

NOTICE TO MEMBERS 80-51
Notices to Members should be
retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
1735 K STREET NORTHWEST • WASHINGTON D. C. 20006

October 8, 1980

MEMORANDUM

TO: All NASD Members
ATTN: Compliance, Legal and Registration Personnel
RE: Reporting of Disciplinary Action; Introduction of New Form "Notice of Disciplinary Action"

CONTENTS

- Schedule C, Part III of Association's By-Laws
- Amendments to Form BD
- Amendments to Form U-4
- Notice of Disciplinary Action

On June 4, 1980, in Notice to Members No. 80-22, the Association advised its membership of new rules which were approved by the Securities and Exchange Commission on May 15, 1980. The rules were proposed and adopted in response to recommendations of the SEC's Special Study of the Options Markets. Generally speaking, the rules affect those members conducting a public options business.

However, at least one new rule, which is an addition to Schedule C of the Association's By-Laws, affects all members of the Association, regardless of whether the member conducts an options business. Redesignated Part III of Schedule C (NASD Manual, pg. 1054) entitled "Disciplinary Actions," became effective on August 1, 1980, and states:

Every member shall promptly notify the Corporation in writing of any disciplinary action, including the basis therefor, taken by any national securities exchange or association, clearing corporation, commodity futures market or government regulatory body against itself or its associated persons, and shall similarly notify the Corporation of any disciplinary action taken by the member itself against any of its associated persons involving suspension, termination, the withholding of commissions or imposition of fines in excess of \$2,500, or any other significant limitation on activities.

The new requirement covers nearly all disciplinary actions taken against a member firm and/or its associated persons. ^{1/} The membership and individual registration forms currently in use, however, do not cover every circumstance envisioned by the requirement nor do they cover every individual. Therefore, the Association wishes to advise its members of the filing procedure to be used in order to comply with the new rule.

Procedure For Advising the Association of Disciplinary Actions
Taken Against Members And/Or Their Associated Persons

Since 1975, the Association has utilized the SEC's Form BD, "Uniform Application for Registration, License, or Membership as a Broker-Dealer. . .," as its membership application; Form U-4, "Uniform Application for Securities and Commodities Industry Representative and/or Agent," as its application for individual registration, and Form U-5, "Uniform Termination Notice for Securities and Commodities Industry Registration," as its individual termination form for registered persons. Both Forms BD and U-4 require a firm and a registered individual to keep the information provided on the forms current by supplementing the original filing with amendments as changes occur.

Amendments to Form BD

With respect to Form BD, Item 10 deals with disciplinary actions taken against the firm and/or its associated persons by any national securities exchange or association, clearing corporation, commodity futures market or government regulatory body, federal or state. Amendments should be made by filing the page of the form on which the appropriate response has changed, Schedules D and E, as well as an execution page. A copy of the complaint and order or other document disposing of the action, if available, should be attached unless the action was taken by the NASD in which case such documentation need not be attached.

Amendments to Form U-4

A disciplinary action against a registered representative by any national securities exchange or association, clearing corporation, commodity futures market or government regulatory body, federal or state, requires an amendment to the person's Form U-4 in addition to the Form BD amendment required of the firm. The procedure for amending Form U-4 is to file only the page of the U-4 on which the appropriate response has changed. Attached to the proper page of the Form U-4 should be an explanation of the action taken, as well as a copy of the complaint and final decision or other document disposing of the action unless such action was taken by the NASD in which case such documentation need not be attached.

^{1/} "Associated persons" are defined as any sole proprietor, partner, officer, director, or branch manager of a member (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with the member or any employee of the member.

Internal Disciplinary Actions Taken By A Member

In those instances where Forms BD and U-4 do not cover a particular situation, the Association is introducing a new form entitled "Notice of Disciplinary Action" as a vehicle for compliance. This form would be used for an action taken by the member firm to discipline a registered individual or the termination for cause of a non-registered associated person.

The attached form is only to be used to report a disciplinary action by a member firm against its associated persons or termination for cause of a non-registered associated person. All other disciplinary actions or terminations are reportable via Forms BD, U-4 and U-5. Since members of other self-regulatory organizations are required to file like forms for the reporting of disciplinary actions, the Association will accept the filing of similar forms from those firms who are members of more than one such organization.

* * *

In summary, a member, in order to fulfill the requirements of Part III of Schedule C, should file amendments to Form BD, Item 10, and Form U-4 as promptly as possible in the event the member or its associated persons are disciplined by a self-regulatory organization or governmental agency. Again, if a situation arises where the Form BD or Form U-4 are not appropriate, the member should advise the Association of the disciplinary action by using the "Notice of Disciplinary Action" form or like form acceptable by other self-regulatory organizations. Of course, if it is the termination of a registered individual, the firm should promptly file Form U-5 with the appropriate details.

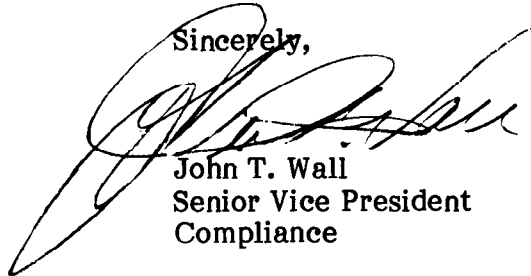
Amendments and filings should be sent to:

National Association of Securities Dealers, Inc.
Membership Department
1735 K Street, N. W.
Washington, D. C. 20006

Additional copies of the "Notice of Disciplinary Action" form are obtainable through the above address or your respective NASD District Office.

Should you have any questions concerning this notice, please contact James J. Cummings, Assistant Director, Special Registration Review, at (202) 833-7297.

Sincerely,



John T. Wall
Senior Vice President
Compliance

Attachment

NOTICE OF DISCIPLINARY ACTIONS

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
1735 K Street N.W., Washington, D.C. 20006

THE SUBMISSION OF THIS FORM IS REQUIRED PURSUANT TO PART III OF SCHEDULE C OF THE ASSOCIATION'S BY-LAWS TO REPORT DISCIPLINARY ACTIONS AND TERMINATIONS TAKEN BY A MEMBER AGAINST ITS ASSOCIATED PERSONS, AS THAT TERM IS DEFINED IN ARTICLE I, SECTION 3(f). ONLY THOSE DISCIPLINARY ACTIONS OR TERMINATIONS NOT COVERED BY FORMS BD, U-4 OR U-5 SHOULD BE REPORTED ON THIS FORM. ALL DISCIPLINARY ACTION TAKEN BY ANY NATIONAL SECURITIES EXCHANGE OR ASSOCIATION, CLEARING CORPORATION, COMMODITY FUTURES MARKET OR GOVERNMENT REGULATORY BODY SHOULD BE REPORTED ON FORMS BD AND/OR U-4.

Name: _____
 Last First Middle

Social Security Number Employment Capacity

Firm Name Firm I.D. Number

Office of Employment

Instructions

Check the appropriate item(s) and provide the details in narrative form in the space provided. Additional sheets may be used if required. Attach copies of pertinent correspondence, memoranda and other documentation so as to avoid additional requests for such information.

The individual above has:

1. been suspended, expelled, barred, censured or otherwise disciplined in any manner which would have significant limitation on the individual's activities on a temporary or permanent basis. _____
2. been fined or has had commissions withheld by the firm in an amount exceeding \$2,500. _____
3. been terminated for cause in his/her capacity as a non-registered associated person. _____
4. Other _____

Date of Disciplinary Action by the Firm _____

Use reverse side of form for narrative description of details.

Signature of Individual Date

Signature of Partner, Officer or Authorized Signatory Date

Print or Type Name and Title

This form should be sent to: NASD
Membership Department
Special Registration Review Section
1735 K St., N.W.
Washington, D.C. 20006

Use this space for narrative description of the details. Use additional sheets as necessary.

NOTICE TO MEMBERS: 80-52
Notices to Members should be
retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

October 17, 1980

TO: All NASD Members and Interested Persons

RE: Administration of Qualification Examinations

ATTENTION: TRAINING DIRECTORS AND REGISTRATION PERSONNEL

I

Closing of Certain Test Centers and Elimination of Written Examinations

Plato Test Administration

Since January, 1979, the Association has been in the process of converting the majority of its qualification examinations from a written format to computerized testing through administration on the Plato System of the Control Data Corporation. By November 1, 1980, implementation of the following programs on Plato will be complete:

<u>Test Series</u>	<u>Description</u>
2	SECO/NASD Non-Member General Securities Examination
3	National Commodity Futures Examination
4	Registered Options Principal Examination
6	Investment Company Products/Variable Contracts Representative Examination
22	Direct Participation Programs Representative Examination
24	General Securities Principal Examination
26	Investment Company Products/Variable Contracts Principal Examination
39	Direct Participation Programs Principal Examination
53	Municipal Securities Principal Examination
63	Uniform Securities Agent State Law Examination

Examination Center Closings

The Association has maintained a network of approximately ninety testing centers in the continental United States, Alaska, Hawaii and Puerto Rico for the purpose of administering written versions of the aforementioned

qualification examinations. With the conversion of these programs to computerized testing, it is neither necessary nor economically feasible to retain written examination sessions in locations serviced by Plato.

Accordingly, all written examination sessions at which the above named examinations have been administered will be terminated as of November 1, 1980. This action does not affect the administration of the General Securities Representative Examination (Test Series 7) or the Municipal Securities Representative Examination (Test Series 52), both of which will continue to be administered in written form on the third Saturday of each month at thirty locations in the United States. Nor will the foreign examination session procedures be affected by this action.

* * * * *

II

Continuation of Certain Written Examination Sessions for Plato Examinations

Written Examinations

Candidates who are required to take a Plato administered examination in a location serviced by a Control Data learning center must take their examinations on the Plato System. However, with the exception of the Municipal Securities Principal Examination (Test Series 53), the Association will make written examinations available at test centers which are located in the following fifteen cities not serviced at the present time by the Plato System.

Anchorage, Alaska	Bismarck, North Dakota
Little Rock, Arkansas	Rio Piedras, Puerto Rico
Honolulu, Hawaii	Sioux Falls, South Dakota
Boise, Idaho	Amarillo, Texas
Des Moines, Iowa	El Paso, Texas
Great Falls, Montana	Spokane, Washington
Las Vegas, Nevada	Casper, Wyoming
Loudonville, New York	

Effective November 1, 1980, written examinations will be administered in these fifteen cities on an appointment basis on the first Saturday of each month. Each test session will be four hours in length and candidates may take any combination of examinations as long as the combined maximum allowed testing time does not exceed four hours.

Procedures for Requesting Written Examinations

Admission Tickets - Each candidate who applies to take a Plato administered examination will be enrolled on the Plato System and a confirmation of Plato

enrollment will be forwarded to the candidate's sponsoring firm. In the case where a candidate intends to take a written examination at one of the fifteen test centers identified above, the candidate must present the Plato enrollment confirmation to the proctor in order to gain admission to the session. The enrollment confirmation will be valid up to and including the expiration date stated on the notice.

Reservation to Sit for Written Examination - Notwithstanding the need to present a valid Plato enrollment confirmation in order to gain admission to a test center, the candidate must also make an advance reservation to ensure that the appropriate examination is available at the session. Reservations must be made at least eight business days prior to sessions held on the first Saturday of each month by calling the Examination Section of the Association's Membership Department in Washington at 202-833-7187. Only reservations for the next scheduled session will be accepted.

* * *

III

Administration of Non-Plato Examinations

Financial and Operations Principal Examinations

Effective November 1, 1980, the NASD and the Municipal Securities Rulemaking Board Financial and Operations Principal Examinations (Test Series 27 and Test Series 54) will be administered in the Association's fourteen District offices. A candidate can make an appointment to sit for either of these examinations by calling the local District office.

New York Stock Exchange Examinations

Effective November 1, 1980, the NYSE Branch Office Manager's Examination (Test Series 12), the Allied Member Examination (Test Series 41) and the Supervisory Analyst Examination (Test Series 16) will be administered on the third Saturday of each month in conjunction with the administration of the General Securities Representative Examination (Test Series 7).

Admission tickets for Series 12, 16 and 41 examinations will continue to be issued by the Exchange and must be presented to examination proctors in order for candidates to gain admission to the test centers. Candidates for these three examinations must also make advance reservations with the Association to ensure that the appropriate examinations are available at the sessions. Reservations must be made at least eight business days prior to sessions held on the third Saturday of each month by calling the Examination Section of the Association's Membership Department in Washington at 202-833-7187. Only reservations for the next scheduled session will be accepted.

Special Sessions

The Association realizes that these schedule changes may not coincide with member training sessions for examinations which were planned on the basis of the sessions being cancelled on November 1, 1980. The Association will, therefore, provide a transition period through the end of December during which special sessions will be arranged at the request of members for groups of ten or more candidates.

State of Ohio Qualification Examination for Registered Representatives

Legislation currently pending in Ohio, providing for the acceptance of the Uniform Securities Agent State Law Examination (Test Series 63), is expected to be enacted in the near future. Until this occurs the Association will continue to administer the State of Ohio Qualification Examination for Registered Representatives at its traditional test centers in Cincinnati, Cleveland and Columbus in accordance with their normally scheduled testing dates.

* * *

IV Plato Test Administration

Appointment Scheduling

Due to the increased volume of testing on Plato, the Association urges candidates to schedule their appointments as far in advance as possible in order to be certain of securing testing dates which coincide with the completion of their preparatory studies. Candidates may find it necessary to wait up to five business days at certain locations for appointments in response to their requests.

Group Reservations - Member firms or training organizations planning training classes may block-reserve terminals at a learning center by calling the learning center at least one month in advance of the desired testing date. The enrollment of each candidate in the group must be confirmed at least seventy-two hours prior to the testing date.

Verification of Enrollment Information

Appointment scheduling on Plato depends upon an exact match between the information provided to a learning center by the candidate and the enrollment information for the candidate entered into the System by the NASD. It is

necessary, therefore, for the firm and/or the candidate to verify the accuracy of the identification data (name spelling, social security number and test identifier) on the candidate's enrollment confirmation and to report any errors to the Examination Section of the Membership Department prior to attempting to schedule an appointment at a learning center. Only after such errors are corrected should an appointment request be made at a learning center.

Premature Appointment Requests

Instances have occurred where a firm or a candidate has assumed an enrollment has been entered on Plato by the NASD even though no enrollment confirmation has been received by the firm. Upon attempting to make an appointment at a learning center, the candidate is often informed that the request is invalid because no enrollment can be found. In many cases this results in scheduling problems and confusion for both the learning center and the candidate. It is advisable that appointment requests be made only after receipt and verification of enrollment confirmations.

Questions regarding this notice should be directed to Janet G. Hale at (202) 833-7174 or Anne F. Pittman at (202) 833-4850 in the Examination Section of the Membership Department.

Sincerely,



John J. Wall

NASD

NOTICE TO MEMBERS 80-53
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NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

October 28, 1980

IMPORTANT

PLEASE DIRECT THIS NOTICE
TO ALL
COMPLIANCE, MARGIN AND MUTUAL FUND DEPARTMENTS

TO: All NASD Members and Interested Persons
RE: Federal Reserve Board Amendment to Regulation T

On November 3, 1980, the Federal Reserve Board's recently-adopted amendment to Regulation T to permit brokers and dealers to extend credit on certain types of investment company securities in general accounts will become effective.

Notwithstanding this action by the Federal Reserve Board, however, the SEC has taken the position that a broker-dealer participating in the distribution of mutual fund shares is prohibited from extending credit on those shares. The basis for this interpretation is the Commission's view that mutual fund shares which are purchased by an underwriter or retailer pursuant to a sales agreement involve the broker-dealer in the distribution of a new issue and new issue distributions are subject to the credit restrictions of Section 11(d)(1) of the Securities Exchange Act of 1934 (the "1934 Act"). The practical effect of this interpretation is to prohibit a broker or dealer from extending credit on such mutual fund shares.

By way of background, Section 11(d)(1) of the 1934 Act makes it unlawful for a member of a national securities exchange who is both a dealer and a broker, or for any person who both as a broker and a dealer, transacts a business in securities through the medium of a member or otherwise, to extend, maintain or arrange for the extension or maintenance of credit to or for any customer on any security which was a part of a new issue in distribution of which the broker and dealer participated as a member of a selling group or syndicate within thirty days prior to such transaction.

Section 11(d)(1) does not apply to broker-dealers who are not distributing mutual fund shares as part of a selling syndicate or group. In the Commission's view, Section 11(d)(1) only prohibits broker-dealers who are distributing the shares of a fund as members of a selling group from either selling these shares on margin or taking as collateral, in the initial purchase of other securities on margin, fully

paid for shares of such fund which they sold to a customer or bought for a customer's account. Broker-dealers are not prohibited from taking fund shares which a customer bought elsewhere as collateral on a purchase of other securities on margin.

The most-recent statement of the Commission staff's views on this subject is contained in a letter to the Investment Company Institute, dated October 9, 1980. This letter has been made public by the Commission and, presumably, will be published by securities reporting services in the near future.

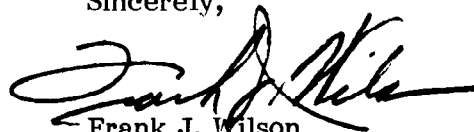
The Association as well as the Investment Company Institute (ICI) have asked the SEC to reconsider its interpretation that the restrictions of Section 11(d)(1) apply to the distribution of mutual fund shares. The NASD and the ICI believe that Section 11(d)(1) was not intended to apply to investment company shares.

Discussions with the SEC on this subject are continuing. Until this matter can be resolved, the membership is cautioned that although Regulation T has been amended by the FRB to permit the extension of credit on such shares, the SEC maintains that, with the exception noted above, Section 11(d)(1) of the Securities Exchange Act of 1934 prohibits a broker-dealer from extending credit on mutual fund shares.

There are also several significant technical and operational difficulties presented by including redeemable investment company securities in margin accounts. A more detailed outline of these matters will be contained in a subsequent notice. In the meantime, members are cautioned to carefully consider the ramifications of extending credit on investment company securities.

Questions concerning this notice should be directed to either Robert L. Butler, Investment Companies-Advertising, at (202) 833-7272, or A. Raymond Brummett, Regulatory Policy and Procedures, at (202) 833-7358.

Sincerely,



Frank J. Wilson
Senior Vice President
Regulatory Policy and
General Counsel

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

October 31 , 1980

IMPORTANT

MAIL VOTE

Officers * Partners * Proprietors

TO: Members of the National Association of Securities
Dealers, Inc.

