SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–39455; File No. S7–31–97]

RIN 3235–AG18

Net Capital Rule

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is proposing for comment amendments to Rule 15c3–1 (''net capital rule'' or ''Rule'') under the Securities Exchange Act of 1934 (''Act''), regarding the Commission's capital requirements for broker-dealers. The proposed amendments, if adopted, would alter the charges, or ''haircuts,'' from net worth in computing net capital for certain interest rate instruments, including government securities, investment grade nonconvertible debt securities, certain mortgage-backed securities, money market instruments, and debt-related derivative instruments.

DATES: Comments must be received on or before March 30, 1998.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 10–9, Washington, D.C. 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–31–97. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at 202/942–0132; Peter R. Geraghty, Assistant Director, at 202/942–0177; Thomas K. McGowan, Special Counsel, at 202/942–4886; Christopher M. Salter, Attorney, at 202/942–0148; or Gary Gregson, Statistician, at 202/942–4156; Office of Risk Management and Control, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 2–2, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

I. Introduction.

The Commission's net capital rule, Rule 15c3–1, is intended to ensure that broker-dealers have sufficient liquid capital to protect the assets of customers and to meet their responsibilities to other broker-dealers.[1] When calculating the value of their assets for the purposes of establishing their net capital under Rule 15c3–1, broker-dealers must reduce the market value of the securities they own by certain percentages, or haircuts. Reducing the value of securities owned by broker-dealers for net capital purposes provides a capital cushion against adverse market movements and other risks faced by the firms, including liquidity and operational risks.[2]

The amendments proposed in this release (the ''Proposed Amendments'') would change the haircuts applicable to most interest rate instruments held in a broker-dealer's proprietary account. The Proposed Amendments are similar in scope to the ''standard approach'' adopted by the Basle Committee on Banking Supervision (''Basle Committee'') in its amendments to the Basle Capital Accord for market risk arising from interest rate products.[3] The amendments adopted by the Basle Committee are discussed more fully in the text below.

A. Fixed Income Products Proposal

The Commission is proposing for comment an amendment to the net capital rule regarding the method of computing the haircuts applicable to interest rate products. The Proposed Amendments would treat most types of interest rate products as part of a single portfolio. Under the Proposed Amendments, the net capital rule would recognize various hedges among a portfolio of government securities,[4] investment grade nonconvertible debt securities (or corporate debt securities), Pass-Through Mortgage-Backed Securities,[5] repurchase and reverse repurchase agreements, money market instruments,[6] and futures and forward contracts on these debt instruments, and other types of debt-related derivatives (''Fixed Income Products''). Consequently, the Proposed Amendments should better match capital charges with actual market risk hedging practices employed by broker-dealers. One result of the Proposed Amendments is that positions may be moved into a registered broker-dealer from an unregistered affiliate to take advantage of the single portfolio concept in calculating haircuts, which should reduce capital charges.[7]

Haircuts for municipal securities and non-investment grade debt securities are not included in the Proposed Amendments. Municipal securities would be treated separately under the net capital rule because their market price depends on tax issues to a much greater extent than other debt instruments. Non-investment grade debt securities are excluded from the Proposed Amendments because their price movements tend to be based primarily on issuer-specific factors, much like equity securities. In addition, the Proposed Amendments will not recognize hedges among interest rate instruments denominated in different currencies because available evidence suggests that while correlations of interest rate products denominated in different currencies are generally positive, they are relatively low compared with correlations for securities denominated in the same currency. Therefore, broker-dealers would be required to separately calculate for each currency their haircuts for Fixed Income Products denominated in that currency.

The Commission requests comment regarding the Proposed Amendments, and in particular, solicits comment on whether the Proposed Amendments

---

[1] 17 CFR 240.15c3–1

[2] Liquidity risk is the risk that a firm will not be able to unwind or hedge a position. Operational risk is the risk of financial loss to the firm from human error or defects in maintaining the firm's operating systems.

[3] The Governors of the G–10 countries established the Basle Committee on Banking Supervision in 1974 to provide a forum for ongoing cooperation among member countries on banking supervisory matters.

[4] 15 U.S.C. 78c(a)(42).

