, rather than impose the additional 1 percent capital charge on all broker-dealers using the alternative method of computing net capital.

The Commission has reviewed the comments received and has determined that imposition of the 1 percent capital charge on the contract value of the excluded fails to deliver is necessary in order to ensure that firms which have a substantial amount of formula debits that consist of fails to deliver excluded from the Reserve Formula will maintain a sufficient minimum level of net capital. The net capital rule establishes minimum levels of capital in an effort to assure that firms have sufficient liquid assets to meet obligations to customers and other broker-dealers as they come due. The rule operates to place an outer limit upon the amount of leverage or risk that broker-dealers may incur. Members of the securities industry do not dispute that the maintenance of sufficient capital requirements is an essential regulatory discipline which ensures both investor and broker-dealer confidence in the securities industry; rather, they argue that the 1 percent capital charge is excessive and therefore unwarranted, particularly with respect to those firms for which the Wien letter was designed.

The Commission, however, is not persuaded by these agruments. First, the Commission has recently reduced by one-half, from 4% to 2%, the minimum percentage of net capital required under the alternative method. This represents a very substantial reduction in the "capital cushion" required to be maintained by broker-dealers who compute net capital under the alternative method. Since under the alternative method, a broker-dealer's net capital requirement is a function of its customer debit items, to permit broker-dealers to exclude fails to deliver (a debit item) which allocate to fails to receive (a credit item) from the Reserve Formula without the additional 1% capital charge could allow many firms to be dangerously overleveraged.

Second, firms which do business primarily with other professionals have the highest percentage of matched fails to deliver. While these firms generally have the least direct customer exposure, they should, nonetheless, maintain sufficient net capital to meet their obligations to other broker-dealers, thereby ensuring continued confidence in the integrity of the securities industry. It is, therefore, not determinative whether the 1% capital charge will provide additional incentive to close-out fails to deliver, though it appears that it will provide such an incentive to some degree. Moreover, broker-dealers with relatively few matched fails will not be significantly affected by the additional 1% capital charge.[41] Upon review, after experience, the Commission believes that the Wien letter fails to provide adequate net capital requirements for broker-dealers on the alternative method. Therefore, the Wien interpretation should be and is withdrawn.[42] Finally, the Commission agrees with the SIA's suggestion that the interpretation should be amended to exclude from the Reserve Formula securities borrowed (that presumably have been used to clear a fail to deliver) that allocate to a fail to receive.[43]

For purposes of the allocation procedure under Rule 15c3–3, the Commission announces the amendment of the Division of Market Regulation's interpretation in Securities Exchange Act Release No. 11497. The new interpretation is as follows:

(1) Fails to receive which are allocable to long positions in the proprietary or other accounts of the broker or dealer or to fails to deliver of the same quantity and issue may be excluded from the computation of the Reserve Formula;

(2) Fails to deliver which are allocable to short positions in the proprietary or other accounts of the broker or dealer or to fails to receive of the same quantity and issue may be excluded from the computation of the Reserve Formula;

(3) Securities borrowed which are allocable to fails to receive may be excluded from the computation of the Reserve Formula.[44]

In addition, the Commission, for the reasons stated above, believes that the 1% charge on matched fails is appropriate and amends the rule accordingly. The change will also be imposed on securities borrowed which are excluded from the formula because of the allocation interpretation.

B. Aging Period

In Securities Exchange Act Release No. 18419, the Commission proposed that the time period for aging a fail to deliver be cut gradually from 11 business days to 5 business days (or from 21 business days to 15 business days in the case of municipal securities).[45] In addition, it proposed that the net capital rule be amended to provide authority to the designated examining authority (the "DEA") to grant, upon application, and under

net the fails and exclude them from the Reserve Formula. There was no additional capital charge on fails to deliver excluded from the formula under the Wien interpretation.

[41] According to an NASD survey, matched fails constituted only 16.3% of total fails to deliver for firms doing a general securities business. Thus, retail oriented firms include approximately 85% of their fails in the Reserve Formula.

[42] The Commission notes that M. S. Wien, Inc. failed in September 1981, and is presently being liquidated pursuant to SIPA.

[43] The Commission notes that securities failed to receive for which the broker-dealer has a receivable related to securities borrowed are excluded from aggregate indebtedness pursuant to subparagraph (c) (1) (iii) of Rule 15c3–1.

[44] Some broker-dealers complain that it is difficult to back out matched fails from the Reserve Formula. The interpretation does not, however, require them to do so. They may choose to comply with the interpretation before amended.