RE: Mail Vote on Proposed Amendments
to the By-Laws Concerning Expansion of the
Association's Board of Governors

LAST VOTING DAY IS NOVEMBER 30, 1980

Enclosed herewith are proposed amendments to Article IV of the Association's By-Laws which would expand the Board of Governors by the addition of four Governors-at-Large. This would increase the composition of the Board from 27 to 31 members.

On August 4, 1980 a notice was sent to the membership soliciting their comments on the expansion proposal. A total of 30 comment letters were received. Most of the comments received supported the proposal, however, some commentators expressed concern with respect to the possible dilution of membership control of the Association's affairs by the selection of additional Governors-at-Large and the ability of a larger body (31 members) to operate efficiently. All of the comment letters received were reviewed by the full Board at its meeting in September. After lengthy deliberations, the Board determined to approve the proposed expansion and to establish a special nominating process, discussed below, which the Board believes will alleviate some of the concerns expressed by the commentators. The proposed amendments are, therefore, being presented to the membership for vote. If the proposed amendments are approved by the membership they must be approved by the Securities and Exchange Commission prior to becoming effective.

Background and Purpose

The overall management and administration of the affairs of the NASD is vested in its Board of Governors ("Board") consisting of a total of 27 persons including the President. Under present Article IV of the By-Laws, the composition of the Board is established so that a total of 21 members are required to be elected by the membership while 5 are elected by the Board and are designated Governors-at-Large. The President is a member of the Board by virtue of his office.

The present composition of the Board reflects a process of evolution in response to changing conditions in the investment banking and securities business. In 1964 the membership approved amendments to the By-Laws authorizing the Board to elect the first Governor-at-Large from among members who are underwriters of investment company shares. In 1969 the membership approved further amendments providing for a second Governor-at-Large from among insurance company members and insurance company affiliated members. In 1970 the membership authorized the Board to elect 3 additional Governors-at-Large who do not necessarily have to be from member firms. These positions have been filled by a number of distinguished persons having unique expertise and other special qualifications and who have been engaged in such fields as law, business, academics and government. A number of persons representing NASDAQ companies have also served in these positions. Governors-at-Large have assisted immeasurably in the Board's deliberations on many important issues.

The current proposal would authorize the Board of Governors to elect four additional Governors-at-Large. The Board believes that increasing the number of at-large Governors offers substantial benefits to the Association, its constituent NASDAQ companies, the membership as a whole and the public. Thus, it would provide the Association with greater flexibility to assure representation on the Board by persons having expertise in newer and more specialized areas of member activities and to assure adequate representation thereon by NASDAQ companies. Important in the latter respect is that fees from NASDAQ companies comprise a significant portion of the Association's annual operating budget. For several years the Board has had as part of its membership a Governor-at-Large representative from companies whose securities are quoted in the NASDAQ System. The proposal would permit, but would not require, appointment of additional such Governors-at-Large thus recognizing the increasingly important relationship of those companies to the operation of the NASD. The input of these NASDAQ company officials in recent years has been most helpful to the Board's deliberations and determinations.

The Association's membership will also continue to provide individuals with specialized expertise to be drawn upon as needed in filling the at-large Governor positions. For example, major proposals have been made for legislation in the area of government backed securities with the Association having a major role in the suggested regulatory activities which would ensue from that proposed legislation. If this comes about at a time when the Board does not have adequate expertise in the area, an individual with the appropriate background could be selected as a Governor-at-Large. The same would apply to other areas, such as, options, municipals, commodities and real estate to name a few. The Board could even determine that expertise in

computer technology may be necessary given the movement toward greater utilization of sophisticated technology in necessary areas of the Association's activities.

The Board recognizes the concerns expressed by some firms in their comment letters that increasing the number of at-large Governors on the Board could result in dilution of control by the membership and that the increase in size to 31 members could impact the ability of the Board to operate efficiently. The Board has operated without difficulty at its present size for over seven years. Since the proposed four additions would amount to an expansion of less than 15%, the Board feels that its present operating procedures will not be impacted adversely. As to dilution of control, all Board members strongly favor membership control of the Association and an overwhelming number of Governors strongly support the proposal for Board expansion. Even with the additional Governors-At-Large, 67% of the Board would be directly elected by vote of the membership. All Governors-At-Large would, in turn, be elected by the full Board. Thus the proposal, while encouraging a wider range of participants on the Board, retains a very strong degree of member control.

The Board, at its September meeting, in addition to authorizing the proposal for Board expansion, voted to establish a National Nominating Committee to be composed of the then present Chairman of the Board and the four most recent past Board Chairmen. The nominating committee would thus be made up of individuals with long experience in the Association's activities and strong allegiance to its philosophy of member control. The function of the new committee would be to recommend candidates for all Governor-At-Large positions including the vacancies created by the expiration of the terms of each present and succeeding Governor-At-Large. The Board believes that this procedure would encourage an experienced, geographically diversified, member-oriented approach to attracting and screening candidates to serve as Governors-At-Large.

Proposed By-Law Amendments

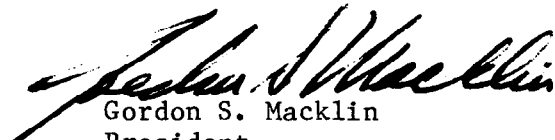
The proposal would be accomplished by amending Article IV, Section 3(h) of the By-Laws to increase from three (3) to seven (7) the number of Governors-at-Large elected by the Board from among groups of persons who may be affiliated or unaffiliated with members. A conforming amendment to Article IV, Section 2(a) of the By-Laws would provide that the Board shall consist of 31 members reflecting the increased number of the Board members and to correct certain references to the provisions of Section 3.

It is intended that the Board should be given maximum flexibility in filling the four new Governor-at-Large positions to enable them to phase in the new members based upon an evaluation of industry needs at any given time. Thus, amended Article IV, Section 3(h) would provide that each new Governor-at-Large shall be elected by the Board at such time as the Board in its discretion deems appropriate. It is contemplated at the present time, however, that two of the new positions would be filled upon effectiveness of the proposal and that one will be filled during each of the following two years.

Finally, the reference in present Article IV, Section 3(h) to the years in which the existing three Governor-at-Large positions shall be filled is deleted as no longer necessary.

The proposed amendments merit your immediate attention. Please mark the ballot according to your conviction and return it in the enclosed stamped envelope to "The Corporation Trust Company." Ballots must be postmarked no later than November 30, 1980.

Sincerely,


Gordon S. Macklin
President

Text of Proposed Amendments to
Article IV, Sections 2 and 3 of the By-Laws

(Deleted language is stricken; new language is underlined)

ARTICLE IV OF BY-LAWS

Sec. 2(a)

The management and administration of the affairs of the Corporation shall be vested in a Board of Governors, which shall be composed of ~~twenty-seven~~ thirty-one members, twenty-one to be elected by the members of the various districts in accordance with the provisions of Section 3(a) through ~~(d)~~ (e) of this Article, ~~five~~ nine to be elected by the Board of Governors in accordance with the provisions of Section 3(~~e~~), (f) and (g) and (h) of this Article, and the President of the Corporation to be selected by the Board of Governors in accordance with the provisions of Article V, Section 2.

Sec. 3(f)

One member of the Board of Governors shall be elected by the Board of Governors from among the principal underwriter members of investment company shares, and he shall be designated Governor-at-Large.

Sec. 3(g)

One member of the Board of Governors shall be elected by the Board of Governors from among insurance company members or insurance company affiliated members of the Association and he shall be designated Governor-at-Large.

Sec. 3(h)

~~Three~~ Seven members of the Board of Governors shall be elected by the Board of Governors and they shall be designated Governors-at-Large. ~~One such Governor-at-Large shall be elected by the Board of Governors in 1970 to take office in 1971. Once such Governor-at-Large shall be elected by the Board of Governors in 1971 to take office in 1972. One such Governor-at-Large shall be elected by the Board of Governors in 1972 to take office in 1973.~~ Any Governor-at-Large initially filing a Governor-at-Large office shall be elected at such time as the Board of Governors in its discretion deems appropriate.

NOTICE TO MEMBERS 80-55
Notices to Members should be
retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D. C. 20006

November 7, 1980

TO: All NASD Members

RE: Rescission of Restricted Options Rule


The Securities and Exchange Commission has approved the rescission of Section 8 of Appendix E to Section 33 of the Rules of Fair Practice, the "restricted options rule." This rule prohibited customers and firms from entering any order, subject to certain exceptions, for an opening transaction in any exchange listed option contract which was more than \$5 out-of-the-money and trading for less than \$.50 per unit of trading.

The restricted options rule was initially adopted in response to regulatory concerns that investors may not fully appreciate the risks involved in purchasing or selling deep-out-of-the-money options. Regulatory authorities were concerned that public customers would be induced to purchase or sell deep-out-of-the-money options without fully understanding the possibility that long positions in such options could expire worthless or short positions in such options could increase dramatically in price.

Recently, the Association adopted a number of new options rules (see Notice to Members No. 80-22, dated June 4, 1980) following recommendations pertaining to options selling practices contained in the SEC's Options Study. Recognizing that an unhedged position in deep-out-of-the-money options may be unduly speculative and not consistent with the objectives of many customers, members are urged to review recommended transactions involving deep-out-of-the-money options in light of the new rules to ensure that they are not unsuitable for the customer; that the customer fully understands the risks in establishing long or short positions in such options; and, that the customer can financially bear the risk of the transaction. Additionally, firms should continue to employ appropriate supervisory procedures to ensure that trading in deep-out-of-the-money options is reviewed on an ongoing basis.

Questions concerning this circular may be addressed to John J. Cox, Assistant Director, Department of Regulatory Policy and Procedures, National Association of Securities Dealers, Inc., 1735 K Street, N.W., Washington, D.C. 20006, telephone number (202) 833-7320.

Sincerely,



Gordon S. Macklin
President

NASD

NOTICE TO MEMBERS 80-56
Notices to Members should be
retained for future reference.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

November 12, 1980

IMPORTANT

PLEASE DIRECT THIS NOTICE
TO ALL
FINANCIAL AND OPERATIONAL OFFICERS AND PARTNERS

TO: All NASD Members

RE: SEC Proposed Amendments to the Uniform Net Capital Rule

SUMMARY

On October 9, 1980, the Securities and Exchange Commission announced proposed amendments to Rule 15c3-1 (the "Uniform Net Capital Rule") under the Securities Exchange Act of 1934. The proposed amendments are explained in Securities Exchange Act Release Nos. 17208 and 17209, copies of which are reprinted at the conclusion of this notice. The releases describe the proposed changes to Rule 15c3-1 and solicit comments from interested parties on the impact of these proposed amendments on the securities industry. According to the Commission, the purpose of these amendments is part of an ongoing effort to revise and modify the Uniform Net Capital Rule to keep pace with changes which have taken place in the securities industry since the adoption of the rule in 1975.

Among other things, the proposals embodied in these releases would accomplish the following:

- lower the ratio and minimum net capital requirement for those firms electing the alternative method in computing net capital;
- increase the haircut percentages on government and federal agency securities, non-convertible debt securities and certain investment company securities;
- solicit comments on recommendations made by the Securities Industry Association.

A more detailed discussion of these proposals follows.

Discussion of the Proposals

Background

When the Uniform Net Capital Rule was adopted in 1975 (see Securities Exchange Act Release No. 11497), the Commission anticipated that it would periodically revisit the financial responsibility rules to determine their adequacy in relation to changes in the structure of the industry and the nature and volume of the business of brokers and dealers. In this regard, the Commission states that a dramatic shift has taken place in the business of firms since 1975, which has been measured in terms of major revenue sources and balance sheet structures.

The amendments proposed in Release No. 17208 will lower the capital requirement of those firms utilizing the alternative method of capital. This is to be accomplished by lowering the ratio and minimum net capital requirement and by excluding certain items from the Reserve Formula Computation.

Recent events in the debt market have led the Commission to question the adequacy of existent haircut provisions for debt securities. In this regard, the Commission has analyzed the performance of debt securities over a 49-month period (February, 1976, through February, 1980) and based upon this study, is proposing to increase existent percentage haircuts on government and federal agency securities for which the principal and interest is guaranteed by the United States ("qualified securities"), municipal securities, non-convertible debt securities and certain investment company securities.

Haircuts

The proposed amendments to the Uniform Net Capital Rule, as embodied in Securities and Exchange Release No. 34-17209, would increase the percentage deductions from the market value of certain debt securities maintained in proprietary or other accounts of broker-dealers, which must be made in computing net capital.

- Government Securities - with more than three months to maturity will be subject to a percentage deduction. Additionally, hedging of long and short positions is to be allowed where the securities have a relationship by virtue of relatively close maturity dates rather than because fixed in the same haircut category.
- Municipal Securities - with more than two years but less than five years to maturity are to receive a five percent (5%) haircut, and these municipal securities with five years or more to maturity are to receive a seven percent (7%) haircut.
- Non-Convertible Debt Securities - with five years or more to maturity having a fixed interest rate and maturity date not trading flat or in default as to principal or interest and rated in one of the four highest rating categories will receive a haircut of 9 percent.

- Investment Company Shares - investment companies whose assets are in the form of cash or securities or money market instrument shares receive a haircut equal to 7% of the market value of the greater of the long or short position. Further, for securities issued by investment companies whose portfolio consists of cash or securities or money market instruments and non-convertible debt securities will reserve a haircut equal to 9% of their market value.

Alternative Net Capital Requirement

In Release No. 17208, the Commission is proposing changes which will affect only those firms computing net capital pursuant to the alternative method. The proposed amendments will not only lower the ratio of required net capital to certain debit items and the minimum but will also affect the treatment of certain debit items in the Reserve Formula. In this regard, the following amendments have been proposed for broker-dealers which have elected the alternative method of computing net capital:

- reduce the 4% minimum requirement on customer debit balances (Item 10 of the Formula for Determination of Reserve Requirements for Brokers and Dealers) to 3% on debit balances in margin accounts and 4% on the remainder of debit balances;
- reduce the minimum net capital requirement from \$100,000 to \$75,000;
- exclude fails to deliver and fails to receive which allocate to one another from the Formula for Determination of Reserve Requirements (Items 4 & 12), if fails to deliver are aged three business days after settlement date pursuant to paragraph (c)(2)(ix) of Rule 15c3-1, on all fails except fails related to municipal securities. The aging period on fails to deliver related to municipal securities would be eleven business days;
- to exclude from the Reserve Formula all C.O.D. transactions (RVP/DVP), so long as the security which is subject to the C.O.D. transaction is handled as if it were a proprietary position and the appropriate haircut taken; and,
- replace the 7% level under paragraph (e) of Rule 15c3-1 (Limitations on the Withdrawal of Capital) and 6% under Rule 17a-11 with amounts equal to 175% and 150%, respectively, of the amount of net capital required.

Alternatively, a broker-dealer choosing to place these items (fails and C.O.D. transactions) in the Reserve Formula would continue to have the 4% capital requirement on these items.

Questions

The following questions are excerpted from Release No. 17208. In our opinion, these questions represent the most substantive points raised relative to the financial and operation rules.

- What changes could be made in the early warning system so that the Commission and the self-regulatory organizations would have timely notice of a firm's potential difficulties without forcing firms to maintain excessive regulatory capital?
- Do you believe that the net capital rule can be substantially revised or even eliminated so as to place greater emphasis on the other financial responsibility rules, particularly Rule 15c3-3?
- Can the customer protection rules, other than the net capital rule, be structured to make such rules less complex? If so, how can this be accomplished?
- Are current regulatory capital standards adaptable to the changing capital needs of a firm?
- To what extent, if any, do present financial responsibility rules affect the ability of these broker-dealers to raise capital? In particular, can the rules be made less burdensome to smaller broker-dealers without substantially reducing customer protection?
- Do you believe that Rule 15c3-1 and Rule 15c3-3 could be integrated into a single less complex financial responsibility requirement? If so, how could this best be accomplished?
- Should all brokers and dealers be required to follow the alternative and, as a result, also be subject to Rule 15c3-3?
- Should the haircut provisions of the alternative and basic net capital requirements be made uniform?
- What is the feasibility of substituting for the net capital rule a net worth test with a minimum net worth computed in accordance with generally accepted accounting principles (the Commission suggests a \$25,000 figure) for brokers and dealers who do not handle customer funds and securities?

* * *

The above discussion briefly addresses the issues and proposed amendments to SEC Rule 15c3-1 upon which the Commission is soliciting comment. A reprint of Releases No. 34-17208 and 34-17209 as contained in the October 22, 1980, edition of the Federal Register is incorporated in this

notice. For a more complete explanation of the changes being proposed by the Commission to the Uniform Net Capital Rule, members are advised to review these releases carefully.

In connection with the above, the Association strongly recommends that members and other interested parties provide the Commission with their written comments on these proposals. In order for such comments to receive consideration by the Commission, they should be received by the Commission on or before January 15, 1981, the comment period closing date. Comments to the Commission should be marked File No. S7-855 and S7-856 and directed to:

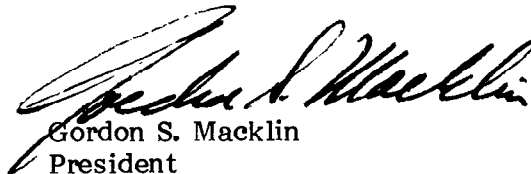
George A. Fitzsimmons, Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

To assist the NASD's Capital and Margin Committee which will meet shortly to review the proposed amendments, the Association asks that each member complete the short-form questionnaire included with this notice. Member input will be useful to the Committee in developing Association comments on these very important proposals. The Association will also be appreciative of receiving copies of any correspondence sent by members to the Commission on this subject. These duplicate copies can be directed to:

Capital Proposal
Department of Regulatory Policy and Procedures
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

Finally, questions concerning this notice or the Commission's proposed amendments to the Uniform Net Capital Rule can be directed to either John J. Cox at (202) 833-7320 or Donald J. Catapano at (202) 833-7209.

Sincerely,


Gordon S. Macklin
President

Attachment

17 CFR Part 240

[Release No. 34-17208; File No. S7-855]

Net Capital Requirements for Brokers and Dealers**AGENCY:** Securities and Exchange Commission.**ACTION:** Proposed rules and solicitation of comments on financial responsibility rules.

SUMMARY: The Commission is proposing amendments to the net capital rule which would affect those portions of the rule applicable when brokers and dealers have elected the alternative net capital requirements. The proposed amendments would lower the ratio of required net capital to debit balances in customers' margin accounts and lower the minimum net capital requirements for those firms electing the alternative. The Commission is also proposing certain changes regarding the entries in the Reserve Formula of the customer protection rule which will also affect the computation of required net capital under the alternative. Finally, the Commission is soliciting comments on a broad range of questions regarding the financial responsibility rules for brokers and dealers in its reexamination of the scope, adequacy and necessity of those rules.