[5] For the purposes of the proposed Rule, ''Pass-Through Mortgage-Backed Securities'' means any security issued under the sponsorship of the United States or any agency thereof that represents a pro rata interest or participation in the principal and interest cash flows generated by a pool of mortgage loans of which at least 95% of the aggregate principal is composed of fixed rate residential mortgage loans on one to four family homes, including five and seven year mortgage loans with balloon payments at maturity. Under the proposed rule, multifamily, adjustable rate, commercial, and mobile home mortgage loans are not considered Pass-Through Mortgage-Backed Securities.

[6] Money market instruments are defined in the Proposed Amendments as commercial paper rated in one of the three highest categories by at least two nationally recognized statistical rating organizations, and negotiable certificates of deposit and bankers acceptances issued by a bank as defined in Section 3(a)(6) of the Act.

[7] In a companion release being issued contemporaneously with this release, the Commission is proposing a limited regulatory system for a class of registered dealers active in over-the-counter derivatives markets that will provide additional incentives to move positions out of an unregistered affiliate into a registered broker-dealer. For example, the Commission is proposing to allow these dealers to use value-at-risk models for determining market risk capital charges. These models would recognize more offsetting among positions than the approach being proposed in this release. Securities Exchange Act Release No. 34–39454 (December 17, 1997).

comport with how broker-dealers currently hedge their positions in interest rate products, what instruments are used to hedge interest rate risk, how capital charges for Fixed Income Products will differ for particular firms under this proposal from the current Rule, and alternative methods of calculating haircuts on interest rate products.

B. Background

The Commission is proposing for comment the Proposed Amendments as the result of its efforts with the Basle Committee and the International Organization of Securities Commissions (''IOSCO'') to develop a consensus among different countries on the conceptual framework underlying capital standards for interest rate instruments. In 1988, the Basle Committee adopted its Capital Accord regarding a minimum risk-based capital framework for banks. At that time, the Capital Accord was designed primarily to deal with the credit risk in a bank's loan portfolio, but the Basle Committee recognized that the capital adequacy portion of the Capital Accord would have to be broadened to cover market risk.[8]

In January 1996, the Basle Committee amended its Capital Accord to include a comprehensive system of capital charges based on the market risk in a bank's securities trading portfolio. Under the Capital Accord, subject to the approval of applicable national banking authorities, a bank may choose from two alternative methods for calculating its market risk capital requirement. One method bases the capital charges on a table of fixed-percentage charges similar to the Proposed Amendments. The other method approved by the Basle Committee allows certain banks to use value-at-risk models for calculating their market risk capital requirements.

In May 1993, the Commission issued a Concept Release [9] soliciting comments on alternative methods for computing haircuts on derivative financial instruments. Despite that release's focus on derivative financial instruments, the Commission intended to commence a broader dialogue with the industry regarding how the Rule could better reflect the market and credit risks inherent in a broker-dealer's proprietary securities portfolio. At that time, the Commission envisioned a multi-step revision of the net capital rule that would substantially change how broker-dealers calculate market and credit risk haircuts arising from their proprietary positions.

In 1995, the Commission received the Framework for Voluntary Oversight of the Derivatives Policy Group (''DPG''), consisting of the six U.S. securities firms most active in the over-the-counter (''OTC'') derivatives market. The DPG agreed to four major subjects of controls: management controls, enhanced reporting, evaluation of risk in relation to capital, and counterparty relationships. The DPG's evaluation of risk envisioned a capital-at-risk computation that would enable the Commission to assess the market risk in each firm's OTC derivative positions.

At about the same time, the Commission proposed for comment amendments to the net capital rule that would allow broker-dealers to use a theoretical option pricing model to determine capital charges for listed equity and currency options, and related positions.[10] At that time, the Commission also authorized the Division of Market Regulation (''Division'') to issue a no-action letter that permitted broker-dealers to use the theoretical option pricing model to calculate haircuts for listed options and related positions. In February 1997, the Commission adopted final amendments to the net capital rule, substantially as proposed, that allow firms to use theoretical option pricing models in determining net capital requirements for listed options and related positions.[11]

The Commission has also issued a concept release simultaneously with this release that requests comment on how the net capital could be amended, including whether statistical models should be used for regulatory capital purposes.[12] The method for calculating haircuts on Fixed Income Products proposed in this release represents one alternative for amending the Commission's net capital rule.

