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

ISION OF
T REGULATION

February 14, 1994

Mr. Jeffrey Bernstein
Chairman
Securities Industry Association
Capital Committee
120 Broadway
New York, New York 10271

Re: Ready Marketability of Noninvestment Grade, Nonconvertible Debt Securities

Dear Mr. Bernstein:

This is in response to the October 9, 1992 letter of the Capital Committee of the Securities Industry Association ("SIA"), on behalf of its members and similarly situated broker-dealers regarding the treatment of noninvestment grade, nonconvertible debt securities for purposes of calculating net capital under Rule 15c3-1 under the Securities Exchange Act of 1934 ("Exchange Act").[1]

I.

Paragraph (c)(2)(vii) of Rule 15c3-1 requires a broker-dealer to deduct from its net worth 100% of the carrying value of securities it holds in its proprietary account for which there is no ready market. The term "ready market" is defined in paragraph (c)(11) of Rule 15c3-1 to include:

> a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a

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[1] 17 C.F.R. § 240.15c3-1.

relatively short time conforming to trade custom.[2]

With respect to nonconvertible debt securities, the staff of the Division of Market Regulation has set forth a safe harbor with regard to the determination of a ready market. Under this interpretation nonconvertible debt securities will be deemed to have a ready market if the securities: (i) have a fixed interest rate and maturity date; (ii) are not traded flat or in default as to principal or interest; and (iii) are rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations ("NRSROs") (i.e., investment grade). Debt securities that meet these criteria may be treated in accordance with the haircut provisions in paragraph (c)(2)(vi)(F) of the net capital rule.[3] Substantial questions, however, have been raised concerning the treatment, for net capital purposes, of nonconvertible debt securities that are not investment grade, sometimes called high-yield securities.

II.

The SIA believes that two main factors are representative of whether a ready market exists for noninvestment grade, nonconvertible debt securities: (1) the initial issuance size of the securities; and (2) the availability of acceptable information about the issuer. Acceptable information, in the SIA's view, would include public information filed by the issuer with the Commission, or with a bankruptcy court, or the existence of current ratings of any issuance of the issuer by two NRSROs. The unavailability of acceptable information automatically would require a broker-dealer to take a 100% capital charge under paragraph (c)(vii) of Rule 15c3-1.

Due to the unique characteristics of noninvestment grade, nonconvertible debt securities, the SIA is of the opinion that the use of a combination of ratings, issuance size and availability of public information is the best possible means for determining the liquidity of these securities. Moreover, the SIA believes that the haircuts described below, combined with both an undue concentration charge and a portfolio concentration charge, will generate requirements that appropriately reflect the amount of regulatory capital that should be maintained by broker-dealers

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[2] 17 C.F.R. § 240.15c3-1(c)(11)(i).

[3] Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, Securities and Exchange Commission to Dominic A. Carone, Chairman, Capital Committee of the Securities Industry Association (June 12, 1992).

that carry noninvestment grade, nonconvertible debt securities in their proprietary accounts.

III.

Based on the above discussion, the Division of Market Regulation will not raise any question or recommend enforcement action to the Commission if broker-dealers treat nonconvertible debt securities that are not rated in one of the four highest rating categories by at least two NRSROs as having a ready market for purposes of Rule 15c3-1 under the following conditions:[4]

1. The securities can be sold publicly without registration with the Commission under Section 5 of the Securities Act of 1933; and

2. Current information concerning the issuer is available to the public. Unless the broker-dealer has information to the contrary, current information is deemed to be available to the public if:

(a) The issuer filed with the Commission public reports consisting of the most recently required periodic financial report; or

(b) The issuer (provided it is the subject of a bankruptcy proceeding) filed with a bankruptcy court public information that is sufficient to value the assets and liabilities of the issuer and such information is dated not more than six months prior to the date of the broker-dealer's capital computation.

The current information requirement also will be deemed to be satisfied by the existence of current ratings by two NRSROs on any issuance of the issuer. For purposes of this interpretation, a rating by an NRSRO is considered to be current if the NRSRO itself continues to hold out its rating for the issuance of the issuer.

Noninvestment grade, nonconvertible debt securities that,

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[4] Where a broker-dealer has a small quantity of bonds of a particular issuer (less than $ 10,000 in face value) where the issue is listed and traded on a national securities exchange, the broker-dealer may, generally, regard these bonds as having a ready market.

pursuant to this letter, are deemed to have a ready market shall be treated in accordance with the haircut provisions below.

1. The broker-dealer shall deduct from its net worth the following percentages from the gross long and short market value of noninvestment grade, nonconvertible debt securities' positions in each of the categories specified below:

(a) An initial issuance of at least $100 million.....15%

(b) An initial issuance of at least $75 million and less than $100 million.....20%

(c) An initial issuance of at least $50 million and less than $75 million.....25%

(d) An initial issuance of at least $20 million and less than $50 million.....50%

(e) An initial issuance of less than $20 million[5] or have been held in inventory for more that 90 days as the result of the failure to complete an underwriting.....100%

Broker-dealers may not include the value of noninvestment grade, nonconvertible debt securities, subject to the haircut percentages set forth above, in paragraph (c)(2)(vi)(J) of Rule 15c3-1 for the purposes of netting long or short securities positions under paragraph (c)(2)(vi)(J).

2. The broker-dealer shall take an additional portfolio concentration charge on the securities in categories (b), (c) and (d) above, to the extent the market value of the greater of the total long or short positions in categories (b), (c) and (d) combined

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[5] Securities with an initial issuance of less than $20 million will be deemed to be included in category (d) above if the issuer has another outstanding issue of noninvestment grade, nonconvertible debt securities, which has an initial issuance of $50 million or more.

exceeds 25 percent of the broker-dealer's tentative net capital. The portfolio concentration charge shall be 50 percent of the haircuts otherwise taken on that portion of the total market value of the securities in categories (b), (c) and (d) in excess of 25 percent of tentative net capital. This portfolio concentration charge may be reduced by any undue concentration charge computed in accordance with paragraph (c)(2)(vi)(M) of Rule 15c3-1.

The treatment accorded in this letter shall not apply to existing positions in the broker-dealer's proprietary or other accounts until July 1, 1994.

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You should understand that this is a staff position with respect to enforcement only and does not purport to state any legal conclusion on this matter. Any material change in circumstances may warrant a different conclusion and should be brought immediately to the Division's attention. Furthermore, this position may be withdrawn or modified if the staff determines that such action is necessary in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the securities law.

Sincerely,

Michael A. Macchiaroli

Michael Macchiaroli
Associate Director