[45] The proposal provided that this time period be lowered in 2 nine month steps, from 11 business days (21 business days for municipal securities to 7 business days) (17 business days for municipal securities) during the first nine months after adoption and then to 5 business days (15 business days for municipal securities) after the second nine months.

appropriate circumstances, an extension of those time periods for a period up to 5 business days before requiring percentage deductions for "aged" fails under the net capital rule. Among other things, the firm must be able to show that the fail had not been disavowed in some way.

The majority of commentators generally objected to the proposal to accelerate the aging of fails to deliver. Both the NASD and the SIA questioned whether the 5 business day aging period realistically reflected the clearing period for fixed income securities and foreign securities transactions.[46] One broker-dealer stated that the aging proposal favors large trading firms doing a listed business while penalizing the small trading firms who trade over-the-counter with many non-clearing firms located across the nation. The NASD and the SIA suggested that the existing aging schedule remain in place until further study and analysis of industry practices and capabilities supports the need for specific changes.

The NYSE noted that, while much has been done to expedite the clearing process and the vast majority of deliveries are completed within 5 business days, overly restrictive time limits may be detrimental to domestic brokers and dealers vis-a-vis their foreign competition. The NYSE maintained that the 5 business day aging proposal was unnecessarily stringent and would have a particularly harsh impact on the bond business and the secondary market in new issues. The SIA and NYSE stated that the current aging period satisfactorily reflects the credit risk presented by fails and should not be changed.[47]

A broker-dealer asserted that the reduction in the aging period for excluded fails to deliver which involve only broker-dealers is unnecessary. It argued that broker-dealer firms with relatively large percentages of matched fails do not present a concern with respect to the protection of public customers. They questioned whether the reduction in the aging period would provide any incentive or leverage to broker-dealers to obtain resolution of the fails from their retail customers. However, they suggested that, assuming some reduction in the aging period is necessary, matched fails be specifically excluded from the general reduction in the aging period. They believed that this approach would reduce the aging period on customer-related fails generally without penalizing firms which have few retail customers. Alternatively, they suggest that matched fails allocable to transactions with other broker-dealers be excepted from the general reduction in the aging period.

The municipal securities dealers asserted that a reduction in the aging period for fails to deliver of municipal securities would be punitive since most events which result in fails are beyond their control. They also pointed to the uniqueness of the municipal securities market.

The Commission believes that the 5 business day aging period realistically reflects the clearing period for most non-municipal securities. It recognizes, however, that transactions in certain types of securities, such as foreign securities, certain fixed income securities and new issues, may not generally clear within 5 business days from settlement date. Therefore, the Commission suggests that broker-dealers with fails to deliver in such securities consult with the staff which will, under appropriate circumstances, permit adjustments to the aging period on a no action basis.[48] In addition, the rules provide that, upon an appropriate showing that an extension is warranted, the DEA may grant an extension of time up to 5 business days before the required percentage deductions for "aged" fails must be taken. A second extension may be granted under unusual circumstances.

The Commission notes that the dramatic improvements in the operational condition of securities firms since the 1968–70 "Paperwork Crisis" have resulted in a marked decline in fails to deliver as a percentage of total assets and trading volume. The decline is due in part to the substantial improvements in the clearance and settlement of securities transactions.[49] The Commission believes that the acceleration of the aging period will provide additional incentives to broker-dealers to obtain prompt resolution of fails to deliver, and thereby increase the overall efficiency of the clearance and settlement systems.

We have reviewed the comments received with respect to municipal securities. The Commission notes that the Municipal Securities Rulemaking Board (the "MSRB") has taken substantial steps toward improving the overall efficiency of the municipal securities clearing systems. While the MSRB has not supported the revision, it is clear that the Board is firmly committed to the continued development of more advance systems for the comparison, clearance, and settlement of transactions in municipal securities.[50] In recognition of this commitment, the Commission has determined not to implement its proposal to shorten the time period for aging a municipal fail to deliver from 21 to 15 business days for at least six months. Thereafter, the Commission will reconsider whether the aging period should be reduced and review the progress made toward the development of an automated clearing system for municipal securities, and the improvement of the overall clearance systems for municipal securities. In furtherance of this aim, the Commission is requesting that the MSRB furnish a

[46] One trading firm noted that ex-clearing house transactions resulting from customer preference and transactions in foreign securities that trade ex-clearing house are seldom resolved within 5 business days. Similarly, one retail firm stated that based on its experience in dealing with foreign correspondent banks and brokers, the existing time frames for aged fails in foreign securities were restrictive and should be lengthened to 14 business days.