II. Fixed Income Products

A. Current Haircut Treatment of Debt Securities

Haircut charges on interest rate securities are based on their residual times to maturity and credit quality. This results in securities with longer residual maturities receiving greater haircuts than similar securities with shorter residual maturities. The charges on adjustable rate debt securities are based generally on residual maturity. The current Rule divides interest rate securities into categories and subcategories. The current Rule permits complete or partial netting (depending on the type of security) within a subcategory, and it permits lesser netting within and between categories.

Haircuts for each type of interest rate security (*e.g.*, government, municipal, and nonconvertible debt securities) are computed separately from other types of interest rate securities, with limited exceptions, restricting a broker-dealer's ability to reduce its haircut on offsetting positions among different types of securities. For example, the net capital charges for portfolios of government securities tend to be lower than for other debt instruments because of significant, if not complete, hedging allowances among government securities. The current net capital rule recognizes to a lesser extent hedges between corporate bonds and government securities.[13]

B. The Proposed Amendments

1. General Description

Under the Proposed Amendments, a broker-dealer would calculate two haircuts on its Fixed Income Products: a General Market Risk Charge and a Specific Market Risk Charge.[14] General market risk is the risk that the price of the Fixed Income Product will change because of market-wide changes in interest rates. The General Market Risk Charge is intended to cover market risk factors common among different types of interest rate instruments. Specific market risk is the risk of an adverse price movement for a security which is unique to a particular issue, but differs from a credit risk charge based on the risk that a counterparty will not be able to fulfill its obligations.

By separating the haircut for Fixed Income Products into two components, the Proposed Amendments recognize offsetting among the changing market values of many different types of securities, such as government securities and corporate debt, arising from general market-wide changes in interest rates, and use the Specific Market Risk Charge to capture risk that is not offset through these hedges.

2. General Market Risk Charge

Under the Proposed Amendments haircuts on unhedged positions in Fixed Income Products would not change

[8] The Basle Accord is a common measurement system and a minimum standard for capital adequacy of international banks in the Group of Ten countries.

[9] Securities Exchange Act Release No. 32256 (May 4, 1993), 58 FR 27486 (May 10, 1993) (''Concept Release'').

[10] Securities Exchange Act Release No. 33761 (March 15, 1994), 59 FR 13275 (March 21, 1994).

[11] Securities Exchange Act Release No. 38248 (February 6, 1997), 62 FR 6474 (February 12, 1997).

[12] Securities Exchange Act Release No. 34–39456 (December 17, 1997).

[13] 17 CFR 240.15c3–1(c)(2)(vi)(F)(*3*).

[14] Appendix I is an example demonstrating how the haircuts are calculated on a hypothetical portfolio under the Proposed Amendments.

significantly from the current net capital rule. However, as noted above, Fixed Income Products under the proposal would be treated as part of a single portfolio which would allow for greater hedging benefits when calculating the General Market Risk Charge than under the current Rule. In general, most Fixed Income Products would be slotted into five maturity bands, or zones, and fifteen sub-zones based on their residual maturity.[15] For each sub-zone or zone, there would be an associated haircut with offsets across different maturities.

Similar to the current net capital rule, the Proposed Amendments would impose progressively larger haircuts as the securities increase in maturity. This recognizes that the price volatility of Fixed Income Products generally increases as their residual maturity increases. Further, the Proposed Amendments assume that short and long term interest rates tend to move together and that a movement in the market value of a Fixed Income Product with a short residual maturity will, to some degree, be offset by the price movement in the market value of an opposite position in a Fixed Income Product with a longer residual maturity. However, the degree to which prices of Fixed Income Products with different maturities move in the same direction after a change in interest rates is smaller as their residual maturities get farther apart. In other words, the price movements of debt instruments of similar residual maturities are more highly correlated than the price movements of debt instruments with significantly different residual maturities.

The calculation of the General Market Risk Charge incorporates the assumptions described above regarding the correlation of debt instruments based on residual maturity. Offsetting positions in Fixed Income Products positions with the same residual maturities are subject to a haircut. Any remaining amounts not offset within the same sub-zone may then be netted against positions with different residual maturities, albeit with greater haircuts. Essentially, this method of calculating haircuts for a mixed portfolio is designed to account for risk across the interest rate curve and the basis risk for those securities which are closely related in maturity.