DATE: Comments to be received by January 15, 1981.**ADDRESSES:** All comments should be submitted in triplicate and addressed to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. All comments should refer to file No. S7-855 and will be available for public inspection at the Commission's Public Reference Room, 1100 L Street, NW., Washington, D.C.**FOR FURTHER INFORMATION CONTACT:** Gregory N. Smith, Division of Market Regulation (202) 272-2368, 500 N. Capitol Street, NW., Washington, D.C. 20549. For questions relating to the analysis and interpretation of the economic data herein, please contact Rosanne F. Greene, Directorate of Economic and Policy Analysis (202 523-5495).**SUPPLEMENTARY INFORMATION:** During the 1970's, the Commission substantially reformed its broker-dealer financial responsibility standards in response to

the collapse of large firms and subsequent losses to customers arising from the financial and operational weaknesses of the firms in the late 1960's. In 1973, the Commission adopted Rule 15c3-3, which for the first time established procedures for the segregation of customers' fully-paid and excess margin securities held by broker-dealers and prohibited use of customer funds on deposit with broker-dealers except in certain customer related areas.¹

The second major reform occurred with the adoption of the present uniform net capital rule (the "Rule"), 17 CFR 240.15c3-1, in 1975 after a lengthy review by the Commission of the then-existing financial responsibility rules and extensive public comment. The Rule eliminated the exemption in the Commission's prior net capital rule for all members of national securities exchanges and made virtually all registered brokers and dealers subject to the Commission's capital requirements.² The Rule continued the basic liquidity concept under which the securities industry had operated for many years. That concept requires a firm to have and maintain designated minimum amounts of liquid assets in relating to its aggregate indebtedness. In addition, the Commission introduced an alternative concept to measure the capital adequacy of brokers and dealers. The alternative concept linked the capital requirements of brokers and dealers to their customer related business as measured by the requirements of Rule 15c3-3. These reforms were significant steps in the Commission's continuing efforts to structure its rules to provide adequate protection for customers' assets while recognizing the need of securities firms for flexibility in efficiently using their capital resources.

When it adopted the present net capital rule, the Commission anticipated that it would revisit the financial responsibility rules at some time in the future. The Commission concludes that

¹ Rule 15c3-3 was adopted pursuant to Section 15(c)(3) of the Securities Exchange Act of 1934 (the "Act") which was amended by Section 7(d) of the Securities Investor Protection Act of 1970. The amendment required the Commission to adopt rules and regulations to provide "... safeguards with respect to the financial responsibility and related practices of brokers and dealers: including, but not limited to, the acceptance of custody and use of customers' securities, and the carrying and use of customer's deposits or credit balances. Such rules and regulations shall require the maintenance of reserves with respect to customers' deposits or credit balances, as determined by such rules and regulations."

² Section 15(c)(3) of the Act was further amended by the Securities Reform Act of 1975 to require the Commission, by September 1, 1975, to establish minimum, financial responsibility requirements for all brokers and dealers.

this review should be undertaken now because of changes in the structure of the industry and the nature and volume of the business of brokers and dealers.

Brokers and dealers and the markets in which they deal are different from those in the early 1970's. The financial data set forth in Tables 1 and 2 for New York Stock Exchange ("NYSE") member firms doing a public business³ show that there has been a dramatic shift in the business mix of firms measured in terms of their major revenue sources and in their balance sheet structures.⁴ In addition, many brokers and dealers now can clear significant portions of their business through a single clearing agency, regardless of the market where the transaction was executed. Participants in securities depositories can move securities throughout the country more efficiently and with less overall loss, to effect transfers and to make deliveries by book entry as a result of the expanded interfaces among depositories. This development has also had the effect of further immobilizing securities certificates.

These factors raise the question whether the present net capital rule properly assesses the risks involved in the business and requires appropriate reserves. The amount of liquid reserves required to prevent losses to customer assets and at the same time maximize scarce capital available to the intricate securities system is a subject which can elicit different responsible opinions. The object of this release is to explore these issues and elicit comment from the public. Accordingly, there follows a brief description of the net capital rule and certain proposed changes. The release concludes with an invitation for public comment on a broad range of questions regarding the financial responsibility rules.

The Commission intends that the proposals and issues raised in this release be considered in conjunction with the release proposing an amended schedule of haircuts on debt securities, also being issued today.⁵ The haircut schedule, as proposed, may have a substantial effect on the net capital of

³ Historical data for NYSE member firms doing a public business has been available on a consistent basis since 1972 while comparable data for other industry segments did not become available until 1976 with the adoption of the FOCUS Report (Financial and Operational Combined Uniform Single Report).

⁴ For an analysis of the financial structure of the broker-dealer industry, see Securities and Exchange Commission, *Staff Report on the Securities Industry in 1979*, September 1980.

⁵ Securities Exchange Act Release No. 17209 (October 9, 1980).

Table 1.—Unconsolidated Annual Revenues and Expenses of NYSE Member Firms Doing a Public Business

[In millions of dollars]

	1972	1973	1974	1975	1976	1977	1978	1979
REVENUES								
Securities commissions.....	\$3,224	\$2,660	\$2,271	\$2,925	\$3,164	\$2,809	\$3,779	\$4,012
Realized and unrealized gain or (loss) in trading and investments.....	909	415	592	914	1,400	1,296	1,543	2,671
Commodities revenue.....	120	181	160	174	210	243	351	436
Profit or (loss) from underwriting and selling groups.....	770	430	430	781	853	776	742	770
Revenue from sale of investment company securities.....	95	100	41	35	45	58	59	78
Margin interest.....	507	641	616	455	565	755	1,173	1,652
Revenue unrelated to the securities business.....	28	41	67	89	137	136	237	353
All other revenues.....	337	343	443	494	530	657	949	1,294
Gross revenues.....	5,990	4,811	4,620	5,867	6,902	6,730	8,832	11,264
Number of firms at year-end.....	490	463	420	409	384	364	361	374

Sources: NYSE Joint Regulatory Report and FOCUS Report directorate of Economic and Policy Analysis Securities and Exchange Commission.

Table 2.—Summary Balance Sheet for NYSE Firms Doing a Public Business; 1972-79

[In millions of dollars]

	1972	1973	1974	1975	1976	1977	1978	1979
ASSETS								
Cash.....	\$816.6	\$687.6	\$581.6	\$664.7	\$761.0	\$797.0	\$984.0	\$1,763.0
Receivables from other broker-dealers and clearing corporations:								
Securities failed to deliver.....	1,967.5	1,496.9	987.4	1,183.2	1,663.0	2,030.0	1,781.0	2,279.0
Securities borrowed.....	1,260.8	1,043	808.3	1,447.1	1,874.0	2,211.0	2,484.0	3,912.0
Other.....	297.2	272.3	848.8	621.4	418.0	741.0	844.0	632.0
Receivables from customers.....	12,321.1	8,122.7	6,539.8	6,265.4	11,453.0	13,537.0	15,868.0	17,981.0
Long positions in securities and commodities.....	8,307.2	7,063.0	8,319.2	8,860.5	15,662.0	13,799.0	15,238.0	20,199.0
Securities owned—not readily marketable.....	94.0	103.2	75.1	79.8	41.0	32.0	22.0	30.0
Securities borrowed under subordinated agreements and partners' individual and capital securities accounts.....	198.3	95.2	54.0	65.4	93.0	65.0	63.0	67.0
Securities purchased under agreement to resell ¹	NA	NA	NA	NA	4,255.0	8,187.0	14,018.0	24,244.0
Secured capital demand notes.....	268.7	412.3	343.3	292.7	291.0	236.0	248.0	255.0
Exchange memberships.....	218.5	134.1	109.8	102.2	129.0	106.0	108.0	139.0
Other assets.....	1,365.9	1,244.2	1,139.0	1,163.5	1,541.0	1,880.0	2,244.0	3,503.0
Total assets.....	27,115.8	20,674.7	19,805.9	22,725.9	38,181.0	43,621.0	53,902.0	75,004.0
LIABILITIES AND EQUITY CAPITAL								
Bank loans payable:								
Secured by customer collateral.....	5,720.1	2,499.2	1,522.2	2,054.1	4,725.0	5,683.0	5,123.0	4,002.0
Secured by firm collateral.....	5,960.4	5,146.2	6,783.8	6,803.0	5,108.0	5,612.0	4,337.0	4,557.0
LIABILITIES AND EQUITY CAPITAL								
Securities sold under repurchase agreements ¹	NA	NA	NA	NA	11,222.0	10,584.0	16,306.0	23,851.0
Payable to other broker-dealers and clearing organizations:								
Securities failed to receive.....	2,077.0	1,389.0	1,039.1	1,173.6	1,539.0	2,161.0	1,745.0	2,105.0
Securities loaned.....	1,236.3	839.7	573.6	1,033.9	1,585.0	1,828.0	2,198.0	3,715.0
Other.....	817.4	782.4	619.8	836.1	430.0	902.0	733.0	671.0
Payable to customers.....	3,998.8	3,610.3	2,934.5	3,323.4	4,786.0	5,099.0	7,202.0	10,992.0
Short positions in securities and commodities.....	1,285.1	1,018.9	645.2	931.0	2,129.0	3,960.0	6,610.0	13,706.0
Other liabilities.....	1,828.2	1,785.0	2,432.2	3,103.8	2,744.0	3,839.0	5,258.0	6,406.0
Total liabilities excluding subordinated liabilities.....	22,925.3	17,070.7	16,550.4	19,258.9	34,268.0	39,688.0	49,512.0	70,005.0
Subordinated liabilities.....	1,041.2	1,077.5	809.4	777.6	766.0	759.0	963.0	1,040.0
Total liabilities.....	23,966.5	18,148.2	17,459.8	20,036.5	35,034.0	40,447.0	50,475.0	71,045.0
Equity capital.....	3,149.3	2,526.5	2,346.1	2,689.6	3,147.0	3,174.0	3,427.0	3,959.0
Total liabilities and equity capital.....	27,115.8	20,674.7	19,805.9	22,725.9	38,181.0	43,621.0	53,902.0	75,004.0
Number of firms at year-end.....	490	463	420	409	384	364	361	374

¹Data on repurchase agreements is not available before the first quarter of 1976. Prior to 1976, securities purchased under agreement to resell were combined with long positions in securities and commodities, while securities sold under repurchase agreements were combined with money borrowed secured by firm collateral. Much of the considerable growth of assets in 1978 reflects the increased involvement of broker-dealers in U.S. Government and Agency obligations which was accompanied by a substantial growth in the use of repurchase agreements.

Sources: NYSE Joint Regulatory Report and FOCUS Report.

firms. It should also be noted that the Commission's proposed amendments to the FOCUS report would provide new detailed data relative to firms' activities.⁶

I. Present Net Capital Requirements

Historically, the principal regulatory tool relied upon to insure the financial integrity of broker-dealers was the required maintenance of a net capital base relative to a firm's aggregate indebtedness in order to ensure sufficient liquid assets to cover a firm's current indebtedness. The Commission's basic net capital rule currently requires that a broker-dealer's "aggregate indebtedness" never be more than 1500% of his "net capital," as those terms are defined in the Rule. Net capital essentially means the net worth of a broker-dealer reduced by prescribed percentages of the market value of securities owned by the broker or dealer ("haircuts") and reduced by other assets not readily convertible into cash, but including certain subordinated debt, i.e., net liquid assets. Aggregate indebtedness includes all the money liabilities of a broker or dealer, except certain specifically described items. In essence, the Rule requires a broker or dealer to cover each dollar of his liabilities with not less than one dollar and six and two-thirds cents of liquid assets.

The alternative method of calculating net capital requires a broker or dealer to maintain minimum net capital equal to the greater of \$100,000 or 4% of aggregate debit items in the Formula for Determination of Reserve Requirements for Brokers and Dealers under Rule 15c3-3 ("Reserve Formula"), 17 CFR 240.15c3-3a. The debit items in the Reserve Formula represent moneys owed the broker-dealer in relation to customer transactions. The alternative approach is founded on the concept that, if the debit items in the Reserve Formula can be liquidated at or near their contract value, these assets along with any cash required to be on deposit under the Rule, will be sufficient to satisfy all liabilities to customers (which are represented as credit items in the Reserve Formula). As an additional safeguard, election of the alternative requires a firm to reduce by 3% its aggregate debit items to provide, in essence, a bad debt reserve of firm capital to assure adequate resources to pay customer claims. Election of the alternative also requires that operational charges (stock record differences and suspense account items)

be reflected in the Reserve Formula after seven business days, rather than after 30 business days, as permitted for those firms which have not elected the alternative. Together, these limitations allow a firm to increase its customer commitments only as a function of its net capital.

Most broker-dealers utilize the basic method for complying with the net capital rule. Tables 3 through 6 provide a financial profile of firms electing the alternative and basic methods for computing net capital. As Tables 3 and 4 indicate, 139 of the 374 NYSE member firms conducting a public business as of December 31, 1979 were using the alternative method for the computation of net capital. These 139 firms accounted for 68% of the aggregate assets, 76% of the aggregate equity capital, and 81% of the aggregate revenues of the 374 NYSE firms conducting a public business. Of

the classified NYSE member firms, all ten National Full Line firms elected the alternative capital approach, while 57 Regional firms (48% of NYSE member firms classified as Regional) utilized this method.⁷

Only 44 of the 2,066 broker-dealers that conducted a public business as of December 31, 1979 and were not members of the NYSE used the alternatives method for the computation of net capital (see Tables 5 and 6). These 44 firms were, on average, substantially larger than the 2,022 firms using the basic method.

⁷ National Full Line firms conduct a general securities business and have a nationwide branch office network. Regional firms, on the other hand, confine their activities to a more limited geographic area. For further information on classified NYSE member firms, see Chapter 3, Securities and Exchange Commission, *Staff Report on the Securities Industry in 1979*, September 1980.

Table 3.—Unconsolidated Revenues and Expenses of NYSE Firms Doing a Public Business 1979

(Millions of dollars)

	Firms using alternate method			Firms using basic method		All firms
	National full line	Regional firms	Other firms ¹	Regional firms	Other firms	
REVENUES						
Commissions:						
Listed equities on an exchange ..	\$1,275.2	\$331.9	\$976.5	\$153.2	\$368.2	\$3,126.0
Listed option transactions	251.7	45.6	112.9	15.0	18.0	443.2
All other commissions	138.9	99.2	113.1	42.3	50.7	444.2
Total securities commissions	1,665.8	476.7	1,202.5	210.5	456.9	4,012.4
Gains or losses on trading accounts	793.0	141.6	771.9	65.5	399.3	2,171.3
Realized and unrealized gains or losses on securities investment accounts	69.8	7.7	241.6	3.5	177.0	499.6
Profits or losses from underwriting and selling groups	313.0	77.0	238.2	61.5	79.8	769.5
Margin interest	915.1	183.4	452.5	13.0	87.5	1,651.5
Sale of investment company shares	32.9	14.5	17.0	9.8	1.4	75.6
Investment advisory, account supervision	35.8	7.6	28.3	8.9	41.0	121.6
All other revenue	700.3	106.1	610.2	82.4	463.5	1,962.5
Gross revenue	4,525.7	1,014.6	3,562.2	455.1	1,706.4	11,264.0
EXPENSES						
Employee expenses other than registered representatives' compensation	680.9	175.9	677.0	88.2	270.6	2,092.6
Salaries and other employment costs for general partners and voting Stockholder officers	63.2	78.1	139.2	45.4	113.5	439.4
Commissions and clearance paid ..	176.3	59.5	298.7	25.5	86.3	646.3
Interest expense	931.2	142.1	988.5	40.2	573.3	2,675.3
Regulatory fees and expenses	19.4	6.3	9.9	3.9	7.9	47.4
All other expenses	2,126.0	468.5	1,068.2	203.9	396.2	4,262.8
Total expenses	4,197.0	930.4	3,181.5	407.1	1,447.8	10,163.8
Net income before taxes	328.7	84.2	380.7	48.0	258.6	1,100.2
Number of firms in group as of end-of-year 1979	10	57	72	60	175	374

¹ Includes three quarters of data for two firms that were acquired or went out of business in the fourth quarter. Source: FOCUS Report, Directorate of Economic and Policy Analysis, Securities and Exchange Commission.

⁶ Securities Exchange Act Release No. 17138 (September 19, 1980).

Table 4.—Summary Balance Sheet for NYSE Firms Doing a Public Business 1979

[Millions of dollars]

	Firms using alternate method			Firms using basic method		
	National full line	Regional firms	Other firms ¹	Regional firms	Other firms	All firms
ASSETS						
Cash.....	\$1,180.1	\$70.3	\$258.6	\$34.7	\$239.3	\$1,763.0
Receivables from other broker-dealers:						
Securities failed to deliver.....	879.5	152.3	963.4	56.2	227.6	2,279.0
Securities borrowed.....	1,110.8	166.3	2,005.6	36.3	593.0	3,912.0
Other.....	272.9	38.1	127.1	20.0	173.9	632.0
Receivables from customers.....	9,548.6	1,724.4	3,690.2	467.0	2,552.8	17,981.0
Long positions in securities and commodities.....	4,755.6	541.0	6,754.1	219.8	7,928.3	20,199.0
Securities owned—not readily marketable.....	1.8	2.8	11.0	1.7	12.7	30.0
Securities borrowed under subordinated agreements and partners' individual and capital securities accounts.....	0	21.7	22.1	15.0	8.2	67.0
Securities purchased under agreement to resell.....	5,453.1	93.0	7,929.2	275.5	10,493.2	24,244.0
Secured capital demand notes.....	38.6	32.2	119.9	30.3	33.8	255.0
Exchange memberships.....	30.5	13.2	53.7	9.5	32.1	139.0
Other assets.....	1,440.9	176.4	1,056.1	70.2	759.4	3,503.0
Total assets.....	24,690.8	3,031.7	22,991.0	1,236.2	23,054.3	75,004.0
LIABILITIES AND EQUITY						
CAPITAL						
Bank loans payable:						
Secured by customer collateral.....	1,927.7	861.9	1,004.7	144.0	263.7	4,002.0
Secured by firm collateral.....	1,610.1	150.3	1,910.7	77.1	808.8	4,557.0
Securities sold under repurchase agreements.....	6,697.2	85.7	6,267.4	234.9	8,565.8	23,851.0
Payable to other broker-dealers:						
Securities failed to receive.....	871.3	172.6	757.5	63.7	239.9	2,105.0
Securities loaned.....	1,963.1	211.9	1,230.2	19.6	290.4	3,715.0
Other.....	169.1	100.9	103.2	25.8	272.2	671.0
Payable to customers.....	4,517.1	820.5	2,873.1	242.6	2,538.7	10,992.0
Short positions in securities and commodities.....	1,783.1	217.2	3,777.3	41.5	7,886.9	13,706.0
Other liabilities.....	3,361.0	220.2	1,431.5	159.3	1,234.0	6,406.0
Total liabilities excluding subordinated liabilities.....	22,899.7	2,641.2	21,355.4	1,008.3	22,100.4	70,005.0
Subordinated liabilities.....	378.3	70.2	349.4	43.4	198.7	1,040.0
Total liabilities.....	23,278.0	2,711.4	21,704.8	1,051.7	22,299.1	71,045.0
Equity capital.....	1,412.8	320.3	1,286.4	184.5	755.0	3,959.0
Total liabilities and equity capital.....	24,690.8	3,031.7	22,991.2	1,236.2	23,054.1	75,004.0
Number of firms in group as of end-of-year 1979.....	10	57	72	60	175	374

¹Includes three quarters of data for two firms that were acquired or went out of business in the fourth quarter. Source: FOCUS Report, Directorate of Economic and Policy Analysis, Securities and Exchange Commission.