[47] The NYSE suggested that the Commission state explicity in the rules that open transactions in continuous net settlement clearing systems which are marked to market daily and subject to constant clearing house supervision are not subject to the aging provisions. We agree with its statement. In addition, it suggested that the new rules specifically state the circumstances under which the DEA may extend the time period before a deduction must be taken for aged fails to deliver. For example, they asserted that the authority should be broad enough to grant appropriate relief in such instances where, for example, delays occur as a result of a customer or operational problem, a snowstorm or other acts of God, or a postal strike. The Commission, however, believes it appropriate to defer further action at this time and will instead rely on the staff to develop appropriate criteria with the industry by interpretation or by no-action letters.

[48] For example, the staff has taken a no-action position with respect to trades effected on the Associated Australian Stock Exchanges which do not clear for 15 business days.

[49] The Securities Reform Act of 1975 (the "1975 Amendments") added a new Section 17A to the Exchange Act requiring registration of entities involved in the securities handling process, including clearing corporations, securities, depositories and transfer agents. Since 1975, the Commission has approved numerous rules regarding the operation of clearing agencies. This has resulted in improvements in their systems and methods of operation and increased participation by broker-dealers and other financial institutions in the clearing system.

[50] The MSRB has worked extensively with the Depository Trust Company and the National Securities Clearing Corporation to this end. It appears that the development of such systems depend heavily on the use of a CUSIP-like security identification numbering system for purposes of data entry, comparison, and generation of instructions. The MSRB recognizes that if the industry is to adapt successfully to the use of such systems, some means must be found of coordinating the industry's current trading and delivery practices with the need to identify securities by their appropriate security identification number. Therefore, trading must be conducted in a manner that is sufficiently specific to permit identification of the precise security identification number needed for proper instructions to these advanced comparison and clearance systems. Deliveries must also be made in accordance with the identification number of the specific securities.

report to the Commission by January 1, 1983 reporting on the progress it has achieved to that date and supplying an evaluation of what further steps will be required to bring the municipal securities clearance and settlement system into parity with the rest of the securities industry.

C. Municipal Bond Brokers

The Commission has received persuasive opposition to its proposed treatment of fails from a specialized type of municipal securities firm generally known as "municipal bond brokers" or "brokers' brokers." [51] The brokers' brokers maintain that their functions and operations differ significantly from those of other broker-dealers. Due to the very limited and indirect customer exposure inherent in the brokers' broker's business, they request that the Commission adopt special net capital rules for brokers' brokers which are more appropriate to their unique function.

The brokers' brokers objected to the reduction in the time period allotted for aged fails to deliver and the imposition of the 1% capital charge on excluded fails to deliver. They maintained that these proposed amendments were unwarranted and would substantially reduce the liquidity of the municipal securities trading market without materially increasing the protection of the investing public. Moreover, they asserted that the combined effect of the 1% charge and the acceleration of the aging period for fails to deliver will force a substantial number of the brokers' brokers out of business.

Brokers' brokers act exclusively as undisclosed agents in the purchase and sale of municipal securities for registered broker-dealers or registered municipal securities dealers. They have no "customers" as defined in Rule 15c3-1(c)(6). Because they act only as "agents", brokers' brokers do not maintain inventories in municipal securities. All trades by brokers' brokers are offsetting transactions which are executed simultaneously for other securities professionals. They act as middlemen for these professionals who do not want their identities disclosed. Thus, the brokers' brokers are dependent on their dealer clients to make delivery to them in order to complete the trades and close-out the fails.

Unlike the general practice in the equities securities industry, municipal securities brokers' transactions are effected by physical delivery of the certificates rather than by computerized book entries between members of a clearing agency. Brokers' brokers use a registered clearing agency or bank as agent to handle the receipt and delivery of the securities. The agent pays for the securities after receipt and verification and then redelivers them to the brokers' broker. Upon reverification, the agent is paid and the brokers' account is credited. However, because of delivery time limits, agents may be unable to redeliver all securities received for the account of a brokers' broker on the same day. In those instance, the brokers' broker must borrow funds to carry the securities overnight.