Prior to calculating the General Market Risk Charge, a broker or dealer must place each long or short Fixed Income Product into one of 15 designated sub-zones. The use of 15 sub-zones provides for a capital cushion for offsetting positions with significantly different residual maturities and reflects the fact that prices of Fixed Income Products tend to move at increasingly different rates when their residual maturities are further apart.

Fixed Income Products, with certain exceptions, are placed into the sub-zones based on residual maturity, while certain variable rate instruments are categorized by the time to their Next Interest Reset Date.[16] By categorizing Fixed Income Products other than by residual maturity, the Proposed Amendments may more accurately group Fixed Income Products with similar market risks into the same sub-zone. Mortgage-Backed Pass-Through Securities fit into the sub-zones based on their market value relative to par value. Deep discount bonds (which include bonds that do not pay current interest) are slotted into one of two sub-zones that apply only to deep discount bonds. Each leg of an interest rate swap is translated into a synthetic bond with a market value equal to the value of the notional coupon and a maturity equal to the residual maturity of the swap or the time until the Next Interest Reset Date, if appropriate. These synthetic bonds then are placed into the sub-zones like any other Fixed Income Product.[17]

The General Market Risk Charge is defined as the sum of (A) the Sub-Zone Charges, (B) the Zone Charges, (C) the Between Zone Charges, and (D) the Residual Charge, each of which is described below.

The percentage haircut for particular sub-zones, or market risk weight, ranges from 0 percent for a Fixed Income Product with one month or less to maturity to 12 percent for deep discount bonds with more than 20 years to maturity. These percentages were developed based on two components. The first component is the modified duration of a bond with a maturity equal to the mid-point of the respective sub-zone, assuming an 8 percent interest rate environment and an 8 percent coupon. The second component is an assumed change in yield that is designed to cover about two standard deviations of one month's yield volatility in most major markets. The two components are multiplied to give a percentage weighting factor for each sub-zone.

a. *Sub-Zone Charge*. Because most hedged positions among Fixed Income Products are not perfect hedges, the Proposed Amendments place a charge, the Sub-Zone Charge, on hedged positions to reflect the broker-dealer's residual exposure to market risk from the hedge. The Sub-Zone Charge is calculated in two steps. The first step is to calculate the Sub-Zone Charge for offsetting swap positions, and the second step is to calculate the Sub-Zone Charge for other offsetting positions within the same sub-zone. The Sub-Zone Charge for offsetting swaps is calculated separately from other offsetting positions because of the significantly higher degree of correlation among offsetting swaps positions compared to hedges among other types of debt instruments.

The Sub-Zone Charge for offsetting swaps applies only to hedged positions exclusively between interest rate swaps in the same sub-zone. The Sub-Zone Charge for offsetting swap positions is determined by multiplying the lesser value of the long or short swap positions in each sub-zone by the applicable sub-zone percentage; then multiplying that product by one percent. The remaining swap positions are then combined with other Fixed Income Product positions in that sub-zone.[18]

The Sub-Zone Charge for positions other than swaps is calculated by multiplying the lesser value of the long or short positions in each sub-zone by the applicable sub-zone percentage; and then multiplying that product by five percent. The sum of the Sub-Zone Charge for offsetting swaps and the Sub-Zone Charge for other positions, for each sub-zone, is the total Sub-Zone Charge. The difference between the aggregate values of the long and short positions in these Fixed Income Products in each sub-zone (the unhedged amount), multiplied by the applicable sub-zone percentage, is the Long or Short Sub-Zone Carry-Forward

[15] The zone and sub-zone grid may be found in section vi(A)(3)(i)(A) of the Proposed Amendments.

[16] Next Interest Rate Reset Date means the maturity date of the instrument or, if earlier, the next date as of which the interest rate on the instrument is subject to being either increased or decreased, as applicable, by an amount that is at least 0.5% greater or lesser than the current interest rate on the instrument. The requirement that the rate be able to move by at least 0.5% excludes those securities that are at or near their rate cap and therefore tend to behave like a fixed rate security.

[17] The reasons for slotting these assets into the sub-zones other than by residual maturity is explained in further detail in Section II.C. of this release.