Table 5.—Unconsolidated Revenues and Expenses of NASD And Regional Broker-Dealers Filing Four Quarters During 1979

[Millions of dollars]

	Firms using alternate method	Firms using basic method	All firms
Revenues:			
Commissions:			
Listed equities on an exchange.....	\$19.1	\$187.5	\$206.6
Listed option transactions.....	1.8	32.7	34.5
All other commissions.....	42.3	258.2	300.5
Total securities commissions.....	63.2	478.4	541.6
Gains or losses on trading accounts.....	86.2	342.6	428.8
Realized and unrealized gains or losses on securities investment accounts.....	2.2	96.7	98.9
Profits or losses from underwriting and selling groups.....	17.3	133.7	151.0
Margin interest.....	17.0	26.9	43.9
Sale of investment company shares.....	1.9	117.0	118.9
Investment advisory, account supervision.....	1.9	100.6	102.5
All other revenue.....	102.1	273.1	375.2
Gross revenue.....	291.8	1,569.0	1,860.8

Table 5.—Unconsolidated Revenues and Expenses of NASD And Regional Broker-Dealers Filing Four Quarters During 1979 —Continued
[Millions of dollars]

	Firms using alternate method	Firms using basic method	All firms
Expenses:			
Employee expenses other than registered representatives' compensation	32.6	271.1	303.7
Salaries and other employment costs for general partners and voting Stockholder officers	15.7	147.7	163.4
Commissions and clearance paid	10.1	140.8	150.9
Interest expense	114.5	111.9	226.4
Regulatory fees and expenses	1.9	14.8	16.7
All other expenses	88.4	656.9	745.3
Total expenses	283.2	1,343.2	1,606.4
Net income before taxes	28.6	225.8	254.4
Number of firms in group as of end-of-year 1979	44	2,022	2,066

Source: FOCUS Report, Directorate of Economic and Policy Analysis, Securities and Exchange Commission.

Table 6.—Summary Balance Sheet for NASD and Regional Broker-Dealers Filing Four Quarters During 1979
[Millions of dollars]

	Firms using alternate method	Firms using basic method	All firms
Assets:			
Cash	\$19.3	\$272.2	\$291.5
Receivables from other broker-dealers:			
Securities failed to deliver	111.0	763.1	874.1
Securities borrowed	45.1	285.2	330.3
Other	29.9	415.7	445.6
Receivables from customers	229.4	434.5	663.9
Long positions in securities and commodities	760.0	1,882.8	2,662.8
Securities owned—not readily marketable	7.7	28.9	37.6
Securities borrowed under subordinated agreements and partners' individual and capital securities accounts	1.6	8.4	10.0
Securities purchased under agreement to resell	1,377.0	958.6	2,335.6
Secured capital demand notes	1.3	34.6	35.9
Exchange memberships3	9.4	9.7
Other assets	82.8	712.8	805.6
Total assets	2,695.3	5,807.3	8,502.6
Liabilities and equity capital:			
Bank loans payable:			
Secured by customer collateral	98.1	156.0	254.1
Secured by firm collateral	126.7	541.1	667.8
Securities sold under repurchase agreements	1,596.7	1,004.7	2,601.4
Payable to other broker-dealers:			
Securities failed to receive	123.8	843.1	966.9
Securities loaned	12.4	161.9	174.3
Other	15.0	126.2	141.2
Payable to customers	148.1	280.5	428.6
Short positions in securities and commodities	303.1	602.6	905.7
Other liabilities	120.4	499.7	620.1
Total liabilities excluding subordinated liabilities	2,544.2	4,216.0	6,760.2
Subordinated liabilities	7.1	129.0	136.1
Total liabilities	2,551.3	4,345.0	6,896.3
Equity capital	144.0	1,462.3	1,606.3
Total liabilities and equity capital	2,695.3	5,807.3	8,502.6
Number of firms in group as of end-of-year 1979	44	2,022	2,066

Source: FOCUS Report, Directorate of Economic and Policy Analysis, Securities and Exchange Commission.

II. Proposed Rule Amendments

The Commission is proposing changes to the net capital rule which will affect only the alternative method of computing net capital. Under the proposed amendments, the alternative will still require, for the protection of customers, a cushion of liquid assets beyond the "net" amount of liquid assets needed to offset a broker's or dealer's liabilities. Later in this release, the Commission discusses the

possibility of reexamining the liquidity concept.

The proposed amendments will not only lower the ratio of required net capital to certain debit items and the minimum but also will affect the treatment of certain debit items in the Reserve Formula.

A

The moneys owed by customers of a broker or dealer in connection with their securities transactions are included in

Item 10 (a debit item) of the Reserve Formula. This item includes debit balances in customers' cash and margin accounts (other than unsecured accounts and accounts doubtful of collection). The Item 10 debits comprise approximately 85% of aggregate debit items and thus for most brokers and dealers which have elected the alternative are the major determinants of their net capital requirements. In times of heavy trading volume these customer debits will generally increase, thereby causing a broker's or dealer's capital requirement to increase by at least 4% of the increased debit balances in customers' accounts. The Commission's present review of the net capital rule focused on whether the increased requirement was commensurate with the risk connected with these debits.

Initially, it must be noted that there is not necessarily any direct correlation between the 4% figure presently in the Rule and the amount of liquid capital required to protect customers. That figure was selected based on judgments inferred from the then-existing system. The result was that the 4% requirement under the alternative was estimated by the staff to require approximately 15% to 25% less capital than if the firm were required to maintain net capital based on the aggregate indebtedness test.

Since 1975, the year of the adoption of the alternative, these Item 10 debits have increased substantially, thereby resulting in increased net capital requirements. While the level of margin debt is volatile, it has displayed a general trend of expansion since the beginning of 1975. In the first quarter of that year, customers owed NYSE member firms an average of \$4.1 billion as debit balances in margin securities accounts. This increased 173% to \$11.2 billion in the fourth quarter of 1979. During this same time period, the largest quarter-to-quarter increase in the level of margin debt was \$1.1 billion, while the largest decrease was \$740 million.⁸

In addition to the 4% capital requirement ratio, the Commission's early warning rules and comparable programs of the various self-regulatory organizations in effect require firms to maintain greater net capital than the minimum. The financial responsibility rules not only restrict withdrawal of firm capital if the ratio of net capital to aggregate debit items falls below 7%, but also require periodic reports in addition to those required generally of brokers and dealers when the ratio falls below 6%. See Rule 15c3-1(e) and Rule 17a-11, and discussion under "B", *infra*. The

⁸ See, Federal Reserve Bulletin, January 1975 through December 1979, Table 82d.

practical effect of these provisions is to cause is broker-dealers to maintain net capital substantially in excess of 7% in order to maintain a cushion of net capital at a level which will avoid an inadvertent piercing of these early warning thresholds. Moreover, the NYSE (of which all major retail firms are members) imposes by rule restrictions on those member firms whose net capital falls below 7% of aggregate debit items. See NYSE Rule 326.

In combination, the present capital cushion represented by Item 10 debits and the early warning provisions cited above may be excessive when viewed against the risks of the collectibility of these debit items and the relatively small losses experienced by firms in this area since 1975. Despite recent events revealing both the imprudence and operational inefficiencies of some broker-dealers, it seems appropriate to propose a reduction in the basic requirements. Experience has indicated that other provisions of the Rule (which require capital charges) provide the required discipline in sufficient time to permit the correction of unsound practices or the liquidation of potentially dangerous positions.

The Securities Industry Association Capital Committee (the "SIA") has recommended to the Commission that the minimum capital required under the alternative based on Item 10 debits should be lowered from 4% to 2%.

While that may be the proper figure to determine capital adequacy for financing these particular transactions, at this time the Commission believes that it is appropriate to propose a reduction of the 4% minimum figure to 3% and have that reduction apply only to debit balances in margin accounts rather than to those in cash accounts and other debit items in the Reserve Formula. It should be noted that the SIA did not recommend reductions in the capital requirements based on other debit items.

In sum, the Commission herein proposes to require brokers and dealers which have elected the alternative to have and maintain a net capital of 3% rather than the present 4% of the debit balances in customers' margin accounts which are maintained in compliance with Regulation T of the Federal Reserve Board or the maintenance margin requirements of the various self-regulatory organizations. This reduction appears to be prudent because these margin accounts should be virtually 100% collectible. It appears that any risk of loss is adequately safeguarded against by Regulation T and maintenance margin requirements as

well as by the cushion provided by the 3% reduction of debit items required of firms electing the alternative.

This reduction will have no effect on most registered brokers and dealers (see Tables 7 and 8). As noted above, of the approximately 2,400 broker-dealers doing public business in 1979, only 185 broker-dealers elected the alternative method for computing net capital at year-end 1979, 169 of which carried or cleared customer accounts.

These 169 (128 NYSE and 41 non-NYSE) firms electing the alternative capital method in the fourth quarter of 1979 had required net capital of \$1.2 billion based upon the 7% Early Warning Test. Under the SIA proposal, the required net capital of these 169 firms would have been \$684 million

Table 7.—Selected Financial Data for Broker-Dealers Doing a Public Business and Using the Alternative Capital Approach¹ Year-End 1979

	[Millions of Dollars]		
	NYSE firms	Non-NYSE firms ²	All firms
Customer Cash/Margin Debits.....	\$14,199	180	\$14,379
Aggregate Debits.....	\$16,687	269	\$16,956
Net Capital.....	\$2,011	72	\$2,083
Required Net Capital ³	\$1,168	19	\$1,187
Excess Net Capital ³	\$843	53	\$896
Impact of SIA Proposal ⁴ :			
a. Required Net Capital.....	\$671	13	\$684
b. Excess Net Capital.....	\$1,340	59	\$1,399
Number of Firms.....	128	41	169

¹Excludes 16 firms filing Part IIA of the FOCUS Report who neither carry nor clear customer accounts.

²Firms submitting four quarters of FOCUS data in 1979.

³Based on Early Warning 7% Test.

⁴Based on 2% "Item 10 Debits" criteria and Early Warning 7% Testing.

Source: FOCUS Report, Directorate of Economic and Policy Analysis, Securities and Exchange Commission.

Table 8.—Selected Financial Data For Groups of NYSE Firms Doing a Public Business and Using The Alternative Capital Approach¹ Year-End 1979

	[Millions of Dollars]			
	National full line	Regional	Other	Total
Total Assets.....	\$24,691	\$2,987	\$22,511	\$50,189
Total Liabilities ²	\$22,900	\$2,603	\$20,966	\$46,469
Subordinated Debt.....	\$378	\$78	\$299	\$755
Equity Capital.....	\$1,413	\$716	\$4,226	\$2,955
Customer Cash/Margin Debits.....	\$8,237	\$1,693	\$3,269	\$14,199
Aggregate Debits.....	\$10,222	\$1,993	\$4,472	\$16,687
Net Capital.....	\$1,022	\$227	\$762	\$2,011
Required Net Capital ³	\$716	\$140	\$313	\$1,168
Excess Net Capital ³	\$307	\$87	\$449	\$843
Impact of SIA Proposal ⁴ :				
a. Required Net Capital.....	\$395	\$80	\$197	\$671
b. Excess Net Capital.....	\$627	\$147	\$565	\$1,340
Number of Firms.....	10	57	61	128

¹Excludes 16 firms filing Part IIA of the FOCUS Report who neither carry nor clear customer accounts.

²Excludes subordinated debt.

³Based on Early Warning 7% Test.

⁴Based on 2% "Item 10 Debits" criteria and Early Warning 7% Test.

Source: FOCUS Report, Directorate of Economic and Policy Analysis, Securities and Exchange Commission.

compared to an estimated \$1.02 billion under the current proposal.⁹

While the Commission is proposing some net capital reduction in certain areas, the Commission emphasizes that the primary burden is on the securities industry to substantiate, with empirical data where feasible, the basis for this or any other proposed reduction. The Commission is concerned that the consequence of this reduction may simply be a withdrawal of capital from the broker-dealer business. The Commission therefore requests response to the following question: Will the additional capital which is no longer required by the net capital rule be used in the "core" securities activities of the firm or will it tend to be diverted into non-securities activities or be removed from the firm altogether?

As noted above, under the current Rule, brokers and dealers who have elected to operate under the alternative are required to maintain net capital of not less than 4% of Reserve Formula aggregate debit items. Under this provision no broker-dealer may effect a securities transaction if his net capital is less than 4% of aggregate debit items. In addition, the Rule provides that no capital, either equity capital or subordinated debt, may be withdrawn from the firm when its net capital is less than 7% of aggregate debits, i.e., 175% of minimum required net capital. Under Rule 17a-11, a broker-dealer operating under the alternative whose net capital is less than 6% of aggregate debit items (150% of minimum required net capital) must file certain reports monthly on Form X-17A-5 in furtherance of the Commission's early-warning program for broker-dealers who may be approaching financial or operational difficulty.

Unless these thresholds are revised, no effective reduction would be made in the amount of net capital required. Accordingly, the Commission proposes to replace the 7% level under paragraph (e) of Rule 15c3-1 and 6% under Rule 17a-11 with amounts equal to 175% and 150% respectively of the amount of net capital required (i.e., 175% and 150% of the sum of 3% of margin debits as proposed in "A" *infra* and 4% of the remaining debits in the Reserve Formula).

While the Commission recognizes that

⁹The precise impact of the modified proposal set forth in the proposed rule cannot be determined because debit balances in customers' margin accounts are not reported as a separate item on the FOCUS Report. Debit balances in customers' margin accounts in the aggregate represented approximately 72% of cash and margin debits in the Reserve Formula in a sample of 100 broker-dealers who elected the alternative as of year-end 1979.

the early warning levels must be adjusted in connection with implementing any change in net capital requirements, the Commission must also examine whether the existing early warning mechanisms effectively alert the Commission and self-regulatory organizations of a firm's potential financial and operational difficulties in time to take action to protect customers. For example, a firm has reason to believe that a material charge to net capital may arise in the near future. Under the present rules, even if the charge would put the firm's net capital below the minimum, no early warning notice need be given until the charge is actually required to be made. The Commission therefore solicits comment on the following questions: Is the present structure of the early warning system, which is based on a firm's net capital level as of a certain day, adequate to insure customer protection? Do the proposed early warning levels (150% and 175% of minimum required net capital) provide an adequate margin of safety or should they be increased? What changes could be made in the early warning system so that the Commission and the self-regulatory organizations would have timely notice of a firm's potential difficulties without forcing firms to maintain excessive regulatory capital?

C

In order to qualify to operate under the alternative net capital requirement, a broker or dealer must maintain net capital of at least \$100,000. That minimum apparently acts as a deterrent to many firms who carry customer accounts from electing the alternative. Yet, if the benefits of the alternative are as significant as believed and if the alternative is a proper measurement of financial responsibility for broker-dealers, there may be no reason for a minimum greater than that applicable to those who comply with the aggregate indebtedness test (the basic rule). The minimum under the basic rule for these brokers or dealers which do a general securities business and carry customer accounts is \$25,000.

Year-end 1979 FOCUS data indicate that there were approximately 1001 firms doing a public business¹⁰ and which have net capital of at least \$100,000, (or 7%¹¹ of aggregate debits) but were not utilizing the alternative method. If the net capital threshold were reduced to \$25,000, the FOCUS data indicate that approximately 399

¹⁰ The non-NYSE firms "doing a public business" consists of firms filing four quarters of FOCUS data in 1979.

¹¹ See paragraph B above.

additional broker-dealers would have been eligible to use the alternative computation. The number of additional broker-dealers eligible to use the alternative computation at \$75,000 and \$50,000 thresholds, respectively, would have been 205 and 252.

The Commission has decided that consideration should be given to lowering the minimum in stages. Initially, it proposes for comment a new minimum of \$75,000 for election of the alternative.¹² That figure would represent a reduction of 25% from the present minimum and would still appear to provide adequate reserves to ensure that customer funds and securities are not at undue risk. After a monitoring period, ending no later than December 31, 1982, during which the Commission will review FOCUS data and liquidations by the Securities Investor Protection Corporation ("SIPC") and make periodic on-site examinations, the Commission will consider a further reduction.

D

A "fail to receive" arises when a broker or dealer purchasing securities has not taken delivery from the selling broker or dealer as of settlement date. A "fail to deliver" arises when a selling broker or dealer has not made delivery to the buying broker or dealer as of settlement date. When these transactions are related to customer purchases and sales, they are included in Reserve Formula Items 4 and 12, respectively. For a firm electing the alternative, the inclusion of the fails to deliver (a debit item) raises its net capital requirement and the inclusion of the fails to receive (a credit item) increases its potential cash deposit requirement.

As recognized in Securities Exchange Act Release No. 9922 (January 2, 1973), brokers or dealers doing a large volume of business normally find it impractical

¹² Under the present alternative net capital rule, an introducing broker may still elect the alternative even though he is exempt from Rule 15c3-3 and therefore does not calculate the Reserve Formula. In lieu of the 4% of aggregate debit items calculation, he is required to maintain the \$100,000.