The brokers' brokers asserted that the adoption of the 1 percent capital charge on all excluded fails to deliver will force brokers' brokers to revoke their election to compute net capital under the alternative method. However, they noted that computing net capital under the basic method would impose a similar hardship on brokers' brokers because they would be required to include overnight bank loans used to carry half completed transaction in their calculation of aggregate indebtedness. Counsel to a group of brokers' brokers argued that if the 1 percent charge is adopted to include all fails and brokers' brokers are not specifically exempted, overnight bank loans for municipal securities failed to deliver should be excluded from aggregate indebtedness for one business day.[52]

Moreover, many of the brokers' brokers maintained that the 1 percent charge unreasonably affects firms that have previously relied on the Wien letter to exclude matched fails by subjecting them to an additional 1 percent capital charge. The MSRB claimed that, contrary to the expressed intent of the release, the withdrawal of the Wien letter and the adoption of the 1 percent charge on excluded fails would actually increase the capital and reserve requirements for brokers' brokers.[53]

In addition, the MSRB pointed out that fails to deliver are generally among the most secure assets of a broker-dealer.[54] The MSRB asserts that the risk that the contra-party might refuse to or be unable to honor the "fail to deliver" contract is far more theoretical than real since the incidence of dishonored fails to deliver contracts is extremely low.

The brokers' brokers maintained that the acceleration of the time period for aged fails to deliver is wholly ineffective in expediting the settlement of municipal securities transactions. Since municipal bond brokers act only as agent for the buyer and seller, both of which are securities professionals, they assert that there exists apart from Rule 15c3-1(c)(2)(ix) sufficient financial incentives for the parties to settle each trade in a timely manner.

In addition, they argued that the brokers' brokers have absolutely no control over aged fails. They pointed out that the nature of the municipal securities business, including the lack of automation in the transaction process, the cumbersome necessity for hand delivery of certificates and the difficulty of conducting buy-ins,[55] renders futile the attempts of the brokers' broker to speed the settlement of municipal securities transactions.

The Commission has reviewed the comments received and determined that, in light of the unique functions and operations of the brokers' brokers, it is appropriate to adopt special net capital requirements for municipal brokers' brokers which will require them to compute net capital pursuant to the aggregate indebtedness method. In recognition of the problem created by overnight bank loans for municipal securities failed to deliver, and in view of the high minimum net capital requirement discussed below, the Commission has determined that it is appropriate to allow brokers' brokers to exclude such loans from their aggregate indebtedness for one business day.

Because of their important role in the municipal securities business, brokers' brokers should maintain a substantial minimum net capital, as they appear to be responsible for a trade from execution through delivery and payment. They are liable for trading errors as well. In addition, brokers' brokers incur risk as a result of fails to deliver and fails to receive. High volume periods create aggravated fails and, in turn, proportionally increase risk. "When issued" municipal bonds likewise increase the brokers' brokers

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[51] PSA notes that there are currently 19 brokers' brokers.

[52] Another brokers' broker suggested that brokers' brokers should use the aggregate indebtedness method for computing net capital.

[53] PSA, noting the absence of any discussion of the 1 percent charge in the Regulatory Flexibility Analysis, suggested that the Commission defer making a determination of the amount of the capital charge until it has more accurately assessed its impact.

[54] However, two brokers' brokers currently have claims with the trustee of A. E. Pearson & Co. One entity which clears and finances trades in municipal securities in the securities industry, pointed out that it had never suffered any loss from the failure of any brokers' broker or the failure of any seller to or buyer from a brokers' broker to honor their municipal securities trade obligations.

[55] It was noted by several brokers' brokers that substitute bonds are difficult to find, primarily because of the very thin floating supply and numerous serial maturities of municipal securities. The scarcity of substitute bonds makes buy-ins and borrowing of securities virtually impossible.

exposure, and consequently the risk of loss.

The Commission is adding a new elective paragraph (a)(8) to Rule 15c3–1, which will require brokers' brokers at maintain to all times net capital of not less than $150,000. Under the provisions of paragraph (a)(8), a 1% capital charge, however, will be imposed on the contract value of all failed to deliver contracts which are outstanding 21 business days or more. Brokers' brokers, however, will not be subject to the aged fail to deliver requirement of Rule 15c3–1(c)(2)(ix) nor will they be required to take a capital charge on fails to receive outstanding longer than 30 calendar days as specified in paragraph (c)(2)(iv)(E) of Rule 15c3–1.

Summary of Final Regulatory Flexibility Analysis

The Commission has prepared a Final Regulatory Flexibility Analysis (the "Analysis") in accordance with the Regulatory Flexibility Act ("RFA")(5 USC 604) regarding the proposed amendments to the net capital rule and the customer protection rule.

As indicated in the Initial Regulatory Flexibility Analysis, the amendments were proposed as part of the Commission's review of the broker-dealer financial responsibility rules. The proposed amendments, among other things, were intended to reflect changing economic and business practices in the securities industry.

The Commission received few comments specifically addressing its Initial Regulatory Flexibility Analysis. It also received a number of comments, primarily from members of the municipal securities industry, generally opposing the Commission's proposals regarding the revised net capital treatment of municipal securities and failed to deliver contracts.