[18] For example, if a broker-dealer had a $20 million long swap position and a short swap position of $30 million in sub-zone (ii), the sub-zone disallowance for offsetting swaps would be equal to the product of $20 million $\times$ 0.2%$\times$1% (or $400); the difference between the $30 million short position and the $20 million long position would be added to the aggregate value of the broker-dealer's short positions in other securities in sub-zone (ii) for the purposes of calculating the sub-zone disallowance for other securities.

Amount for each sub-zone.[19] The Sub-Zone Carry-Forward Amounts are used to calculate the Zone Charge.

b. *Zone Charge*. Similar to the Sub-Zone Charge, the Zone Charge is the haircut on hedged positions within the same zone. Because there will be greater disparity among the residual maturities of these positions, the percent charge for these offsetting positions is higher than the Sub-Zone Charge.

In calculating the Zone Charge, the Long and Short Sub-Zone Carry Forward Amounts for each zone are totaled separately and are identified respectively as the Long and Short Zone Positions. The Zone Charge for each zone equals the lesser of the Long or Short Zone Positions for each Zone multiplied by the percentage set forth in the Rule's Zone Charge provisions.[20] The difference between the Long and Short Zone Positions in each zone (the unhedged amount) is called the Long or Short Zone Carry-Forward Amount for that zone and is used to calculate the Between Zone Charge.[21]

c. *Between Zone Charge*. The Between Zone Charge is the charge for offsetting positions in different zones. As the disparity between the residual maturities of the hedged positions grows, the percentage charge increases because the positions reflect increasingly imperfect hedges. Calculating the Between Zone Charge requires two separate computations: one for adjacent zones and the other for non-adjacent zones. Because the difference in the residual maturities of offsetting positions in non-adjacent zones may be much greater than between positions in adjacent zones, the charges are greater for offsetting positions in non-adjacent zones.

The Between Zone Charge for adjacent zones is arrived at by multiplying the lesser of the Long or Short Zone Carry-Forward Amounts in two adjacent zones by the Between Zone Charge percentages.[22] The difference between the Long and Short Zone Carry-Forward Amount in two adjacent zones (the unhedged amount) may be used to offset positions in other adjacent zones. Any remaining Long and Short Zone Carry-Forward Amounts not offset by amounts in adjacent zones is called the Long or Short Between Zone Carry-Forward Amount.

The Between Zone Charge for non-adjacent zones is arrived at by multiplying the lesser of the Long or Short Between Zone Carry-Forward Amounts by the Between Non-Adjacent Zone Charge percentages.[23] Generally, this permits a substantial amount of netting on a weighted basis among positions that vary in maturities, some as far apart as twenty years.

d. *Residual Charge*. The Residual Charge consists of any remaining Between Zone Carry-Forward Amounts that have not been offset. For the purposes of the Proposed Amendments, these are the equivalent of unhedged positions.

The Commission requests comment on the Sub-Zone, Zone, Between Zone and Residual Charges, and how these Charges may be modified.

3. Specific Market Risk Charge

Fixed Income Products, with the exception of government securities and synthetic bond positions, are subject to a Specific Market Risk Charge. A broker-dealer's total Specific Market Risk Charge is the sum of the charges for each individual Fixed Income Product. The Specific Market Risk Charge is intended to address issuer-related and liquidity risks associated with the underlying instruments. There is no need for this Charge for synthetic bonds which do not have identifiable specific risks. This Charge, as noted above, has no relationship to a credit charge for counterparty risk in derivative non-exchange traded instruments.

The Specific Market Risk Charge is a prescribed percentage of the market value of the instrument. The two factors used in determining the percentage rate for this Charge are the maturity of the instrument and whether its interest rate is fixed or adjustable.

The Specific Market Risk Charge may not be reduced by offsetting positions in different securities of the same issuer or securities of different issuers because these securities and issuers may have different liquidity and issuer risks which might prevent correlated market movements.

C. Treatment of Specific Fixed Income Products

Provided below is a description of how haircuts are presently calculated for the various types of Fixed Income Products affected by the proposed amendments and how the haircuts for those Fixed Income Products would be calculated under the Proposed Amendments. The Commission request comment on the proposed net capital treatment of each of the interest rate instruments discussed below.