One of the benefits of the alternative is that it enables a broker-dealer to take smaller haircuts on inventory positions, thereby allowing him greater flexibility in market making, underwriting and firm trading. Many introducing brokers engage in these activities and therefore could elect the alternative. Under the proposal, the Commission has not changed the \$100,000 minimum for introducing brokers electing the alternative, in part, because there is no other capital constraint on the level of an introducing broker's business. The public is invited to respond to the problem of minimum capital requirements for introducing brokers. See Part IV, *infra*, question 7. Other brokers or dealers who have elected to operate pursuant to an exemption from Rule 15c3-3, as at present, will not be able to elect the alternative under the proposal.

or unduly burdensome to determine which fail to receive contracts and fail to deliver contracts relate to proprietary accounts or customers accounts on a transaction by transaction basis. That release provided that a conservative allocation should be made to accomplish maximum protection for customers. If such an allocation is used with regard to the foregoing items, the broker or dealer should be able to demonstrate that the result so obtained regarding designations of customer and proprietary positions would be comparable to those which would be obtained if the respective positions had been developed without the use of an allocation.

When the alternative method of computing net capital was adopted, the Commission authorized conservative interpretations regarding Reserve Formula items where an allocation procedure was used. Fails to receive not allocable to the broker's or dealer's proprietary long positions and fails to deliver not allocable to the broker's or dealer's proprietary short positions were presumed to be customer-related and thus includable in the Reserve Formula. These interpretations were intended to insure that customer related fails would be provided for through a Reserve Formula deposit or increased capital requirements.

Before the Rule was amended in 1975, segments of the securities industry had argued that transactions in which corporate and municipal bond fails to deliver are paired off in the Reserve Formula with fails to receive (for instance, when a broker or dealer makes a simultaneous purchase and sale of a security, and the transaction has not yet settled) should not be included in either side of the Reserve Formula since not related to customer activity. That view was rejected in large part because of the experimental nature of the alternative concept and the Commission's desire to test its operation.

That situation may no longer be justifiable. Accordingly, the interpretation should be relaxed where a broker or dealer can demonstrate that it has full possession or control of all customer fully paid and excess margin securities as required under Rule 15c3-3. Moreover, where no customers of the calculating broker or dealer are involved in a particular offsetting fail transaction, the only risk to customers is where the broker or dealer on the other side of the fail to deliver must redeliver to its customer. This is basically a credit risk which should more properly be measured by a charge on "aged" fails to deliver.

At present, paragraph (c)(2)(ix) of the net capital rule requires a capital charge

based on the haircuts applicable to the securities underlying the contract for "aged" fail to deliver contracts. A fail becomes "aged" when it has been outstanding 11 business days or longer (except in the case of municipal securities, where the fail must be outstanding 21 business days or longer).

Since elimination of these fails from the Reserve Formula would exclude from net capital consideration a firm's collection risk on fails to deliver until these items became "aged," the Commission herein proposes a new amendment. A broker or dealer may elect a procedure whereby he may exclude from the Reserve Formula both fails to deliver and fails to receive which allocate to one another, so long as the broker or dealer for purposes of paragraph (c)(2)(ix) treats the fail to deliver as "aged" three business days after settlement date of the transaction on all fails except fails related to municipal securities. On fails related to municipals, the aging period would be 11 business days under the proposed amendments. This change would not require significant regulatory capital to support normal street side clearance which settles routinely. The proposed approach would provide a reduction in required net capital. At the same time, an appropriate capital reserve would be imposed on a timely basis to insure customer protection. The broker or dealer must still, of course, be able to demonstrate full possession or control of customer fully paid and excess margin securities.

If the broker or dealer chooses, at his election, to place these "paired" fails in the Reserve Formula, the percentage of net capital required for these fail to deliver items remains the present 4%. Under this approach, the Rule would in addition still require a capital charge for fails to deliver more than 11 business days old (and in the case of municipals, more than 21 business days). A broker-dealer electing either alternative, of course, must treat all fails consistently and continuously in accordance with his election. Under either, the Rule assures protection of any customers which may be involved by providing incentives for the broker-dealer to resolve these items.¹³

E

In C.O.D. transactions with customers, money and securities change hand simultaneously at settlement. C.O.D. transactions with customers (Primarily institutions) as a practical and economic

matter may be broken out into receipt vs. payment and delivery vs. payment items which are included in Reserve Formula Items 1 and 10 respectively. However, in either a sale or purchase of securities on a C.O.D. basis, the only financial exposure of a firm to its customer is the "net-equity" on one side as a result of market movement before completion of the transaction. Hence it appears that the Rule, by requiring equal to at least 4% of the amount of such transactions, may require more liquid capital than necessary to protect against the risks in C.O.D. transactions.

The Commission proposes to amend the Rule to allow the broker or dealer to make a choice similar to the alternative presented above related to fails to deliver. The broker-dealer may exclude C.O.D. transactions from the Reserve Formula, treat the security which is the subject of the C.O.D. transaction as if it were a proprietary position and take the appropriate haircut for that security (this would occur as of settlement date, however, with no period allowed for "aging"). Since many C.O.D. transactions currently appear to involve debt securities (government or municipal securities), the haircut on the underlying securities normally may be less than the 7% early warning threshold which currently would be required by including such items in the Reserve Formula. Alternatively, a broker or dealer choosing to place these items in the Reserve Formula would continue to have the 4% capital requirement on these items.

III. Solicitation of Comments on the Report of the Securities Industry Association Capital Committee

As noted earlier in the release, the Capital Committee of the SIA has made certain recommendations to the Commission which would alter both the net capital rule and Rule 15c3-3. Some of those recommendations are reflected in the amendments proposed above; others relating to stock loans and non-customer securities in firm bank loan, have been ongoing subjects of staff study and should before the end of the year result in public releases. With respect to the four remaining recommendations below, the Commission has insufficient data to make a proper evaluation. The Commission requests comment to assist it in determining their merit. They are:

(1) The value of certain illiquid assets (specifically, certain unsecured receivables and exchange memberships, as described below) now deducted from net worth in computing net capital should no longer be required to be deducted.

(2) Delivery vs. payment and receipt vs. payment accounts (C.O.D. accounts)

should be excluded from the Reserve Formula, and only the customer equity in an unsettled transaction should be included as a credit (cash item) in the Reserve Formula.

(3) The Commission should reduce to 15% the haircut on preferred stocks under the alternative, or permit its inclusion in paragraph (f)(3)(ii) of the Rule if the inclusion would result in a smaller deduction from net worth than that prescribed by paragraph (c)(2)(vi)(H) of the Rule.

(4) Where a firm short position is allocated to a customer debit, both sides should be excluded from the Reserve Formula.

A

The SIA Report points out that a substantial amount of a firm's non-collateralized receivables are considered non-allowable assets for purposes of computing net capital and that certain receivables due from other brokers and dealers (floor brokerage and other commissions receivable) are allowable assets for a certain time after they arise. The SIA recommends that all receivables from brokers and dealers should be allowable assets on the theory that all brokers and dealers are subject to the Commission's financial responsibility rules and should therefore be able to pay promptly.

The SIA also recommends that receivables related to fees for investment banking and other services which are due from highly rated, financially sound corporations present no greater risk than debt instruments issued by those corporations and should be accorded similar treatment for net capital purposes. Related to these issues, the SIA proposes that receivables against which the broker or dealer has accrued taxes should be allowed to the extent of the accrued tax.

Finally, the SIA report recommends that a firm should be allowed to include the value of exchange memberships in computing net capital. It argues that the memberships are readily liquid, and an appropriate haircut could be devised to compensate for fluctuations in value.

The Commission notes that these proposals go to the very heart of the liquidity concept of the Rule, which is that a broker or dealer must always maintain sufficient liquid assets to satisfy promptly customer demands. With certain limited exceptions, unsecured receivables have not been treated as readily convertible into cash because they may not be readily collectable on the initiative of the broker or dealer. If the broker's or dealer's debtor disputes the claim, or simply does not pay, court action and its attendant delays may be the only recourse. Thus customers may be in the position of

¹³ Under either alternative, the staff responses in a letter to Wien & Co., Inc., dated July 15, 1976, and in similar letters to other brokers or dealers would no longer be applicable.

waiting for the broker or dealer to liquidate claims against others. Furthermore, it should be noted, there are no objective standards for classifying which receivables should be regarded as collectable and how they should be valued. With respect to exchange memberships, though in most cases they may be readily sold at some price, because of the priorities set forth in exchange rules,¹⁴ it is not certain what amount of the proceeds would benefit customers.

The Commission requests comment from the public regarding these proposals. Specifically, interested persons are encouraged to address the problem of how to determine which unsecured receivables should be treated as readily convertible into cash.

B

The SIA proposes removing both sales and purchases on a C.O.D. basis from the Reserve Formula (both are now included in Reserve Formula Items 1 and 10). The net equity, which would be determined by computing the sum which the firm would owe a customer on the date of a Reserve Formula calculation, would be entered as a credit in the Reserve Formula.

Elimination of this item from the debits distorts the initial intention of the alternative, which was to utilize the aggregate dollar amount of firm assets which have as their source transactions with customers as the standard for determining the maximum permissible level of the broker's or dealer's activity. In this regard, the impact of the proposal is difficult to measure primarily because data relative to C.O.D. transactions is not segregable on FOCUS or other reports. The Commission understands that many large institutions purchase securities on a C.O.D. basis, and that some broker-dealers use C.O.D. transactions almost exclusively. Excluding C.O.D. transactions from the Reserve Formula theoretically could reduce the capital requirement of a firm doing primarily this type of business to the \$100,000 minimum.

Moreover, the Commission notes that, since a broker or dealer could allow under Regulation T a C.O.D. account to remain open for as long as 35 days, the broker or dealer may be taking a significant credit risk which is unmeasured by the net capital rule. Furthermore, because firms under the alternative are required to compute their Reserve Formula only once a week, there is no assurance that reserves will be set aside to cover transactions entered into between computation dates. Finally, it should be noted that a

credit entry in the Reserve Formula under Rule 15c3-3 may actually impose a greater financing burden on a firm than the 4% minimum capital requirement based on the contra debit item, since any excess of credits caused by the inclusion of net equity in C.O.D. accounts over aggregate debit items (reduced by 3%) would be required to be placed in the Reserve Bank Account. The broker or dealer then may have greater financing needs and be forced to borrow to meet the deposit requirement.

The Commission requests information from the public in assisting it to determine the potential impact of this proposal and the ability of firms to isolate C.O.D. transactions from their other cash and margin transactions. Commentators are also asked to respond to the issue of evaluating capital requirements for firms executing orders on behalf of institutions dealing in large blocks of securities.

C

Under paragraph (c)(2)(vi)(H) of the Rule, the haircut on preferred stock is 20% of the market value of the greater of the long or short position. Under paragraph (f)(3)(ii) of the Rule, which applies to firms utilizing the alternative, the haircut on securities other than those specifically enumerated is reduced to 15%. Preferred stock is one of the classes of securities which is ineligible for the 15% haircut. The SIA argues that the imposition of a 20% haircut on preferred stock under the alternative does not appear to be reasonably related to the risks involved with positions in such securities and may hinder market making activities in this area.

The SIA proposal does not address the fact that the prices of preferred stocks tend to move in tandem with those of debt instruments and is thus influenced by other factors than those affecting common stocks. The present haircuts for debt securities are based on historical data of the fluctuations of these instruments over a long period of time. That same kind of record should be made for preferred stock. Moreover, like corporate debt securities, preferred stocks are rated by statistical rating services. It may be appropriate to require a greater haircut for those lower-rated preferred stocks than for higher-rated stocks. The Commission requests any information which may assist in the resolution of this issue.

When a firm sells short, as principal, to a customer, both sides of the transaction are included in the Reserve Formula, (i.e., the customer debit and the market value of the short proprietary position). However, when the firm buys as principal from a selling customer who is short and has not resold, the customer

credit and related debit can be excluded from the Reserve Formula. The SIA recommends that a firm short position which allocates to a customer debit should be treated in the same manner as a firm long position which allocates to a customer credit.

This recommendation, however, appears to disregard the fact that the broker or dealer who has sold short as principal owes the customer securities and may be required to borrow in order to meet his delivery requirement under Rule 15c3-3. The public is invited to respond to the SIA's proposal and suggest any other possible solution to the difficulty pointed out by the Commission.

IV. Solicitation of Comments on Basic Concepts of Financial Responsibility Rules

The Commission adopted its uniform net capital rule over five years ago and the customer protection rule (Rule 15c3-3) nearly eight years ago. In promulgating these rules, the Commission sought to protect the investing public from the risk of dealing with thinly capitalized and operationally unsound brokers and dealers, while, at the same time, avoiding the imposition of unduly onerous capital requirements and burdensome operational restrictions. As noted above, current industry conditions and recent improvements to back office operations systems suggest it may now be appropriate to revisit the basic concepts.

The Commission therefore, welcomes the participation of the public in this important effort. This release contains questions about a number of areas of particular concern to the Commission. It is not necessary, however, that comments be limited to these questions. Commentators should feel free to provide any reasonable, constructive suggestion or comment regarding any aspect of the Commission's financial responsibility program.

Areas of Inquiry

1. In Securities Exchange Act Release No. 11497, (June 26, 1975) announcing amendments to the net capital rule, the Commission indicated that "[u]ltimately, it may be possible for Rule 15c3-3 in some form to replace the liquidity requirements of the net capital rule and become the primary source of protection of customer assets held by the broker or dealer." The Commission is considering whether this statement has continued validity in today's market environment.

(a) Do you believe that the net capital rule can be substantially revised or even eliminated so as to place greater emphasis on the other financial responsibility rules, particularly Rule 15c3-3?

¹⁴ See e.g., Article XI, Section 3 of the New York Stock Exchange Constitution.

(b) If so, please explain how and what the effect would be on brokers and dealers and their customers. Would it be necessary to strengthen these rules, particularly Rule 15c3-3, to ensure that customer funds are not deployed in unsafe areas of a firm's business, other than by requiring daily Reserve Formula computations under Rule 15c3-3?

(c) If not, can Rule 15c3-1 be so structured as to make the computation of net capital less complex? If so, please explain.

(d) Can the customer protection rules, other than the net capital rule, be structured to make such rules less complex? If so, how can this be accomplished?

2. As illustrated in Tables 1 and 2, the securities industry is undergoing substantial change. Broker-dealers deploy their capital in new and different areas to enhance their competitive positions and provide new services to investors and corporate issuers.

(a) In what ways, if any, have current financial responsibility requirements, including the net capital rule, altered firms' investment decisions?

(b) Are current regulatory capital standards adaptable to the changing capital needs of a firm? If not, please explain.

3. The ability of small or regional broker-dealers to raise investment capital may differ from that of larger firms or those which are national in scope.

(a) To what extent, if any, do present financial responsibility rules affect the ability of these broker-dealers to raise capital? In particular, can the rules be made less burdensome to smaller broker-dealers without substantially reducing customer protection?

(b) What additional cost burdens and/or financial risks does the quest for "regulatory capital" (capital required to satisfy regulatory requirements with arguably little or no business justification) impose on small broker-dealers?

4. A number of securities firms have formed subsidiaries or affiliates whose product lines fall outside the securities business and beyond the regulatory reach of the Commission. To what extent, if any, have financial responsibility requirements, including the net capital rule, created incentives to diversify into activities unrelated to the securities business? Please explain.

5. The alternative represented a new concept for the determination of net capital requirements. The aggregate indebtedness standard measures a firm's capital requirements based on its liabilities. The alternative changes this concept considerably by making the capital requirement contingent upon the

level of a firm's customer related assets, in the form of secured receivables. The alternative net capital approach integrates the net capital requirements with the custodial and reserve requirements of Rule 15c3-3 and places greater reliance for the protection of customer funds and securities on Rule 15c3-3. This corresponds to the policy of Rule 15c3-3 and the Securities Investor Protection Act of 1970, both of which exclude other brokers and dealers from their protective provisions.

As the Commission stated in Release 34-11497 when it adopted the alternative:

The Commission believes the alternative approach will effectively create and maintain an environment of customer protection while enabling the securities industry to fulfill its function of capital raising and the maintenance of a liquid secondary market by:

1. Acting as an effective early warning device to provide reasonable assurance against loss of customer assets through a logical interface with other operation standards and existing surveillance, reporting and examination aspects of the securities industry regulatory framework;

2. Avoiding the inefficient and costly commitment of capital within the securities industry where such a commitment is not necessary for customer protection;

3. Eliminating, to the extent possible and consistent with the objective of customer protection, competitive restraints on the securities industry's ability to compete effectively with other diversified financial institutions;

4. Making the capital structures of brokers and dealers as well as their investment and operating policies more understandable to lending institutions and other suppliers of capital and to the public; and

5. Providing some reasonable and finite limitation on broker-dealer expansion to minimize the possibility of customer loss and the possibility that the SIPC Fund will have to be utilized to protect customers.

The Commission is largely satisfied with the operational experience of the alternative since its adoption five years ago. Consequently, the Commission would like to explore the possibility of supplanting the traditional aggregate indebtedness test with the alternative. To do so might require the elimination of the exemptive provisions to Rule 15c3-3 found in paragraph (k)(2)(i) of that rule (and perhaps all of its exemptive provisions) and other adjustments.

(a) Do you believe that Rule 15c3-1 and Rule 15c3-3 could be integrated into a single less complex financial responsibility requirement? If so, how could this best be accomplished?

(b) Do you believe that the alternative can effectively replace the traditional aggregate indebtedness test for brokers and dealers? Please explain.

(c) Should all brokers and dealers be required to follow the alternative and,

as a result, also be subject to Rule 15c3-3? Please explain.

(d) Have the objectives voiced by the Commission in the release quoted above been met? Will they continue to be met if the entire industry is subject to the alternative? Please explain.

(e) The alternative measures a broker-dealer's capital requirement in terms of its customer related business. However, a broker-dealer has many obligations running to other brokers and dealers which in turn have customers. Would requiring all firms to comply with the alternative undermine the interdependence of the broker-dealer industry by inadequately protecting broker-dealers who do a large business outside of their customer activity? Please explain.

6. The alternative net capital provisions sought to enhance the ability of brokers and dealers to engage in market making. It does this primarily by modifying the haircuts from those applicable in the basic net capital rule. It has, however, been suggested that even more flexibility might be appropriate.

(a) Does the alternative net capital provision measure market risk in any unreasonable manner and thus require more net capital of market makers with no customer exposure than necessary to ensure the liquidity of a broker or dealer?

(b) Should the haircut provisions of the alternative and basic net capital requirements be made uniform? Please explain.

(c) What standards of financial responsibility are appropriate for market makers? Please explain.

7. The liquidity concept of the net capital rule is premised on the policy that a broker or dealer must maintain a cushion of cash or assets readily convertible into cash in order to meet promptly the demands of customers. It may be unnecessary, however, to require such strict standards of liquidity with respect to firms who do not carry customer accounts and who do not handle customer funds or securities.