Some of the comments received focused on changes in the treatment of municipal securities. The commentators contended that the increase in haircuts for municipal securities and implementation of the presumed marketability test were unwarranted and would adversely affect the municipal marketplace. They also argued that the proposed changes discriminated against smaller regional firms. With respect to the Commission's proposals regarding the revised treatment of failed to deliver contracts, many commentators, including the PSA and a specialized type of municipal securities firm known as a brokers' broker, opposed imposition of the 1% charge on failed to deliver contracts excluded from the reserve formula and contended that reduction of the time period before aged failed to delifver contracts were required to be deducted from net worth was unwarranted. More specifically, the PSA, noting that the Commission failed to assess the impact of the 1% charge on excluded fails in its Initial Regulatory Flexibility Analysis, contended that this charge will increase the capital requirements for certain broker-dealers.[54]

Aside from the revised net capital treatment of municipal securities and failed to deliver contracts (and to some extent the proposed percentage increases in the haircuts for Government securities), however, the Commission's proposals were generally well received.

As noted in the Initial Regulatory Flexibility Analysis, the Commission recognizes the need to formulate compliance and reporting requirements that take into account the economic impact on small brokers and dealers. In this regard, RFA directs the Commission to consider significant alternatives to the proposed amendments that would accomplish the stated objectives of applicable statutes and minimize any significant economic impact on small brokers and dealers. As discussed in the Initial Regulatory Flexibility Analysis, however, the Commission believes that it would be inconsistent with the purposes of the Exchange Act to exempt, categorically, any small brokers and dealers from the proposed provisions of these amendments.

Nonetheless, in response to the comments received and on the basis of data developed in the course of the rulemaking process, the Commission has made a number of modifications to its original proposals which should provide net capital relief for certain broker-dealers, particularly municipal securities brokers and dealers and brokers' brokers. These alternatives include, among other things, a simplified method of computing haircuts on Government securities, certain hedging techniques for Government securities which will allow broker-dealers to utilize certain risk-reducing combinations so as to reduce their capital requirements, creation of additional haircut categories for municipal securities, modification and clarification of the presumed marketability test and creation of a separate provision for brokers' brokers.[55]

A copy of the Analysis may be obtained by contacting Michael A. Macchiaroli, Division of Market Regulation, U.S. Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549 at (202) 272–2372.

Statutory Basis and Competitive Considerations

Pursuant to the Securities Exchange Act of 1934 and particularly sections 15(c)(3) and 23(a) thereof, 15 U.S.C. 78*o*(c) and 78w(a), the Commission is amending §240.15c3–1 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 to provide safeguards with respect to the financial responsibility of brokers and dealers.

List of Subjects in 17 CFR 240

Reporting requirements, Securities.

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. By adding paragraphs (a)(8), (c)(2)(iv)(F) and (G) and (f)(5)(iv) to §240.15c3–1, and revising paragraphs (c)(2)(vi)(A), (B)(2), (D), (F) and (H) and (c)(2)(ix) of 240.15c3–1 to read as follows:

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

* * * * *

(a) * * *

(8) *Municipal Securities Broker' Brokers.* (i) A municipal securities brokers' brokers, as defined in subsection (ii) of this paragraph (a)(8), may elect not to be subject to the limitations of paragraph (c)(2)(ix) of this section provided that such brokers' broker complies with the requirements set out in subsections (iii), (iv) and (v) of this paragraph (a)(8).

(ii) The term municipal securities "brokers' broker" shall mean a

[54] While the Commission recognized that imposition of the 1% charge on excluded fails will increase the capital requirements for certain broker-dealers (particularly, those broker-dealers operating under the alternative method which had been excluding matched fails pursuant to the Wien interpretation), it appears that the overall impact on municipal securities dealers should be small since most have elected to compute their net capital the basic method. Apparently, the 1% charge on excluded fails will severely impact brokers' brokers which compute their net capital under the alternative method. However, the Commission has created a new provision for brokers' brokers which should alleviate the problems presented.

[55] Changes have been made to that part of Appendix D dealing with "revolving subordination agreements" to correct an error in the prior release and to clarify the intent of the provision.

municipal securities broker or dealer who acts exclusively as an undisclosed agent in the purchase or sale of municipal securities for a registered broker or dealer or registered municipal securities dealer, who has no "customers" as defined in this rule and who does not have or maintain any municipal securities in its proprietary or other accounts.

(iii) In order to qualify to operate under this paragraph (a)(8), a brokers' broker shall at all times have and maintain net capital of not less than $150,000.