1. Government Securities

Currently, the government securities haircut schedule, set forth in paragraph (c)(2)(vi)(A) of the Rule, separates government securities into four categories and twelve subcategories. Each subcategory includes a prescribed band of maturities.[24] The haircut for each subcategory, assuming no other netting, is the net position in a particular subcategory multiplied by a specified percentage, or haircut.[25] The haircuts for government securities range from 0 percent for securities with a residual maturity of less than three months to 6 percent for securities with a residual maturity of 25 years or more. The charge for each category is the net of the aggregate charges on the long subcategory positions and the aggregate charges on the short subcategory positions in the category plus 50 percent of the lesser of the aggregate charges on the long or short positions.[26] For example, under the current Rule, a firm with a $40,000,000 long position in government securities with 16 months remaining maturity and a $10,000,000 short position in government securities with 30 months remaining maturity (both category 2 government securities), would take the following deduction for category 2:

[19] For example, a broker-dealer that has positions in sub-zone (ii) other than swap positions, equal to a long position of $10 million, a short position of $5 million, and $2 million in a non-offsetting short swap position that carried forward, the sub-zone disallowance would be equal to $7 million × 0.2%×5% (or $700). The Long Sub-Zone Carry-Forward Amount would be $3 million × 0.2% (or $6,000).

[20] See paragraph (c)(2)(vi)(A)(*3*)(*iii*)(*A*) of the Proposed Amendments.

[21] If in Zone 1, a firm had a $10,000 Long Sub-Zone Carry-Forward Amount from sub-zone (ii), and a $4,000 Short Sub-Zone Carry-Forward Amount from sub-zone (iii), the Zone Charge would be $4,000×0.25 (or $1,000). The Long Zone Carry-Forward Amount would be $10,000 less $4,000, or $6,000.

[22] See paragraph (c)(2)(vi)(A)(*3*)(*iv*)(*A*) of the Proposed Amendments.

[23] If a broker-dealer had a Long Zone Carry-Forward Amount of $6,000 from Zone 1 and a Short Zone Carry-Forward Amount of $10,000 from Zone 2, the Between Zone Disallowance would be $6,000×50% (or $3,000). The remaining Short Zone Carry-Forward Amount from Zone 2 ($4,000) may be used to offset long amounts in Zone 3 or Zone 4.

[24] Category 1 covers securities with a residual maturity of less than 12 months to maturity. Category 2 covers securities from 1 year to 3 years. Category 3 covers securities from 3 years to 10 years. Category 4 covers securities over 10 years.

[25] For example, the haircut for a broker-dealer with a $7 million long position and a $4 million short position in Treasuries with remaining maturities between 9 months and one year would be $3 million multiplied by 1%, or $30,000.

[26] See the text.

Long	Short	Net	%	Haircut
(i) 40,000,000		40,000,000	1.5	600,000
(ii)	(10,000,000)	(10,000,000)	2.0	(200,000)
				400,000
200,000×50%=				100,000
Total Deduction				500,000

This treatment allows partial netting of long and short positions within a category. The current Rule also allows further netting of a position within one category and one in an adjacent category under certain circumstances, and permits the partial netting of certain corporate securities with government securities within certain limits. In sum, the current Rule permits limited offsets within categories, and complete offsets for certain offsetting long and short positions (*e.g.,* those in the same subcategory). A broker-dealer that has been designated as a primary dealer by the Federal Reserve Bank of New York may reduce its haircut charges on government securities by 25 percent if it maintains a minimum tentative net capital of at least $50 million.[27]

Under the Proposed Amendments, government securities would not be subject to a Specific Market Risk Charge. With respect to the General Market Risk Charge, under the Proposed Amendments, government securities generally would be placed into one of the fifteen sub-zones based on residual time to maturity. Because the Proposed Amendments adopt a portfolio view for calculating haircuts by allowing all types of Fixed Income Products (with certain exceptions) to be combined into the same sub-zones, the Proposed Amendments would expand the ability of firms to hedge positions in government securities with other types of interest rate instruments.