(a) What, if any, financial responsibility standards are appropriate for brokers or dealers who do not handle customer funds or securities? Please explain.

(b) What is the feasibility of substituting for the net capital rule at net worth test with a minimum net worth computed in accordance with generally accepted accounting principles (the Commission suggests a \$25,000 figure) for brokers and dealers who do not handle customer funds and securities? Please explain.

8. In the last four years, brokers and

dealers have become increasingly involved in government financial instruments, including T-bills and GNMA certificates. Not only do they act as instruments as a means to speculate on interest rates or to hedge other positions or, in the case of repurchase agreements, to borrow cash for short periods of time. The staff has issued interpretations dealing with some of these matters. It may be necessary, however, to examine brokers' and dealers' involvement in this entire area to determine if there is need for more specific requirements than those now in effect.

(a) What rules, if any, should the Commission adopt to protect the liquidity of a broker-dealer from the risks of dealing in the financial instruments market?

(b) What amendments, if any, should be made to the net capital rule to protect the liquidity of a broker-dealer from the risks of dealing in the financial instruments market?

(c) What risks, if any, does a broker-dealer experience because of customer transactions in the financial instruments futures or forward markets which are not now provided for by the net capital rule? How should the net capital rule treat those risks?

(d) What modifications, if any, should be made to Rule 15c3-3 in connection with brokers' and dealers' or customers' transactions in financial instruments?

9. The net capital rule requires that in computing net capital several deductions from net worth of certain specified percentages of the market values of marketable securities ("haircuts") be taken. Some have contended that the haircuts for certain securities are unwarranted.

(a) Do you believe that any of the percentage deductions are unwarranted? If so, which are unwarranted and what should be the appropriate deduction? Please supply any data or explanation which may support such changes.

(b) The net capital rule refers to "nationally recognized statistical rating organizations" in determining lower haircut categories for certain assets. See Rule 15c3-3(c)(2)(vi)(E) and (F). Are these categories appropriate? Are there other means for distinguishing between investment grade and speculative securities for purposes of reduced haircuts? Should ratings by other organizations and institutions be considered?

10. In the recent past, because of market volume and interest rates, capital requirements for firms electing the alternative have substantially increased and then suddenly declined. Some firms have met this additional capital requirements by subordinated

borrowing in accordance with Appendix D of Rule 15c3-1. These loans cannot be repaid within a period of one year and therefore must be maintained even after a firm's capital requirement is reduced. Because of the one year lock-in requirement, these loans frequently prove to be an expensive solution to a perhaps short-term problem.

(a) Is it feasible to modify Appendix D (relating to Satisfactory Subordination Agreements) to allow subordinated borrowings to meet increases in capital requirements based on dramatic increases in customer business, which borrowings may be prepaid within a year if such business returns to normal levels? Please explain.

(b) What, if any, limitations should be placed on such prepayments?

11. The net capital rule requires a deduction from net worth for the inefficiencies or operational defaults of a broker or dealer. For example, a broker or dealer must deduct from net worth the market value of all short securities differences unresolved for seven business days after discovery. In requiring these deductions, the Rule assumes a 100% loss in these unresolved accounts pending their resolution.

(a) Are all of the operational charges warranted? If not, which are not and why not?

(b) Is there a solution other than treating operational inefficiencies as deductions of a broker or dealer? Please explain.

12. The Commission, in its *Study of Unsafe and Unsound Practices of Brokers and Dealers*¹⁵ made the following observations regarding the capitalization of the securities industry at that time:

The defects fall into several broad categories. First and foremost is the inadequacy and impermanence of capital, and, in some cases, the injudicious employment of such capital as does exist.¹⁶

... It should be noted at the outset that protections provided by net capital requirements with a liquidity focus for meeting current obligations are not a substitute for the need for having sufficient long-term capital, in the absence of which the underlying structure of broker-dealers may be unsatisfactory.¹⁷

The Commission at that time was concerned about the extreme difficulties experienced by the industry during the period 1968-1970. Since that time, there has been a tightening of Commission oversight and administration of the capital rules. The self-regulatory

organizations have, during this same time period, also considerably tightened their surveillance of their members.

(a) Aside from statutory compulsion, is there any reason that the Commission should impose financial responsibility rules at all?

(b) If the Commission should impose financial responsibility rules, are the present rules, i.e., Rules 15c3-1 and 15c3-3, and Rules 8c-1 and 15c2-1, the appropriate rules? Should any of these rules be merged, modified or done away with completely? Are these rules realistic in terms of today's market environment?

(c) If the Commission were to substantially review its rules, or substantially reduce the scope of its rules, what safeguards would exist to insure a sound and adequately capitalized broker-dealer industry?

(d) Are there any other concepts which the Commission should consider which are appropriate in determining the financial responsibility of brokers and dealers?

Statutory Basis and Competitive Considerations

The Securities and Exchange Commission, acting pursuant to the Securities Exchange Act of 1934 and particularly Sections 15(c)(3), 17(a) and 23 thereof (15 U.S.C. 78o(c)(3), 78q(a) and 78u), hereby proposes for public comment amendments to Rules 15c3-1, 15c3-3a, and 17a-11, which would affect the computation of net capital for brokers and dealers, all as set forth below.

The rules as proposed, if adopted, will probably have an impact on competition. For the most part, firms computing under the alternative net capital rule would have lower net capital requirements; furthermore, more firms would be able to avail themselves of the alternative and its simplified method of computation. These amendments may therefore give firms eligible for the alternative some competitive advantage over firms required to calculate net capital according to the traditional aggregate indebtedness rule, giving them greater leeway to expand their business in relations to their capital. Lowering the entry level for the election of the alternative to a certain extent ameliorates this situation, and the Commission intends to study the feasibility of further easing restrictions for election of the alternative.

The goals of the Commission in this respect are to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers and to provide a regulatory environment that permits an efficient

¹⁵ Study of Unsafe and Unsound Practices of Brokers and Dealers 92d Congress, 1st Sess., House Doc. No. 92-231 December, 1971).

¹⁶ *Id.*, p. 11.

¹⁷ *Id.*, p. 55.

deployment of scarce industry capital and encouraging diversification while at the same time assuring investors that their funds and securities are protected against financial instability and operational weaknesses of brokers or dealers. The Commission, therefore, specifically solicits comment on the question of competitive impact and how the benefits and/or burdens imposed by this may be more evenly distributed.

Text of Proposed Amendments

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

Note.—The text of the following proposed amendments uses arrows ► ◀ to indicate additions.

It is proposed to amend 17 CFR 240 as follows:

§ 240.15c3-1 [Amended]

1. By amending paragraphs (a), (e), (f)(1)(i) and (ii), (f)(2) and deleting paragraph (g) of § 240.15c3-1 as follows: § 240.15c3-1 Net capital requirements for brokers or dealers.

(a) No broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 1500 percent of his net capital, except as otherwise limited by the provisions of paragraph (a)(1), or, in the case of a broker or dealer electing to operate pursuant to paragraph (f) of this section, no broker or dealer shall permit his net capital to be less than > the sum of the percentages prescribed by that paragraph of debit items < computed in accordance with 17 CFR 240.15c3-3a or, if registered as a futures commission merchant, 4 percent of the funds required to be * * *

(e) *Limitation on withdrawal of equity capital.* No equity capital of the broker or dealer or a subsidiary or affiliate consolidated pursuant to Appendix C (17 CFR 250.15c3-1c) whether in the form of capital contributions by partners (excluding securities in the securities accounts of partners and balances in limited partners' capital accounts in excess of their stated capital contributions), par or stated value of capital stock, paid-in capital in excess of par, retained earnings or other capital accounts, may be withdrawn by action of a stock holder or partner, or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, sole proprietor or employee if, after giving effect thereto and to any other such withdrawals, advances or loans and any Payments of Payment Obligations (as defined in

Appendix D) (17 CFR 240.15c3-1D) under satisfactory subordination agreements which are scheduled to occur within six months following such withdrawal, advance or loan either aggregate indebtedness of any of the consolidated entities exceeds 1000 percent of its net capital or its net capital would fail to equal 120 percent of the minimum dollar amount required thereby or would be less than > 175 percent of the sum of the percentages prescribed by paragraph (f) of 17 CFR 240.15c3-1 of debit items < computed in accordance with 17 CFR 240.15c3-3a, or, if registered as a futures * * *

(f) *Alternative net capital requirement.* (1)(i) A broker or dealer is not exempt from the provisions of 17 CFR 240.15c3-3 under the Securities Exchange Act of 1934 pursuant to paragraph (k)(1) or (k)(2)(i) may elect not to be subject to the limitations of paragraph (a) of this section respecting aggregate indebtedness as defined in paragraph (c)(1) of this section and certain deductions provided for in paragraph (c)(2) of this section. *Provided,* That in order to qualify to operate under this paragraph (f), such broker or dealer shall at all times maintain net capital equal to the greater of > 3 percent of debit item 10a (relating to debit balances in margin accounts) of the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3-3, 17 CFR 240.15c3-3a) plus 4 percent of the total of the remainder of the debit items of such formula or \$75,000 < or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater, and shall notify the Examining Authority for such broker or dealer and the Regional Office of the Commission in which the broker or dealer has its principal place of business, in writing, of its election to operate under this provision. Once a broker or dealer has determined to operate pursuant to this paragraph (f), he shall continue to do so unless a change is approved upon application to the Commission. > A broker or dealer who claims an exemption from Rule 15c3-3 by virtue of paragraph (k)(2)(ii) of that rule shall at all times maintain a net capital of not less than \$100,000. If the electing broker or dealer chooses to exclude fails to deliver and fails to receive from the Rule 15c3-3 Reserve Formula in accordance with Note F thereto, such fails to deliver shall be considered "aged" three business days after settlement date except for fails to deliver related to municipal securities, which shall be considered "aged" after 11 business days.

The electing broker or dealer must charge its net capital with the deduction prescribed by paragraph (c)(2)(ix) for such aged fails. <

(ii) In the case of a municipal securities broker as defined in section 3(a)(31) of the Securities Exchange Act of 1934, who is not exempt from the provisions of 17 CFR 240.15c3-3 under the Securities Exchange Act of 1934 pursuant to paragraph (k)(2) or (k)(2)(i), and who effects transactions only on a payment versus delivery basis with other brokers or dealers or municipal securities brokers or municipal securities dealers, and who does not hold funds or securities for, or owe money or securities to, customers and does not otherwise carry accounts of, or for, customers, in order to qualify to operate under this paragraph (f) such municipal securities broker shall at all times maintain net capital equal to the great of ► 3 percent of debit item 10a (relating to debit balances in customers' margin accounts) of the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3-3, 17 CFR 240.15c3-3a) plus 4 percent of the total of the remainder of the debit items of such formula or \$25,000. ◀ *Provided,* That in order to qualify to operate under this paragraph (f), such municipal securities broker shall notify the Examining Authority for such broker or dealer and the Regional Office of the Commission in which the broker or dealer has its principal place of business, in writing, of its election to operate under this provision. Once a municipal securities broker has determined to operate pursuant to this paragraph (f), he shall continue to do so unless a change in such election is approved upon application to the Commission. ► If the electing broker or dealer chooses to exclude fails to deliver and fails to receive from the Rule 15c3-3 Reserve Formula in accordance with Note F thereto, such fails to deliver shall be considered "aged" three business days after settlement date except for fails to deliver related to municipal securities, which shall be considered "aged" after 11 business days. The electing broker or dealer must charge its net capital with the deduction prescribed by paragraph (c)(2)(ix) for such aged fails. ◀

(2) In the case of a broker or dealer who has consolidated a subsidiary pursuant to Appendix C (17 CFR 240.15c3-1c) such broker's or dealer's minimum net capital requirements shall be ► the sum of the greater of 3 percent of debit item 10a (relating to debit balances in customers' margin accounts) of the Formula for Determination of

Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3-3, 17 CFR 240.15c3-3a) plus 4 percent of the total of the remainder of the debit items of such formula or \$75,000, ◀ or, if the parent is registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, and the total of each consolidated broker or dealer subsidiary's minimum net capital requirements. The minimum net capital requirements of a subsidiary electing to operate pursuant to paragraph (f) of this section shall be ▶ the greater of 3 percent of debit item 10a (relating to debit balances in customers's margin accounts) of the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3-3, 17 CFR 240.15c3-3a) plus 4 percent of the total of the remainder of the debit items of such formula or \$75,000, ◀ or, registered as a futures * * *

(g) [deleted]

2. By amending paragraphs (b)(6)(iii), (b)(7), (b)(8)(i), (b)(10)(ii)(B), (c)(2) and (c)(5) of § 240.15c3-3-1d as follows:

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

* * * * *

(b) * * *
(6) * * *

(iii) The secured demand note agreement may also provide that, in lieu of the procedures specified in the provisions required by paragraph (b)(6)(ii) of this section, the lender with the prior written consent of the broker or dealer and the Examining Authority for the broker or dealer may reduce the unpaid principal amount of the secured demand note. *Provided*, That after giving effect to such reduction the aggregate indebtedness of the broker or dealer would not exceed 1000 percent of its net capital or, in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3-1, net capital would not be less than ▶ 175 percent of the sum of the percentages prescribed by that paragraph ◀ of debit items computed in accordance with 17 CFR 240.15c3-3a, or, if registered as a * * *

(7) *Permissive prepayments*. A broker or dealer at its option but not at the option of the lender, may, if the subordination agreement so provides, make a Payment of all or any portion of the Payment Obligation thereunder prior to the scheduled maturity date of such Payment Obligation (hereinafter referred to as a "Prepayment"), but in no

event may any Prepayment be made before the expiration of one year from the date such subordination agreement became effective; *Provided, however*, That the foregoing restriction shall not apply to temporary subordination agreements which comply with the provisions of paragraph (c)(5) of this Appendix D. No Prepayment shall be made if, after giving effect thereto (and to all Payments of Payment Obligations under any other subordinated agreements then outstanding the maturity or 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 1000 percent of its net capital or its net capital would be less than 120 percent 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 ▶ 175 percent of the sum of the percentages prescribed by that paragraph of debit items ◀ computed in accordance with 17 CFR 240.15c3-3a or, if registered as a * * *

(8)(i) The Payment Obligation of the broker or dealer in respect of any subordination agreement shall be suspended and shall not mature if, after giving effect to Payment of such Payment Obligation (and to all Payments of Payment Obligations of such broker or dealer under any other subordination agreement(s) then outstanding which are scheduled to mature on or before such Payment Obligation) either (A) the aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital or, in the case of a broker or dealer operating pursuant to paragraph (f) of 17 CFR 240.15c3-1, its net capital would be less than ▶ 150 percent of the sum of the percentages prescribed by that paragraph of debit items ◀ computed in accordance with 17 CFR 240.15c3-3a or, if registered * * *

(10) * * *

(ii) Notwithstanding the provisions of paragraph (b)(8) of this Appendix, a subordination agreement may provide that, if liquidation of the business of the broker or dealer has not already commenced, the Payment Obligation of the broker or dealer shall mature, together with accrued interest or

compensation, upon the occurrence of an Event of Default (as hereinafter defined). Such agreement may also provide that, if liquidation of the business of the broker or dealer has not already commenced, the rapid and orderly liquidation of the business of the broker or dealer shall then commence upon the happening of an Event of Default. Any subordination agreement which so provides for maturity of the Payment Obligation upon the occurrence of an Event of Default shall also provide that the date on which such Event of Default occurs shall, if liquidation of the broker or dealer has not already commenced, be the date on which the Payment Obligations of the broker or dealer with respect to all other subordination agreements then outstanding shall mature but the rights of the respective lenders to receive Payment, together with accrued interest or compensation, shall remain subordinate as required by the provisions of this Appendix (D). Events of Default which may be included in a subordination agreement shall be limited to:

(A) * * *

(B) The aggregate indebtedness of the broker or dealer exceeding 1500 percent of its net capital or, in the case of a broker or dealer which has elected to operate under paragraph (f) of 17 CFR 240.15c3-1, its net capital computed in accordance therewith is less than ▶ the sum of the percentages prescribed by that paragraph of debit items ◀ computed in accordance with 17 CFR 240.15c3-3a or, if registered * * *

(c) * * *

(2) *Notice of Maturity or Accelerated Maturity*. Every broker or dealer shall immediately notify the Examining Authority for such broker or dealer if, after giving effect to all Payments of Payment Obligations under subordination agreements then outstanding which are then due or mature within the following six months without reference to any projected profit or loss of the broker or dealer either the aggregate indebtedness of the broker or dealer would exceed 1200 percent of its net capital or its net capital would be less than 120 percent of the minimum dollar amount required by 17 CFR 240.15c3-1, or, in the case of a broker or dealer who is operating pursuant to paragraph (f) of 17 CFR 240.15c3-1, its net capital would be less than ▶ 150 percent of the sum of the percentages prescribed by that paragraph of debit items ◀ computed in accordance with 17 CFR 240.15c3-3a or, if registered * * *

(5) 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. *Provided*, That 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 (i) the aggregate indebtedness of the broker or dealer exceeds 1,000 percent of its net capital or its net capital is less than 120 percent of the minimum dollar amount required by 17 CFR 240.15c3-1, or (ii) 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 175 percent of the sum of the percentages prescribed by that paragraph of debit items computed in accordance with 17 CFR 240.15c3-3a, or, if registered as

* * * * *

3. By amending items 10, 12 and 13 and Notes E and F and adding Note G of § 240.15c3-3a as follows:

§ 240.15c3-3a Exhibit A—formula for determination of reserve requirement of brokers and dealers under § 240.15c3-3.

* * * * *

	Credits	Debits
10a. Debit balances in customers' margin accounts excluding unsecured accounts and accounts doubtful of collection. (See Note E).	XXXX	
10b. Debit balances in customers' cash accounts excluding unsecured accounts and accounts doubtful of collection. (See Note E).		XXXX
11. Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver.		XXXX
12. Failed to deliver of customers' securities not older than 30 calendar days. (See Note F).		XXXX
13. Margin required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in customer accounts. (See Note G).		XXXX
Total credits	XXXX	
Total debits		XXXX
14. Excess of total credits (sum of items 1-9) over total debits (sum of items 10-13) required to be on deposit in the "Reserve Bank Account" (15c3-3(c)). If the computation is made monthly as permitted by this rule, the deposit shall be not less than 105 percent of the excess of total credits over total debits.		XXXX

* * * * *
 Note E.
 * * * * *

►(4) A broker or dealer operating pursuant to paragraph (f) of Rule 15c3-1 (17 CFR 240.15c3-1(f)) may exclude C.O.D. transactions from Items 1 and 10 of the Reserve formula if the security underlying the transaction is treated as a proprietary position and given the appropriate haircut prescribed under Rule 15c3-1(c)(2)(vi) (17 CFR 240.15c3-1(c)(2)(vi)). ◀

►Note F. A broker or dealer operating pursuant to paragraph (f) of Rule 15c3-1 (17 CFR 240.15c3-1(f)) which can demonstrate that its possessions and control of customers' securities requirements are met, may make the following election: Fails to deliver not allocable to the broker's or dealer's long positions and fails to receive not allocable to the broker's or dealer's short positions may be excluded from Items 4 and 12 of the Reserve Formula if those fails to deliver allocate to fails to receive. ◀

►Note G. ◀ Item 13 shall include the amount of margin required and on deposit with Options Clearing Corporation to the extent such margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by customers' securities.