(iv) For purposes of this paragraph (a)(8), a brokers' broker shall deduct from net worth 1% of the contract value of each municipal failed to deliver contract which is outstanding 21 business days or longer. Such deduction shall be increased by any excess of the contract price of the fail to deliver over the market value of the underlying security.

(v) For purposes of this paragraph (a)(8), a brokers' broker may exclude from its aggregate indebtedness computation indebtedness adequately collateralized by municipal securities outstanding for not more than one business day and offset by municipal securities failed to deliver of the same issue and quantity. In no event may a brokers' broker exclude any overnight bank loan attributable to the same municipal securities failed to deliver contract for more than one business day. A brokers' broker need not deduct from net worth the amount by which the market value of securities failed to receive outstanding longer than thirty (30) calendar days exceeds the contract value of those failed to receive as required by Rule 15c3-1(c)(2)(iv)(E).

* * * * *

(c) * * *

(2) * * *

(iv) * * *

(F)(*1*) For purposes of this subparagraph:

(*i*) The term "repurchase agreement" shall mean an agreement to sell securities subject to a commitment to repurchase from the same person securities of the same quantity, issuer and maturity;

(*ii*) The term "reverse-repurchase agreement" shall mean an agreement to purchase securities subject to a commitment to resell to the same person securities of the same quantity, issuer and maturity; and

(*2*)(*i*) In the case of a reverse-repurchase agreement, the deduction shall be equal to a percentage of the difference between the contract price for resale of the securities under a reverse-repurchase agreement and the market value of those securities (if less than the contract price), determined on the basis of the date to maturity of the reverse-repurchase agreement, as of the net capital computation date, as follows:

(*A*) 7 days or less: 0 percent.

(*B*) 8 days to 14 days: 5 percent.

(*C*) 15 days to 30 days: 10 percent.

(*D*) 31 days to 60 days: 25 percent.

(*E*) 61 days to 90 days: 50 percent.

(*F*) 91 days or more: 100 percent.

(*ii*) If the market value of the securities subject to the reverse-repurchase agreement declines to below 50 percent of the contract price for resale under that agreement, the applicable deduction shall equal 100 percent of the difference between the contract price for resale of the securities under the agreement and the market value of those securities.

(*iii*) A deduction on account of reverse-repurchase agreement may be offset by any margin or other deposits held by the broker or dealer on account of the reverse-repurchase agreement or by any excess market value of the securities over the contract price for the resale of those securities under any other reverse-repurchase agreement with the same person.

(*iv*) A broker or dealer shall deduct an amount equal to the excess of the difference between the contract prices for resale of the securities under reverse-repurchase agreements and the market value of the securities (if less than the contract prices) in any single account (or related accounts) if in the aggregate the differences exceed 5 percent of net capital before the application of paragraphs (c)(2)(vi), or (f)(3) of this section, or Appendix A to 17 CFR 240 15c3-1.

(*v*) The required deduction under this subsection (2) shall not exceed 100 percent of the difference between the contract price for resale of the securities and the market value of those securities.

(G) *Securities borrowed.* 1 percent of the market value of securities borrowed collateralized by an irrevocable letter of credit.

* * * * *

(vi) * * *

(A)(*1*) In the case of a security issued or guaranteed as to principal or interest by the United States or any agency thereof, the applicable percentages of the market value of the net long or short position in each of the categories specified below are:

Category 1

(*i*) Less than 3 months to maturity—0 percent.

(*ii*) 3 months but less than 6 months to maturity—½ of 1 percent.

(*iii*) 6 months but less than 9 months to maturity—¾ of 1 percent.

(*iv*) 9 months but less than 12 months to maturity—1 percent.

Category 2

(*i*) 1 year but less than 2 years to maturity—1½ percent.

(*ii*) 2 years but less than 3 years to maturity—2 percent.

Category 3

(*i*) 3 years but less than 5 years to maturity—3%.

(*ii*) 5 years but less than 10 years to maturity—4%.

Category 4

(*i*) 10 years but less than 15 years to maturity—4½%.

(*ii*) 15 years but less than 20 years to maturity—5%.

(*iii*) 20 years but less than 25 years to maturity—5½%.

(*iv*) 25 years or more to maturity—6%.

Brokers or dealers shall compute a deduction for each category above as follows: Compute the deductions for the net long or short positions in each subcategory above. The deduction for the category shall be the net of the aggregate deductions on the long positions and the aggregate deductions on the short positions in each category plus 50% of the lesser of the aggregate deductions on the long or short positions.

(*2*) A broker or dealer may elect to deduct, in lieu of the computation required under paragraph (c)(2)(vi)(A)(*1*) of this section, the applicable percentages of the market value of the net long or short positions in each of the subcategories specified in paragraph (c)(2)(vi)(A)(*1*) of this section.