2. Investment Grade Nonconvertible Debt Securities and Money-Market Debt Instruments

The current formula for determining haircuts for investment grade nonconvertible debt securities, consisting primarily of corporate debt securities, separates bonds into nine different categories based on residual maturity.[28] To be treated as an investment grade nonconvertible debt security, the security must not be traded flat or in default as to principal or interest and must be rated in one of the four highest rating categories by at least two nationally recognized statistical rating organizations. Charges range from 2 percent for securities with less than 1 year residual maturity to 9 percent for securities with a residual maturity of 25 years or greater. The charge is applied to the greater of the long or short position in each category. Firms may also partially offset investment grade nonconvertible debt securities with government securities or other corporate securities with similar residual maturities.

Under the Proposed Amendments, investment grade nonconvertible debt securities as well as commercial paper, bankers acceptances, and certificates of deposit would be subject to the Specific Market Risk Charge as well as the General Market Risk Charge. The criteria for determining whether the paper is investment grade would be the same as under the current net capital rule. The Specific Market Risk Charge for fixed rate investment grade nonconvertible debt ranges from 0.25 percent to 1.6 percent. As with government securities, fixed rate investment grade nonconvertible debt would be placed into the sub-zones based on residual maturity to compute the General Market Risk Charge.

Adjustable rate investment grade nonconvertible debt would be placed into the sub-zones generally based on the time to the Next Interest Reset Date if the interest rate on the instrument may be either increased or decreased, as applicable, by at least 0.5 percent. An adjustable rate investment grade nonconvertible debt instrument that is within 0.5 percent of its rate cap would be placed into the sub-zones based on its residual maturity. That instrument, although technically a variable rate instrument, would tend to behave like a fixed rate instrument given a change in interest rates.

Zero coupon and deep discount bonds[29] with residual maturities of six years or greater would be slotted, based upon residual maturity, into higher sub-zones than their residual maturities. Since their prices tend to be more volatile than coupon bonds of the same maturity, simply slotting such bonds according to residual maturity would underestimate risk and allow offsetting between positions that have substantially different risk profiles.

3. Pass-Through Mortgage-Backed Securities

Under the current net capital rule, mortgage-backed securities issued or guaranteed as to principal or interest by the United States or any agency thereof are treated as U.S. Government securities for the purposes of calculating haircuts. As with Treasury securities and other government securities, the current net capital rule bases the charges for mortgage-backed securities on their residual maturity and allows the securities to be offset against other government securities with similar residual maturities.

Mortgage-backed securities present particularly difficult net capital problems because partial payments of principal are generally made on a routine basis and often the entire principal is paid at an early stage in the maturity of the instrument. These principal payments or probabilities of prepayment drastically change the effective maturity of these instruments. Because the current Rule bases the charges for mortgage-backed securities on residual maturity rather than on criteria that better reflect their price volatility and duration, the haircut may overstate the risk on individual positions, and understate the risk on positions considered hedged by the Rule which may in fact not be adequately hedged. For example, the net capital rule may impose a large haircut on a position in mortgage-backed securities with a small duration but a long residual maturity but impose no charge for a position in the same mortgage-backed security hedged with a Treasury security with a similar residual maturity but with a longer duration.

It has been argued that a mortgage-backed security with a relatively high coupon rate should experience a significant amount of prepayment of principal and, consequently, will tend to act more like a security with less time

[27] 17 CFR 240.15c3–1(c)(vi)(A)(5).

[28] 17 CFR 240.15c3–1(c)(2)(vi)(F). Paragraph (c)(2)(vii) of the Rule regarding non-marketable securities would still apply to all inventory.

[29] Deep discount bonds are defined generally as Fixed Income Products that either do not pay interest or are priced at 50% or less of their par value. See paragraph (c)(2)(vi)(A)(*4*)(*iv*) of the Proposed Amendments.

to maturity. Based on the apparent correlation between the price of an instrument and its probable maturity, the Division issued a no-action letter permitting firms to place certain mortgage-backed securities into the government securities haircut categories of the current net capital rule based on their market price relative to their par value.[30]

The proposed rule incorporates this approach and allows firms to hedge Pass-Through Mortgage-Backed Securities[31] against other Fixed Income Products, consistent with the general intent to allow some hedging of all interest rate instruments.

4. Futures and Forwards

The current net capital rule provides that capital charges for futures contracts are based on the margin requirement of the applicable commodity clearing organization, although these positions may be inserted into the present grid and treated like securities positions. The capital charge for forward contracts on securities is based on the underlying instrument.[32] There also are allowances made for offsetting positions under prescribed circumstances.