4. By amending paragraphs (b)(2) of § 240.17a-11 as follows: § 240.17a-11 Supplemental current financial and operational reports to be made by certain brokers and dealers.

* * * * *
 (b) * * *

(2) If a computation made by a broker or dealer pursuant to paragraph (f) of Rule 15c3-1 (17 CFR 240.15c3-1(f)) shows, at any point during the month, that his net capital is less than 150 percent of the sum of the percentages prescribed by that paragraph of debit items ◀ computed in accordance with 17 CFR 240.15c3-3a, or that his total net capital is less than 120 percent of the minimum net capital required of him, such broker or dealer shall file a report on Part II or Part IIA of Form X-17A-5 (17 CFR 249.617) as determined in accordance with the standards set forth in 17 CFR 240.17a-5(a)(2)(ii) and (a)(2)(iii), within 15 days after the end of each month thereafter until three successive months shall have elapsed during which his net capital is not less than 150 percent of the sum of the percentages prescribed by paragraph (f) of debit items ◀ computed in accordance with 17 CFR 240.15c3-3a

and his total net capital does not fall below 120 percent of the minimum net capital required of him.

* * * * *
 By the Commission.
 October 9, 1980.
 George A. Fitzsimmons,
 Secretary.

17 CFR Part 240

[Release No. 34-17209; File No. S7-856]

Net Capital Requirement for Brokers and Dealers**AGENCY:** Securities and Exchange Commission.**ACTION:** Proposed rule amendments and solicitation of public comments.

SUMMARY: The Commission is proposing amendments to the uniform net capital rule which would increase the percentage deductions from the market value of certain debt securities in the proprietary or other accounts of the broker or dealer which must be made in computing net capital to reflect the recent sharp fluctuations in the market value of these securities. The Commission is also soliciting comments on whether and to what extent these deductions should be reduced by hedging positions in financial futures or securities of a different issuer.

DATE: Comments to be received by January 15, 1981.

ADDRESSES: All comments should be submitted in triplicate and addressed to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. All comments should refer to file No. S7-856 and will be available for public inspection at the Commission's Public Reference Room, 1100 L Street, N.W., Washington, D.C.

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

SUPPLEMENTARY INFORMATION: The uniform net capital rule not only requires a broker or dealer to maintain a minimum net capital the amount of which depends on the nature of its business but also prohibits it from incurring aggregate indebtedness in excess of 1500 percentum of its net capital, as those two terms are defined in the Rule. A broker or dealer electing the alternative method of computing net capital must maintain a minimum net capital equal to the greater of \$100,000 or 4% of aggregate debit items in the formula for Determination of Reserve Requirements for Broker-Dealers.

In computing net capital, a broker or dealer is required to deduct from net worth (net worth as calculated in accordance with generally accepted accounting principles) certain percentages of the market value of all securities carried in its proprietary or

other accounts. These deductions are generally referred to as "haircuts." 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 rating services. In general, the haircuts for debt securities were designed to reflect the historical market fluctuations of each type of instrument.

Recent events in the debt market have led the Commission to question the adequacy of the haircut provisions for debt securities. Interest rates rose to unprecedented heights in the past year, causing precipitous declines in the values of already issued debt instruments. Several broker-dealer firms dealing primarily in municipal securities were forced to liquidate because of the unanticipated sharp movements in debt securities. Moreover, some major broker-dealer firms reportedly suffered large trading losses in debt securities, as did several large national banks.

Data recently provided to the Commission from industry sources tend to confirm doubts as to the adequacy of the present haircut categories. The data were compiled from records accumulated in the ordinary course of business of broker-dealer firms dealing in debt securities. In general, the data covered the period from February 1976 through February 1980, a period of 49 months. In the case of Government securities, daily values were given for three-month, six-month, nine-month and twelve-month treasury bills, and for selected two-year, five-year, ten-year, twenty-year and thirty-year coupon treasury bonds. For corporate bonds, summary price histories were given for representative long-term industrial and utility bonds. For municipals, weekly prices were provided from the BBI municipal index. The data show that the month-end to month-end price movements in most debt securities in the months of January 1977, October 1979, January 1980 and February 1980 were greater than the existing haircuts for the securities. They indicate a need for higher haircuts than the Rule presently provides. Each of the categories is more fully discussed below, as is the question of whether and to what extent the rule should be revised to incorporate various hedging positions.

I. Government Securities**A. Haircut Schedules**

The Rule 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

the market value 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 less than one year to maturity. The deduction for securities having one year but less than three years to maturity is 1%; that for securities having three years but less than five years to maturity is 2%; that for securities five years or more to maturity is 3%. The data submitted to the Commission tend to indicate that these haircuts are inadequate in measuring the risk in carrying the securities, particularly for those securities less than one year to maturity and those five years or more to maturity.

The data show that the majority of monthly changes in market value were greater than the existing haircuts, and that for four months (January 1977, October 1979, January 1980 and February 1980) the month-end to month-end price movements were considerably greater than the existing haircuts. Some examples will help to illustrate the concern. In 26 of the 49 months in the survey, treasury bills maturing in six months moved in price between one-tenth of one percent to over 1% (in February 1980). In October 1979, 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 .1% and 2.51% (in February 1980). In each case, however, the net capital rule required no haircut.

The data for two-year coupons, five-year coupons, ten-year coupons, twenty-year coupons and thirty-year coupons show the same character of discrepancy as securities having one year or less to maturity. For example, in three different months within a six months period, United States Treasury securities 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 is only 3% for these securities.

These figures demonstrate the need to reassess the present haircut category for Government securities.

Based largely on this data, the Commission proposes to alter the haircuts on Government securities in Rule 15c3-1(c)(2)(vi) as follows:

- (A) * * *
- (1) Less than three months to maturity—0% [0%];¹
 - (2) Three months but less than six months to maturity— $\frac{1}{2}$ of 1% [0%];
 - (3) Six months but less than nine months to maturity— $\frac{1}{4}$ of 1% [0%];
 - (4) Nine months but less than one year to maturity— $\frac{3}{8}$ of 1% [0%];

¹ The present haircut is shown in brackets.

(5) One year but less than three years to maturity—1½% [1%];

(6) Three years but less than five years to maturity—3% [2%];

(7) Five years but less than ten years to maturity—4½% [3%];

(8) Ten years but less than 20 years to maturity—5% [3%]; and

(9) 20 years or more to maturity—6% [3%].

While the proposed haircuts are not based on the largest changes in any 30-day period, the Commission believes that they nevertheless represent a more realistic appraisal of the potential movements of Government securities over a 30-day period.

B. Hedges

The present rule assesses deductions only on the net long or net short positions in the fixed categories in subparagraph (A), thereby recognizing certain hedges. In some cases, however, the Rule may not appropriately deal with hedges. For example, the Rule requires no haircut where a broker or dealer is long Government securities one month to maturity and short a Government security 11 months to maturity but requires a haircut of 1% on the short position where the broker or dealer is long a security 11 months to maturity and short a security 13 months to maturity. Furthermore, the Rule requires no haircut on the following positions: a long Government five years to maturity offset by a short Government security, 30 years to maturity. Yet, the data demonstrate that the historical market fluctuations of these two securities are not similar.

To some degree the problem will be lessened by the new haircut categories. But the provisions will still not distinguish adequately between bona fide risk limiting hedges and non-bona fide hedges. The job of precisely measuring hedges is of course a difficult one for the Commission. It is a matter about which experienced traders disagree daily. However, the data provided to the Commission suggest that netting of longs and shorts be allowed where the securities have a relationship by virtue of relatively close maturity dates rather than because fixed in the same haircut category. For short term instruments (less than one year to maturity), the Commission proposes that an appropriate period for netting purposes be no more than three months. For intermediate term instruments, that period will be no more than one year. For long term instruments (those five years or more to maturity), the period will be no more than five years. Hence, the rule, if amended as proposed, would require a haircut only on the net long or

short position for short-term instruments where the long and short positions matured no longer than three months apart. For intermediate-term instruments the netting would be allowed if the instruments matured within one year or less of each other. Long term instruments could be netted if the longs and shorts matured within five years of one another. No netting would otherwise be permitted.

The Commission therefore proposes to amend Rule 15c3-1(c)(2)(vi)(A), as modified by the proposed amendments set forth above, as follows: Long or short positions may be netted as follows:

(j) Long or short positions with maturity dates within one year may be netted against long or short positions with maturity dates within 15 months, but only when such maturity dates are within three months of one another;

(ii) Long or short positions with maturity dates of between one and five years (except as in (j) above) may be netted against long or short positions with maturity dates of between one and six years, but only when such maturity dates are within one year of another;

(iii) Long or short positions with maturity dates of five years or more (except as in (ii) above) may be netted against long or short positions with maturity dates of five years or more, but only when such maturity dates are within five years of one another.

II. Municipal Securities

The haircut provision of the net capital rule which treats with municipal securities specifically divides municipal securities into two general categories (i) any municipal security which has a scheduled maturity at date of issue of 731 days or less and which is issued at par value and pays interest at maturity, or which is issued at a discount, and which is not traded flat or in default as to principal or interest and (ii) any other municipal security which is not traded flat or in default as to principal or interest.

The first category contains seven subcategories. The haircuts range from 0% for those securities having less than 30 days to maturity to 1% for those securities having from 456 to less than 732 days to maturity (hereinafter "short term notes"). The second category has four subcategories which require haircuts ranging from 1% for securities with less than one year to maturity, to 5% for securities with five years or more to maturity.

Although the data supplied to the Commission relating to municipal bonds are not as extensive as that available for Government securities, they show that the existing haircuts in this area are inadequate in relation to the market

fluctuations in the last year. In two months, October 1979 and February 1980, municipal bonds moved in price substantially more than the maximum haircut. In October 1979, bond prices moved 8.58%; in February 1980 they moved 11.05% as a percentage of market value. Based on this data, increased haircuts are being proposed for municipal securities in category (ii) with more than 2 years to maturity.

The Commission does not now have sufficient data to propose any new haircuts for short-term notes in category (i) or for municipal securities with less than two years to maturity in category (ii). The Commission may possibly determine after further analysis that there is no need to change the haircuts at all for these remaining securities. The Commission solicits relevant data and comment as to whether the haircuts for these securities are appropriate.

The haircuts on securities with longer term maturities are proposed to be increased to reflect the recent sharp fluctuations in their market prices. The new proposed Haircut Schedule for municipal securities is as follows:

(B)(ii) In the case of any municipal security other than those specified in subdivision (B)(i), which is not traded flat or in default as to principal or interest, the applicable percentages of the market values on the greater of the long or short position in each of the categories specified below are:

(3) 2 years but less than 5 years to maturity—5 percent; and

(4) Five years or more to maturity—7 percent.

* * * * *

The Commission also solicits comments on two issues that have been the subject of controversy in the past with respect to municipal securities:

(1) Should the haircut provision for municipal securities distinguish between "rated" and "unrated" securities to differentiate between investment grade issues and more speculative issues?

(2) What criteria should be used to determine the market value of municipal securities for net capital and reporting purposes where the securities are the subject of quotations by only the computing broker or dealer?

III. Nonconvertible Debt Securities

Subsection (c)(2)(vi)(F) of the net capital rule requires a deduction in the case of non-convertible debt securities having a fixed interest rate and fixed maturity date and which are rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations, ranging from 1% for those securities with less than one year to maturity to 7% for securities with five years or more to maturity.

The Commission has insufficient data

to make any determination as to appropriate haircuts for securities in this category where the security has less than five years to maturity. The Commission solicits comment on this matter. It appears from the available data, however, that the haircut for long-term debt securities in this category should be raised to 9% rather than the present 7%. The data show that prices of representative issues in this category moved about 30% more than the present haircut in several months of the past year. The new proposed haircut for debt securities in this category will reflect these recent sharp fluctuations in prices.

The proposed new haircut schedule is as follows:

(F) In the case of non-convertible 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 its four highest rating categories by each of at least two of the nationally recognized statistical rating organizations, the applicable percentages of the market values on the greater of the long or short position in each of the categories specified below are:

* * * * *

(6) Five years or more to maturity—9 percent.

IV

Because of the changes in the haircuts for government and municipal securities, it will be necessary to adjust the haircut provision for securities issued by investment companies whose assets are in the form of cash or securities or money market instruments which are described in subparagraph (a)-(C) or (E) of Rule 15c3-1(c)(2)(vi). Subparagraph (D) now requires a haircut of 5% of the market value of the greater of the long or short position. That haircut was based on the highest haircut for municipal securities. Compatible with that approach, the Commission proposes to raise the haircut for those securities in subparagraph (D) to 7%. For securities issued by investment companies whose portfolio consists of the instruments described above and non-convertible debt securities in category (F), the Commission proposes a haircut of 9%. The provision would also be amended to make clear that it applies only to redeemable securities issued by the investment company. The Rule would be amended as follows:

(D) 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 subdivision (A)-(C) above or (E) below, the deduction shall be 7% of the market value of the greater of the long or short position. 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 subdivisions (A)-(C) above or (E) or (F) before, the deduction shall be 9 percent of the market value of the greater of the long or short position.

V. Hedging

Broker-dealers generally do not carry heavy nonhedged positions in debt securities. Often, brokers and dealers have significant positions in instruments which they believe hedge and reduce the market risk in the positions in which they are mainly interested. While not perfect hedges, they are thought to act as buffers to complete speculation. The hedged positions may consist either of positions in securities of the same issuer, positions in financial futures or positions in different issuers. While the Rule, as noted above in the discussion as to Government securities, does take hedges into account to some degree, it has been criticized as being much too conservative.

Much sophisticated analysis has been made of the relationships among the prices of various fixed income securities and interest rate futures. Some believe, for example, that futures contracts may be used not only to hedge the underlying cash instruments but also to crosshedge corporate bonds. The net capital rule, as indicated above, does not recognize any such relationships for purposes of reducing the haircuts, although the Rule does extensively deal with techniques of reducing risks through various hedging devices in listed options trading.

The Commission, in an effort to make its financial responsibility rules compatible to the extent feasible with economic reality, solicits comment on the degree to which the haircut rules should deal with hedges among the instruments described above. From the comments the Commission may be able to develop hedge criteria which are objective, clear and easily determinable for reducing any required haircuts.

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. 78o(c)(3) and 78w(a), the Commission proposes to amend § 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 proposed amendments is necessary in furtherance of the purposes of the Act, and

particularly to implement the Commission's continuing mandate under Section 15(c)(3) thereof, to provide minimum safeguards with respect to the financial responsibility of brokers and dealers.

Text of Proposed Amendments

It is proposed to amend 17 CFR Part 240 as follows:

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

By amending paragraphs (A), (B), (D), and (F) of § 240.15c3-1(c)(2)(vi) as follows:

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

* * * * *
(c) * * *
(2) * * *
(vi) * * *

► (A) 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 as specified below are:

- (1) Less than three months to maturity—0 percent;
- (2) Three months but less than six months to maturity— $\frac{1}{8}$ of 1 percent;
- (3) Six months but less than nine months to maturity— $\frac{1}{4}$ of 1 percent;
- (4) Nine months but less than one year to maturity— $\frac{3}{8}$ of 1 percent;
- (5) One year but less than three years to maturity—1½ percent;
- (6) Three years but less than five years to maturity—3 percent;
- (7) Five years but less than ten years to maturity—4½ percent;
- (8) Ten years but less than 20 years to maturity—5 percent;
- (9) 20 years or more to maturity—6 percent. Long or short positions may be netted as follows:

- (i) Long or short positions with maturity dates within one year may be netted against long or short positions with maturity dates within 15 months, but only when such maturity dates are within three months of one another;
- (ii) Long or short positions with maturity dates of between one and five years (except as in paragraph (c)(2)(vi)(A)(9)(i) of this section) may be netted against long or short positions with maturity dates of between one and six years, but only when such maturity dates are within one year of another;
- (iii) Long or short positions with maturity dates of five years or more (except as in paragraph (c)(2)(vi)(A)(9)(ii) of this section) may be netted against long or short positions with maturity dates of five years or

more, but only when such maturity dates are within five years of one another. ◀

(B)(1) * * *

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

(i) less than 1 year to maturity—1 percent;

(ii) 1 year but less than 2 years to maturity—2 percent;

▶(iii) 2 years but less than 5 years to maturity—5 percent;

(iv) Five years or more to maturity—7 percent. ◀

* * * * *

(D) 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 paragraph (c)(2)(vi) (A)–(C) above or (E) of this section, the deduction shall be ▶ 7 ◀ percent of the market value of the greater of the long or short position. ▶ 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 paragraph (c)(2)(vi) (A)–(C) above or (E) or (F) of this section, the deduction shall be 9 percent of the market value of the greater of the long or short position. ◀

* * * * *

(F) 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 each of at least two of the nationally recognized statistical rating

organizations, the applicable percentages of the market values on the greater of the long or short position in each of the categories specified below are:

(1) Less than one year to maturity—1 percent;

(2) One year but less than two years to maturity—2 percent;

(3) Two years but less than three years to maturity—3 percent;

(4) Three years but less than four years to maturity—4 percent;

(5) Four years but less than five years to maturity—5 percent;

▶(6) Five years or more to maturity—9 percent. ◀

* * * * *

By the Commission.
George A. Fitzsimmons,
Secretary.
October 9, 1980.

NOTICE TO MEMBERS: 80-57
Notices to Members should be
retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

November 12, 1980

M E M O R A N D U M

TO: All NASD Members and Municipal Securities Bank Dealers
ATTN: All Operations Personnel
RE: Thanksgiving Day Holiday Schedule

Securities markets and the NASDAQ System will be closed on Thanksgiving Day, Thursday, November 27, 1980. "Regular-way" transactions made on the business days preceding that day will be subject to the schedule below.