(*3*) In computing deductions under paragraph (c)(2)(vi)(A)(*1*) of this section, a broker or dealer may elect to exclude the market value of a long or short security from one category and a security from another category, *Provided*, That:

(*i*) Such securities have maturity dates:

(*A*) Between 9 months and 15 months and within 3 months of one another.

(*B*) Between 2 years and 4 years and within 1 year of one another; or

(*C*) Between 8 years and 12 years and within 2 years of one another.

(*ii*) The net market value of the two excluded securities shall remain in the category of the security with the higher market value.

(*4*) In computing deductions under paragraph (c)(2)(vi)(A)(*1*) of this section, a broker or dealer may include in the categories specified in paragraph (c)(2)(vi)(A)(*1*) of this section, long or short positions in securities issued by the United States or any agency thereof that are deliverable against long or short positions in futures contracts relating to Government securities, traded on a recognized contract market approved by the Commodity Futures Trading Commission, which are held in the proprietary or other accounts of the broker or dealer. The value of the long or short positions included in the categories shall be determined by the contract value of the futures contract held in the account. The provisions of Appendix B to Rule 15c3-1 (17 CFR 240.15c3-1b) will in any event apply to the positions in futures contracts.

(*5*) In the case of a Government securities dealer which reports to the Federal Reserve System, which transacts business directly with the Federal Reserve System, and which maintains at all times a minimum net capital of at least $50,000,000, before application of the deductions provided for in paragraph (c)(2)(vi) or (f)(3) of this section, the deduction for a security issued or guaranteed as to principal or interest by the United States or any agency thereof shall be 75% of the deduction otherwise computed under subparagraph (c)(2)(vi)(A).

(B)(*1*) * * *

(*2*) In the case of any municipal security, other than those specified in paragraph (c)(2)(vi)(B)(*1*), which is not traded flat or in default as to principal or interest, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

(*i*) Less than 1 year to maturity—1%.

(*ii*) 1 year but less than 2 years to maturity—2%.

(*iii*) 2 years but less than 3½ years to maturity—3%.

(*iv*) 3½ years but less than 5 years to maturity—4%.

(*v*) 5 years but less than 7 years to maturity—5%.

(*vi*) 7 years but less than 10 years to maturity—5½%.

(*vii*) 10 years but less than 15 years to maturity—6%.

(*viii*) 15 years but less than 20 years to maturity—6½%.

(*ix*) 20 years or more to maturity—7%.

* * * * *

(D)(*1*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets consist of cash or money market instruments and which is generally known as a "money market fund," the deduction shall be 2% of the market value of the greater of the long or short position.

(*2*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments of any maturity which are described in paragraph (c)(2)(vi) (A) through (C) or (E) of this section, the deduction shall be 7% of the market value of the greater of the long or short positions.

(*3*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments which are described in paragraphs (c)(2)(vi) (A) through (C) or (E) and (F) of this section, the deduction shall be 9% of the market value of the long or short position.

* * * * *

(F)(*1*) In the case of nonconvertible debt securities having a fixed interest rate and fixed maturity date and which are not traded flat or in default as to principal or interest and which are rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

(*i*) Less than 1 year to maturity—2%.

(*ii*) 1 year but less than 2 years to maturity—3%.

(*iii*) 2 years but less than 3 years to maturity—5%.

(*iv*) 3 years but less than 4 years to maturity—6%.

(*v*) 4 years but less than 5 years to maturity—7%.

(*vi*) 5 years or more to maturity—9%.

(*2*) A broker or dealer may elect to exclude from the above categories long or short positions that are hedged with short or long positions in securities issued by the United States or any agency thereof and that have maturity dates of within—3 months, if the nonconvertible debt security has a maturity date of less than 15 months; 6 months, if the nonconvertible debt security has a maturity date of greater than 15 months but less than 2 years; 1 year, if the nonconvertible debt security has a maturity date of greater than 2 years but less than 5 years; and 5 years, if the nonconvertible debt security has a maturity of 5 years or more. The electing broker or dealer shall also exclude the hedging short or long securities position from the applicable haircut category under paragraph (c)(2)(vi)(A) of Rule 15c3-1 (240.15c3-1(c)(2)(vi)(A)), but shall deduct a percentage of the market value of the hedged long or short position in nonconvertible debt securities as specified in each of the categories below:

(*i*) Less than 1 year to maturity—1%.

(*ii*) 1 year but less than 2 years to maturity—1½%.

