



DIVISION OF
MARKET REGULATION

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

March 15, 1996

Rochelle Pullman
Chairman
Capital Committee
Securities Industry Association
120 Broadway
New York, New York 10271-0080

Dear Ms. Pullman:

This is in response to the September 15, 1995 letter of the Capital Committee of the Securities Industry Association ("SIA"), regarding the treatment of certain securities which may not be publicly offered or sold without registration ("restricted securities") under the Securities Act of 1933 ("Securities Act") for purposes of calculating net capital under Rule 15c3-1 under the Securities Exchange Act of 1934 ("Exchange Act"). 1

Paragraph (c)(2)(vii) of Rule 15c3-1 requires a broker-dealer to deduct from its net worth 100% of the value of proprietary securities for which there is no ready market or which cannot be publicly offered or sold without registration. In a letter dated February 14, 1992, 2 the Division of Market Regulation ("Division") stated it would recommend no-action to the Commission if broker-dealers deemed certain nonconvertible debt securities that are not rated in one of the four highest rating categories by at least two nationally recognized statistical rating organizations ("NRSROs") to have a ready market if the securities: (i) can be sold publicly without registration with the Commission under Section 5 of the Securities Act; and (ii) current information concerning the issuer is available to the public.

1 17 C.F.R. § 240.15c3-1 (1995).

2 Letter to Jeffrey Bernstein, Chairman, Securities Industry Association (February 14, 1992) ("non-rated debt letter").

The SIA believes that similar relief should be accorded to restricted securities 3 issued in a private placement or Rule 144A offering under the exemption from registration under Section 4(2) of the Securities Act, Regulation D, and/or Rule 144A. 4 Specifically, the SIA believes that these restricted securities have developed a deep and liquid market such that a reduction in the charges currently required by the net capital rule is appropriate.

The SIA contends that the Division should consider the following factors in determining whether a ready market exists for restricted securities: (1) investment grade ratings conferred by an NRSRO; (2) the availability of public information on the issuer of the instrument, particularly as demonstrated by the periodic reporting requirements imposed upon issuers whose stock has been included in the S&P 500 or the FT-Actuaries World Index; (3) the initial issuance size; and (4) the convertibility of the instrument into publicly traded securities for which there is a ready market.

Based on the above discussion, the Division will not recommend enforcement action to the Commission if broker-dealers, in computing their net capital, apply haircuts to their proprietary restricted securities (as defined in Rule 144(a)(3) of the Securities Act) that cannot be publicly offered or sold (except as stated hereinafter) in the following manner:

3 17 C.F.R. § 230.144(a)(3) (1995). Rule 144(a)(3) defines the term "restricted securities" to mean: (i) Securities that are acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering; or (ii) Securities acquired from the issuer that are subject to the resale limitations of Regulation D or Rule 701(c) under the Securities Act; or (iii) Securities that are subject to the resale limitations of Regulation D and acquired in a transaction or chain of transactions not involving any public offering; or (iv) Securities that are acquired in a transaction or chain of transactions meeting the requirements of Rule 144A.

4 17 C.F.R. § 230.144 (1995).

- (1) Non-convertible debt securities, convertible debt, convertible preferred stock or preferred stock that have one investment grade rating by an NRSRO in one of the top two categories, would be subject to a 15% capital charge if:
 - the issuer, whether domestic or foreign, has two long term or short term NRSRO investment grade ratings on any debt issue, and
 - the issue's single rating is at least equal to or higher than the above referenced investment grade rating on the domestic or foreign debt, and the NRSRO rating the issue is one of the organizations that rated the debt.
- (2) Non-convertible debt securities, convertible debt, convertible preferred stock or preferred stock that do not have an investment grade rating by an NRSRO, would be subject to a capital charge of between 15% and 100%, based on initial issuance size 5 if:
 - the issuer, whether domestic or foreign, has two long term or short term investment grade ratings by an NRSRO on any debt issue that is pari passu with the issue that does not have an investment grade rating, or
 - the issuer has issued common stock included in the S&P 500 or in the FT-Actuaries World Index. These securities would be subject to portfolio concentration charges described in the non-rated debt letter.
- (3) Non-convertible debt securities, convertible debt, convertible preferred stock or preferred stock that have a below-investment grade rating by an NRSRO, would

5 The charges would be based on initial issuance size in accordance with the non-rated debt letter.

be subject to a capital charge of between 15% and 100%, based on initial issuance size 6 if:

- the issuer, whether domestic or foreign, has two long term or short term investment grade ratings by an NRSRO on any debt issue that is pari passu with the issue that has a below-investment grade rating, or
 - the issuer has stock included in the S&P 500 or in the FT-Actuaries World Index. These securities would be subject to portfolio concentration charges comparable to those described in the non-rated debt letter.
- (4) Commercial paper issues with one investment grade rating by an NRSRO in one of the top two categories would be subject to a 15% capital charge if the issuer, whether domestic or foreign, has two long term or short term investment grade ratings by an NRSRO on any debt and the NRSRO rating the commercial paper is one of the organizations that rated the debt.
- (5) Securities which can be sold pursuant to an exemption from registration, regardless of rating, that are freely convertible into publicly traded securities meeting the ready market provisions of the net capital rule would be subject to the normal capital charge pursuant to Rule 15c3-1(c)(2)(vi) on the security to which it is convertible. In addition to this haircut, an additional charge should be taken for the cost of conversion or the loss upon conversion. These securities would be subject to the portfolio concentration charges described in the non-rated debt letter.
- (6) Securities which can be sold pursuant to an exemption from registration which have registration rights that provide for an exchange offer of the securities for registered securities are to be treated as readily marketable and subject to the respective capital

6 The charges would be determined in accordance with the categories outlined in the non-rated debt letter.

charges set forth in the non-rated debt letter, if the registered securities meet the other criteria of that letter and the company issuing the securities is listed in the S&P 500 or an equity issue of the company is included in the FT-Actuaries World Index. If these securities are not registered within 90 days from the settlement date with the issuer, the capital charges shall increase by 25% each month until such time as the security is subject to a 100% capital charge. These securities would be subject to the portfolio concentration charges described in the non-rated debt letter.

- (7) Securities which can be sold pursuant to an exemption from registration would be subject to a contractual commitment deduction under (c)(2)(viii) of 30%. Any positions remaining in a firm's inventory after the date of the contractual commitment would be subject to the haircuts outlined above.
- (8) Consistent with the non-rated debt letter, securities held in inventory longer than 90 days that were unsuccessfully offered pursuant to Rule 144A would be subject to a 100% capital charge.
- (9) The securities described above shall not include any security the transfer of which is subject to any contractual restriction or limitation imposed by the issuer or the seller of the security other than one whose purpose is to assure compliance with the Federal securities laws or the securities laws of any state regarding the offer and sale thereof in a transaction not involving a public offering.

Page 6 - Ms. Rochelle Pullman

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. 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 Macchiaroli
Associate Director