Trade Date-Settlement Date Schedule For "Regular-Way" Transactions

<u>Trade Date</u>	<u>Settlement Date</u>	<u>Regulation T Date*</u>
November 19	November 26	December 1
20	28	2
21	December 1	3
24	2	4
25	3	5
26	4	8
27	Thanksgiving Day	—
28	5	9

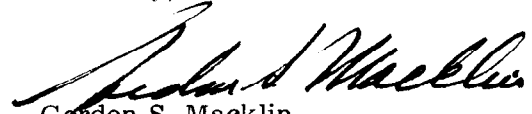
* * * * *

* Pursuant to Section 4(c)(2) of Regulation T of the Federal Reserve Board, a broker-dealer must promptly cancel or otherwise liquidate a customer purchase transaction in a cash account if full payment is not received within seven (7) days of the date of purchase. The date upon which members must take such action for the trade dates indicated is shown in the column entitled "Regulation T Date."

The settlement dates above should be used by brokers, dealers and municipal securities dealers for purposes of clearing and settling transactions pursuant to the Association's Uniform Practice Code and Municipal Securities Rulemaking Board Rule G-12 on Uniform Practice.

Questions concerning the application of this Notice may be directed to the Uniform Practice Department of the NASD at (212) 938-1177.

Sincerely,



Gordon S. Macklin
President

NASD

NOTICE TO MEMBERS 80-58
Notices to Members should be
retained for future reference.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

November 12, 1980

M E M O R A N D U M

TO: All NASD Members

ATTN: Compliance Officers and all Operations Personnel

RE: Securities and Exchange Commission Rule 17f-1 and the
Lost and Stolen Securities Program

Recently, the Securities and Exchange Commission ("SEC" and/or "Commission") and the Association discussed a number of items regarding SEC Rule 17f-1 and the Commission's Lost and Stolen Securities Program (the "Program") adopted pursuant to that rule. Among the principal items of current concern to the SEC is the noticeable decrease in the volume of inquiries being made this year by broker-dealers participating in the Program.

According to statistics compiled by the SEC, for the first six months of 1980, the volume of reports of losses has increased as compared to 1979 volume, but the number of inquiries has decreased. Moreover, the SEC estimates that, at the current rate, the total number of inquiries for 1980 will be significantly below 1979 figures. On the basis of these statistics, the Commission has expressed the belief that reporting institutions have not been making inquiries in all appropriate instances. Because of this concern, the Association and other self-regulatory organizations have been requested by the SEC to remind member firms of their responsibilities in connection with this Program.

Since the Program's purposes, as well as the interests of the broker-dealer community, will be best served by full and complete participation on the part of all registrants, please make certain that all persons associated with your firm who are responsible for handling marketable securities are thoroughly familiar with the requirements of Rule 17f-1. To assist members in their review, paragraph (d)(1) of Rule 17f-1, which sets forth the inquiry provisions of the Program, is reproduced below.

Rule 17f-1 - Requirements for reporting and inquiry with respect to missing, lost, counterfeit or stolen securities.

(d) Required inquiries. (1) Every reporting institution except a registered transfer agent shall inquire of the Commission or its designee with respect to every security which comes into its possession or keeping, whether by pledge, transfer, or otherwise, to ascertain whether such security has been reported as missing, lost, counterfeit, or stolen, unless

(i) The security is received directly from the issuer or issuing agent at issuance;

(ii) The security is received from another reporting institution or from a Federal Reserve Bank or Branch;

(iii) The security is received from a customer of the reporting institution and (A) is registered in the name of such customer or its nominee or (B) was previously sold to such customer, as verified by the internal records of the reporting institution;


(iv) The security is part of a transaction which has an aggregate face value of \$10,000 or less in the case of bonds or market value of \$10,000 or less in the case of stocks; or,

(v) The security is received directly from a drop which is affiliated with a reporting institution for the purposes of receiving and delivering certificates on behalf of the reporting institution.

* * *

Questions concerning this Notice or any aspect of the Lost and Stolen Securities Program may be directed to Susan Lang at (202) 833-4878 or Jack Rosenfield at (202) 833-4828, Department of Regulatory Policy and Procedures.

Sincerely,


Gordon S. Macklin
President

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

November 24, 1980

TO: All NASD Members

RE: Monterey Securities Corporation
235 Montgomery Street
San Francisco, California 94104

ATTN: Operations Officer, Cashier, Fail-Control Department

On Tuesday, November 4, 1980, the Securities Investor Protection Corporation was appointed Trustee for Monterey Securities Corporation, a former NASD member which was expelled from membership in the Association as a result of disciplinary action taken by the NASD. Details of the expulsion are contained in NASD Press Release dated September 2, 1980.

Should you have any questions regarding this firm, please address your inquiries to:

Securities Investor Protection Corporation
Attention: J. H. Moelter
Suite 800, Farragut Building
900 Seventeenth Street, N. W.
Washington, D. C. 20006
Telephone (202) 223-8400

* * * * *

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
1735 K STREET NORTHWEST • WASHINGTON D. C. 20006

November 24, 1980

IMPORTANT

PLEASE DIRECT THIS NOTICE
TO ALL
COMPLIANCE, MARGIN AND MUTUAL FUND DEPARTMENTS

TO: All NASD Members and Interested Persons

RE: Technical and Operational Difficulties Related to
Extension of Credit on Mutual Fund Shares

Effective November 3, 1980, Regulation T of the Federal Reserve Board was amended to permit broker-dealers to extend and maintain credit on securities of certain types of investment companies. As outlined in Notice to Members 80-53, however, significant restrictions on such activity remain in effect because of Section 11(d)(1) of the Securities Exchange Act of 1934, and Rule 11d1-1 thereunder. The purpose of this Notice is to outline some of the important factors members should consider in connection with extending or maintaining such credit. The unique nature of mutual funds presents complicated problems not usually encountered with ordinary stocks and bonds. This notice does not provide answers to these problems; its purpose is to alert members to their existence.

Uncertainties Regarding Certain Applications of Section 11(d)(1)

While Notice to Members 80-53 outlined the basic application of Section 11(d)(1) as currently viewed by the staff of the Securities and Exchange Commission, uncertainties remain with respect to the application of this provision to specific situations. For example, it is clear under Section 11(d)(1) of the '34 Act that a member who is both a broker and a dealer cannot extend credit to a customer on mutual fund shares sold to that customer, if the member is part of the selling group. It is not entirely clear, however, whether the test for determining membership in a selling group is simply whether a written agreement exists or whether additional tests are to be applied. Sales agreements are not required, and normally don't exist, in the case of certain no-load investment companies (even though the shares are regularly sold by broker-dealers who are affiliated with the fund's manager), in distributions of unit investment trusts, or in distributions by non-members of the NASD. While, as noted, the application of Section 11(d)(1) is not entirely clear, there is a substantial likelihood that the prohibitions thereof do apply, at least in certain situations, irrespective of the non-existence of a written selling group agreement.

Another area of uncertainty is related to whether shares purchased in certain transactions, subsequent to the initial purchase by the customer from the broker-dealer, will qualify for credit under Section 11(d)(1). For example, shares normally can be purchased by investors under automatic dividend reinvestment plans, by making payments directly to the fund or its transfer agent, through exchange or transfer from one fund to another under the same management and under payroll deduction plans, among other methods. Broker-dealers may or may not receive compensation in connection with such transactions, but they are normally not executed and confirmed by the broker-dealer.

These and other questions will be the subject of continuing discussions with the Commission, but members should recognize that until these uncertainties are resolved, assumptions regarding the application of Section 11(d)(1) to particular fact situations may be risky.

Certificates vs. "Book" Shares

The mutual fund industry has made significant progress in eliminating stock certificates. A great number of mutual fund shareholders maintain "open accounts," "book" shares, or "plan" accounts where certificates are not normally issued. Certain types of funds do not issue certificates at all. Many other mutual funds discourage the issuance of certificates and do so only upon request. The "open account" system, where a continuing record of a shareholder's share balance is maintained, is a key element in facilitating reinvestment of income dividends and capital gain distributions, and is important in processing orders pursuant to Letters of Intent or Rights of Accumulation where a shareholder's purchase price is reduced in consideration of existing holdings. It also facilitates additions to the account which can usually be made directly with the fund.

A broker-dealer wishing to place a client's mutual fund shares in a margin account may view the issuance of a certificate in "street" name as important in facilitating his handling of the account since this would be the customary method of handling stock placed into a margin account. The issuance of certificates may, however, place serious restrictions on the rights the client would otherwise have, as well as creating significant operating difficulties for the broker-dealer. For example, the volume and frequency of distributions from mutual funds may be substantial, particularly for certain types of money market and bond funds which pay dividends monthly. Also, it may be difficult for the broker-dealer to attempt to duplicate the dividend reinvestment plans of all of the investment companies, including purchases of fractional shares, without extensive back office improvement.

Representatives of investment companies and broker-dealers are currently studying, through the Association, the Investment Company Institute, and the Securities Industry Association, methods of satisfying broker-dealers' concerns for adequate evidence of collateral and the investment companies' concern that important shareholders' privileges be preserved and that companies not be subjected to unnecessarily high costs of certificate issuance. Progress is being made and the outlook is encouraging but solutions to this problem will not be found overnight. In the meantime, careful consideration should be given before members encourage clients to have mutual fund certificates issued for the purpose of making deposits into margin accounts.

Differences in Liquidation Procedures

There are material variations in the procedures utilized by investment companies in the liquidation of shares, which variations are important for broker-dealers to recognize when consideration is being given to extending credit on mutual fund shares. First, it is important to recognize that a shareholder's redemption of mutual fund shares is normally a process handled through the mails. The redemption price is not determined until the fund, or its transfer agent, receives the redemption request and/or endorsed certificates, and the investment company then has up to seven days to pay the redemption proceeds. Obviously, a liquidation of mutual fund shares utilizing the direct redemption procedure would not permit immediate credit of a definite amount to a client's account. This method would, therefore, not seem appropriate should mutual fund shares be sold to meet a margin call.

Investment companies, (or more frequently their principal underwriters) often will accept telephone or "wire" orders from broker-dealers for liquidation of shares at a price determined as of the date of the order. "Repurchase" orders of this type would permit immediate credit to a client's account. There are several important aspects of wire order liquidations which broker-dealers should know, however.

First, such procedures are strictly voluntary. Unlike shareholder redemption rights, an investment company or its principal underwriter can terminate the repurchase procedure at any time. In fact, this service is not offered by all investment companies.

Secondly, the repurchase procedures used vary considerably. In some cases only certificated shares can be sold by a wire order. There are also differences in requirements for signature guarantees among funds which may again vary depending upon whether certificates have been issued. Certain investment companies will not accept wire order liquidations from non-members of the NASD or from broker-dealers who do not have selling group agreements. The latter point may have implications in terms of 11(d)(1) as discussed earlier.

Also, while the use of the wire order does result in a liquidation price which is quickly known, the broker-dealer may not receive actual payment for several days after transmitting certificates or liquidation requests to the fund or its transfer agent. The broker-dealer, therefore, continues to finance the transaction after the liquidation.

Since there are no significant secondary markets in mutual fund shares, broker-dealers must be familiar with the procedures of each investment company whose shares are to be included in a margin account and must recognize the consequences of selling those shares, particularly to meet a margin call.

Restrictions on Certain Transactions

Restrictions in NASD rules, or imposed by investment company organizations,

may impact the ability of a broker-dealer to implement certain types of mutual fund transactions in margin accounts. For example, in the absence of a secondary market for a particular investment company's securities, it may not be possible to execute a short sale of mutual fund shares. NASD rules generally prohibit an investment company principal underwriter from purchasing shares from a dealer acting as principal, or from an investor, unless the dealer or investor is the record owner.⁽¹⁾ Even if the repurchase agent for the investment company were not the principal underwriter, the investment company is not in a position to redeem or repurchase non-existent shares.

Restrictions imposed by investment companies themselves on exchanges or transfer from another investment company in the group may create problems if shares are held in a margin account. In some cases these transfers can be authorized only by mail. This would seem to require the withdrawal of the shares from the account.

Also, while not directly related to margin accounts or credit, members should understand that, the current NASD requirement that sales charges be refunded to the investment company by the broker-dealer if the shares are liquidated within seven days,⁽²⁾ contains no exemptions or exclusions for sales made to meet a margin call.

Unusual Situations Regarding Liquidity or Pricing

Again, since active secondary markets in mutual fund shares are not common, broker-dealers carrying mutual fund shares in margin accounts would need to be alert to situations where an investment company suspends redemptions, where an investment company, pursuant to an SEC exemption, does not price its shares daily, or where the investment company's share prices are not regularly published. While not common, all of these situations may occur.

Suitability

While leveraging or borrowing against mutual fund shares presents the same general suitability considerations as any use of leverage, there are additional factors to be considered in view of the unique nature of mutual funds.

One factor, as outlined earlier in this notice, is related to the flexibility and available services the client may have to give up if he is no longer the record owner of his shares. Such services may include dividend reinvestments, ready availability of certain types of quantity discounts, periodic withdrawal plans, simple procedures for adding to the account, simplified exchange privileges with respect to other funds in the group, and the use of certain methods of redeeming or liquidating shares.

(1) Article III, Section 26(j)(2) of the Rules of Fair Practice

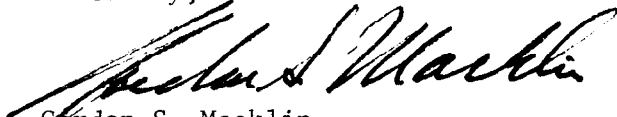
(2) Article III, Section 26(i) of the Rules of Fair Practice

Another factor is that the investment objectives of many investment companies are long term, and every possible use of a margin account may not be entirely consistent with such objectives or with the investor's original purpose in investing in such companies. Deposit of mutual fund shares in a margin account would also seem to preclude the use of such shares to fund a retirement plan or an annuity, uses which are very common.

* * * * *

In summary, while the amendment to Regulation T by the Federal Reserve Board represents an appropriate removal of a competitive inequality between broker-dealers and banks, legal and practical impediments to the widespread use of investment company securities as loan collateral remain. Members should proceed cautiously in this area. Questions regarding this notice should be addressed to Robert L. Butler at (202) 833-7272.

Sincerely,



Gordon S. Macklin
President

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

November 26, 1980

TO: NASD Members, Companies Quoted in the NASDAQ System and Other Interested Parties

RE: Request for Comments Regarding Proposal to Permit Market Makers to Display Size for Quotations in NASDAQ

The Board of Governors of the Association proposes to implement an enhancement to the NASDAQ System which would permit NASDAQ market makers to display size along with their quotations in the NASDAQ System. In connection with this enhancement, the Board is also proposing amendments to Schedule D which would require a market maker displaying size in NASDAQ to execute any order presented to it up to the size and at the quotation displayed. These proposals are being published at this time to provide all interested persons an opportunity to submit comments. After the expiration of the comment period, the Board will again review the proposals giving due consideration to the comments received. If, at that time, the Board approves the amendments, or revised versions thereof, they will be submitted to the Securities and Exchange Commission for approval.

Since August 1978, third market makers displaying quotations for listed securities in the Consolidated Quotations Service ("CQS") have been able to display size accompanying their quotations. For the past several months, the NASDAQ Committee, a standing Committee of the Board of Governors, has been considering whether to expand the availability of size displays to NASDAQ securities. After several months of study, the NASDAQ Committee unanimously recommended to the Board of Governors that the display of size on NASDAQ be permitted on a voluntary basis. The Board of Governors now presents for comment this enhancement, along with enabling and conforming amendments to Schedule D.

The Board believes that the addition of size will be beneficial to users of the NASDAQ System, NASDAQ market makers, and the markets for NASDAQ securities. The Board believes that the display of size will benefit users of the NASDAQ System by giving them more information in which to assess the depth

of the market for a particular security. In addition, the ability of a NASDAQ market maker to display a firm size for which he is willing to trade will enable NASDAQ market makers to more effectively compete for orders. The display of size will also, in the Board's view, result in more efficient execution of transactions by enabling users of the system to better determine the price at which a sizeable order can be executed prior to communicating with various market makers.

A market maker's display and updating of size in NASDAQ will be accomplished in the same manner as presently followed by third market makers for listed securities in CQS. It is important to note the proposal does not require that size be displayed or that a market maker display its maximum size at a particular price, but it does require that if size is displayed an order must be honored up to the size displayed. As in CQS, the absence of size will indicate that a market maker's quote is firm for a normal unit of trading. Displays of size will be available only on Level 2 and Level 3 terminals. No display of size will accompany Level 1 quotations and displayed size will not affect computation of the "inside quotation" for the security or information released to newspapers. The ranking of the various market makers' quotations on the NASDAQ terminal screen will not be affected by the display of size. Thus, a market maker's position will continue to be determined by its price, and the order of market makers at a particular price will be determined by time priority.

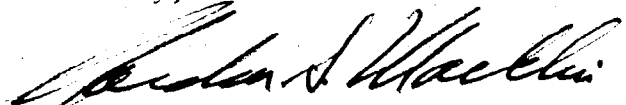
In summary, the Board of Governors is proposing to amend Schedule D of the By-Laws to provide that a market maker's price be firm for up to the size he is displaying, or if no size is displayed, for a normal unit of trading. Failure to honor a quotation for trades up to the specified size could result in a complaint for "backing away". The amendment is attached to this Notice.

The Board of Governors believes this proposal merits your close attention. All comments must be received no later than December 31, 1980, and should be addressed to:

S. William Broka
Secretary
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

Questions regarding this proposal, should be directed to Molly G. Bayley, Vice President, NASDAQ Operations, at (202) 833-7213.

Sincerely,


Gordon S. Macklin
President

Amendments to Part I of Schedule D
(new language is underlined)

* * *

B. Level 2 Service

1. Nature of Service. This service will provide the subscriber with access to the bid/ask quotations and quotation sizes of all of the registered market makers entering quotes on each of the authorized securities.

* * *

C. Level 3 Service

1. Nature of Service. This service will enable the registered market makers to enter bid/ask quotations and quotation sizes into the System only on the securities as to which the Corporation has authorized it to enter quotes. Subscribers to Level 3 Service shall also receive Level 2 service.

* * *

3. Continuing Qualifications

(a) Character of quotations entered into the System. A registered market maker which receives a buy or sell order must execute a trade for at least a normal unit of trading at his quotations as they appear on NASDAQ CRT screens at the time of receipt of any such buy or sell order. Each quotation entered by a registered market maker must be reasonably related to the prevailing market. If a registered market maker displays a quotation which indicates that it is for a size greater than a normal unit of trading, he must execute a buy or sell order up to the size displayed.