(*iii*) 2 years but less than 3 years to maturity—2½%.

(*iv*) 3 years but less than 4 years to maturity—3%.

(*v*) 4 years but less than 5 years to maturity—3½%.

(*vi*) 5 years or more to maturity—4½%.

* * * * *

(H) In the case of cumulative, nonconvertible preferred stock ranking prior to all other classes of stock of the same issuer, which is rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations and which are not in arrears as to dividends, the deduction shall be 10% of the market value of the greater of the long or short position.

* * * * *

(ix) Deducting from the contract value of each failed to deliver contract which is outstanding 5 business days or longer (21 business days or longer in the case of municipal securities) the percentages of the market value of the underlying security which would be required by application of the deduction required by paragraph (c)(2)(vi) or, where appropriate, paragraph (f) of this section. Such deduction, however, shall be increased by any excess of the contract price of the failed to deliver contract over the market value of the underlying security or reduced by any excess of the market value of the underlying security over the contract value of the fail but not to exceed the amount of such deduction; *Provided, however,* That until January 1, 1983, the deduction provided for herein shall be applied only to those fail to deliver contracts which are outstanding 7 business days or longer (21 business days or longer in the case of municipal securities). The designated examining authority for the broker or dealer may, upon application by the broker or dealer, extend for a period of up to 5 business days, any period herein specified where it is satisfied that the extension is warranted. The designated examining authority upon expiration of the extension may extend for one additional period of up to 5 business days, any period herein specified when it is satisfied that the extension is warranted.

* * * * *

(f) * * *

(5) * * *

(iv) Deduct from net worth in computing net capital 1% of the contract value of all failed to deliver contracts or securities borrowed which were allocated to failed to receive contracts of the same issue and which thereby were excluded from Items 11 or 12 of Exhibit A, 17 CFR 240.15c3-3a.

* * * * *

2. By revising paragraph (c)(5) of § 240.15c-1d to read as follows:

§ 240.15c3-1d Satisfactory subordination agreements (Appendix D to 17 CFR 240.15c3-1).

* * * * *

(c) * * *

(5)(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 percentum 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 D.

(ii) A broker or dealer shall be permitted to enter into a revolving subordinated loan agreement which provides for prepayment within less than one year of all or any portion of the Payment Obligation thereunder 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, however, shall not approve any prepayment if:

(A) After giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements then 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 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 or

(B) pre-tax losses during the latest three-month period equalled more than 15% of current excess net capital.

Any subordination agreement entered into pursuant to this subdivision (ii) shall be subject to all the other provisions of this Appendix D. Any such subordination agreement shall not be considered equity for purposes of subsection (d) of section 15c3-1, despite the length of the initial term of the loan.

* * * * *

3. By adding paragraph § 240.15c3-3(b)(3) to read as follows:

§ 240.15c3-3 Customer protection-reserves and custody of securities.

* * * * *

(b) Physical possession or control of securities.

* * * * *

(3) A broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) of this section regarding physical possession or control of fully-paid or excess margin securities borrowed from any person, provided that the broker or dealer and the lender, at or before the time of the loan, enter into a written agreement that, at a minimum:

(*i*) Sets forth in a separate schedule or schedules the basis of compensation for any loan and generally the rights and liabilities of the parties as to the borrowed securities;

(*ii*) Provides that the lender will be given a schedule of the securities actually borrowed at the time of the borrowing of the securities;

(*iii*) Specifies that the broker or dealer (A) must provide to the lender, upon the execution of the agreement or by the close of the business day of the loan if the loan occurs subsequent to the execution of the agreement, collateral, consisting exclusively of cash or United States Treasury bills and Treasury notes or an irrevocable of credit issued by a bank as defined in section 3(a)(6) (A)-(C) of the Securities Exchange Act which fully secures the loan of securities, and (B) must mark the loan to the market not less than daily and, in the event that the market value of all the outstanding securities loaned at the close of trading at the end of the business day exceeds 100 percent of the collateral then held by the lender, the borrowing broker or dealer must provide additional collateral of the type described in proviso (iii) (A) above to the lender by the close of the next business day as necessary to equal, together with the collateral then held by the lender, not less than 100 percent of the market value of the securities loaned; and

(*iv*) Contains a prominent notice that the provisions of the Securities Investor Protection Act of 1970 may not protect the lender with respect to the securities loan transaction and that, therefore, the collateral delivered to the lender may constitute the only source of satisfaction of the broker's or dealer's obligation in the event the broker or dealer fails to return the securities.

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By the Commission.

Dated: May 13, 1982.

George A. Fitzsimmons,

Secretary.

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