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

DIVISION OF
MARKET REGULATION

April 1, 1998

Mr. Jeffrey F. Ingber
Managing Director and General Counsel
Government Securities Clearing Corporation
55 Water Street
New York, NY 10041-0082

Re: Deficit Charges on Repurchase Transactions

Dear Mr. Ingber:

This is in reply to your letter dated August 15, 1997, on behalf of Government Securities Clearing Corporation ("GSCC") and members of its netting system ("Netting Members") that are registered as broker-dealers with the Securities and Exchange Commission ("Commission"). Your letter concerned the appropriate treatment under Rule 15c3-1 of the Securities Exchange Act of 1934 (17 CFR 240.15c3-1) (the "Rule" or the "net capital rule") for repurchase and reverse repurchase transactions ("repos") that have been submitted by Netting Members into GSCC's netting system. Specifically, you request that, when computing their net capital, Netting Members not be required to deduct from their net worth deficits arising from repos and reverse repos that are netted and guaranteed through GSCC's netting system.

I understand the following facts to be pertinent to your request. GSCC is registered with the Securities and Exchange Commission ("Commission") as a securities clearing agency for U.S. government securities. GSCC provides automated trade comparison, netting, and settlement services for U.S. Government securities. Generally, GSCC's netting system aggregates and matches, on a multilateral basis among all Netting Members, deliver and receive obligations resulting from trades submitted by Netting Members. A Netting Member's deliver and receive obligations in a security are offset to establish a single net settlement position for a member's activity in each security on a daily basis. Previously, the Commission approved a proposed rule change regarding GSCC's repo netting system.[1]

[1] Securities Exchange Act Release No. 36491 (November 17, 1995), 60 FR 61577 (November 30, 1995).

Specifically, GSCC's netting system totals and nets, on a daily basis, each Netting Member's buy and sell cash activity, Treasury auction purchases, and repos in a security to establish a single net position as long, short, or flat.[2] After determining the Netting Member's net settlement positions, corresponding receive and deliver obligations are established. GSCC's rules provide that GSCC becomes primarily obligated as the new counterparty for each transaction and that GSCC guarantees settlement of all repos that enter its netting system.[3] GSCC guarantees the return of collateral to the repo participant, the return of principal (i.e., the repo start amount) to the reverse repo participant, and the payment of interest through the full term of the repo to the reverse repo participant.

GSCC employs a number of risk management procedures that enable it to guarantee settlement of all net settlement positions. These procedures include margining and marking to the market all net settlement positions, imposing minimum financial requirements on members that must be maintained on a continuous basis, ongoing monitoring of each Netting Member's financial condition and trading activity, sharing information on common members with other self-regulatory entities, maintaining liquidation procedures, and creating a centralized loss allocation process.

Through its daily mark to the market process, GSCC brings net positions that are not due for settlement from contract value to current market value each day. Each morning, GSCC collects mark payments from Netting Members that are in a debit mark position and pays such marks to Netting members that are in a credit mark position. A Netting Member's debit and credit mark positions across all securities and across all settlement dates are netted so that each Netting Member receives or pays a single net mark amount each day. This process eliminates each Netting Member's deficits on repo contracts on a daily basis. You represent that GSCC's daily mark to the market and settlement process eliminates any deductions, as calculated under paragraph (c)(2)(iv)(F) of Rule 15c3-1, because the marks are never outstanding for more than one business day.

In addition to the risk management procedures described above, another of GSCC's risk management controls is its Clearing Fund. As of January 9, 1998, the Clearing Fund was approximately $2.6 billion. The Clearing Fund is designed to provide GSCC with assets from each Netting Member sufficient to satisfy losses to GSCC if a Netting Member defaults and GSCC must close out of that member's open positions. The Clearing Fund ensures that, if one or more of its members fails, GSCC has sufficient liquidity at all times to meet its payment and delivery obligations. Further, you assert that GSCC's risk management controls have

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[2] For netting purposes, the settlements associated with repo start legs and reverse repo close legs are treated as short positions, and the settlements associated with repo close legs and reverse repo start legs are treated as long positions.

[3] Government Securities Clearing Corporation, Rule 11, Section 6.

been rigorously tested, and that they ensure that GSCC faces no significant risk as a result if a Netting Member should become insolvent.

Paragraph (c)(2)(iv)(F) of the net capital rule requires a broker-dealer to, among other things, deduct from its net worth when calculating its net capital certain deficits arising from the broker-dealer's repo activities. For example, a broker-dealer that has entered into a repo must deduct from net worth the repo deficit, if any. The Rule defines a repo deficit as "the difference between the market value of securities subject to the repurchase agreement and the contract price for repurchase of the securities (if less than the market value of the securities)."[4] Similarly, if a broker-dealer enters into a reverse repo, it must deduct any reverse repo deficit. The Rule defines reverse repo deficits as "the difference between the contract price for resale of the securities under a reverse repurchase agreement and the market value of those securities (if less than the contract price)."[5] The Rule provides that repo and reverse repo deficits may be reduced by "calls for margin, marks to the market, or other required deposits which are outstanding one business day or less."[6]

Based upon the foregoing and the facts and representations in your letter, the Division of Market Regulation will not recommend to the Commission that enforcement action be taken if, when computing net capital, GSCC Netting Members do not deduct from their net worth repo and reverse repo deficits, outstanding one business day or less,[7] arising from repo and reverse repo agreements that are netted and guaranteed by GSCC as part of GSCC's netting system as described above.

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[4] 17 CFR 240.15c3-1(c)(2)(iv)(F)(*1*)(*ii*).

[5] 17 CFR 240.15c3-1(c)(2)(iv)(F)(*1*)(*i*).

[6] 17 CFR 240.15c3-1(c)(2)(iv)(F)(*2*)(*ii*) and (F)(*3*)(*ii*).

[7] For example, a deficit would be outstanding for more than one business day if a GSCC Netting Member did not timely pay its Fund settlement obligation to GSCC.

You should be aware that this is a staff position with respect to enforcement only and does not purport to express any legal conclusions. Factual variations could warrant a different response, and any material change in the facts must be brought to the Division's attention. This position may be withdrawn or modified if the staff determines that such action is necessary for the protection of investors, in the public interest, or otherwise in furtherance of the purposes of the securities laws.

Sincerely yours,

Michael A. Macchiaroli
Associate Director

cc: Raymond J. Hennessy
New York Stock Exchange, Inc.

Thomas R. Cassella
National Association of Securities
Dealers Regulation, Inc.