As proposed herein, all futures and forwards on Fixed Income Products will be included in the General Market Risk sub-zones. A future or forward would be incorporated into the grid by inserting into the sub-zones any of the instruments deliverable against the future or the forward, up to the market value of the future or forward. Once the deliverable instrument is placed into a sub-zone, it would be subject to the same haircuts and offsets as other Fixed Income Products. However, there is no Specific Market Risk Charge for futures and forwards on Fixed Income Products.

5. Interest Rate Swaps

A basic interest rate swap or a ''plain vanilla'' swap involves the exchange of specified or determinable cash flows at specified times based upon a notional amount. The notional amount is not exchanged but is used to calculate the fixed or floating rate interest payments made under the swap. Presently, the current net capital rule generally treats any net interest payment due from an interest rate swap as an unsecured receivable (absent the presence of liquid collateral) that must be deducted from the broker-dealer's net worth in arriving at its net capital. The broker-dealer also is required to take an additional haircut on the notional amount of the swap as the market risk haircut.

The proposed rule would require that interest rate swaps be placed into the General Market Risk sub-zones by converting each side of the swap into synthetic bond positions based on the notional amount of the swap and the interest rates against which payments are calculated. A broker-dealer would calculate the market value of the synthetic bond by adjusting the value of the notional amount under the swap for changes in interest rates in the same way that a debt security is marked-to-market. These synthetic bonds then would be placed into the appropriate sub-zones. As with all synthetic bond positions, these positions would not be subject to Specific Market Risk Charges.

Any obligation to receive payments under the swap would be categorized as a long position; any obligation to make payments under the swap would be characterized as a short position.[33] A position receiving or paying based on a floating interest rate generally will be treated as having a maturity equal to the period until the Next Interest Reset Date; a position receiving or paying based on a fixed rate will be treated as having a maturity equal to the residual maturity of the swap.

Any interest rate portion of a swap that pays or receives according to the value of one or more equity securities (*i.e.*, an equity swap) would be slotted into the General Market Risk sub-zones. The equity portion of the swap would be treated, for purposes of the net capital rule, as an equity security or equity index, as appropriate, with a market value equal to the notional value of the swap.

As noted above, the Sub-Zone Charges, or haircuts, for synthetic bond equivalent positions derived from interest rate swaps would be calculated separately from other Sub-Zone Charges (*e.g.*, government securities and Pass-Through Securities) under the Proposed Amendments. Synthetic bond equivalents derived from interest rate swaps, when offset against one another, would be subject to a 1 percent Sub-Zone Charge, instead of the 5 percent Sub-Zone Charge applicable to non-swap positions.

6. Repurchase (''Repo'') and Reverse Repurchase Agreements (Reverse Repo)

Under the current Rule, a broker-dealer does not take a haircut on repo or reverse repo transactions[34] to reflect market risk. However, a broker-dealer engaging in reverse repo transactions must maintain additional net capital if it is holding collateral that far exceeds the contract price under the agreement.[35] In addition, a broker-dealer must also subtract from its net worth any deficiency arising under a reverse repo if the market value of the securities it holds is less than the contract price.[36] For repo transactions, Rule 15c3–1 requires a broker-dealer to take a deduction from its net worth if it has delivered to the counterparty securities in excess of the contract price of the repo, under certain circumstances.[37]

The Commission is proposing that repos and reverse repos be incorporated into the Proposed Amendments by treating each repo and reverse repo transaction as a short or long position, respectively, in a synthetic bond with a maturity equal to that of the contract or the Next Interest Rate Reset Date, whichever is less. This would allow repos and reverse repos to act as hedged positions where appropriate. In addition, the Commission also requests comments on whether these should be marked-to-market daily for net capital purposes in the same manner that a Treasury security is marked-to-market for a change in interest rates.

D. Product Specific Issues

Although the Proposed Amendments recognize, for net capital purposes, offsetting positions among most types of interest rate products, the Commission believes that it is desirable to expand the proposal to permit offsetting among additional types of interest rate products. Five different types of interest rate products that are not included in the proposal are described below, and

[30] Letter regarding Pass-Through Mortgage Securities (December 30, 1996).

[31] *Supra* note 5.

[32] The general net capital treatment of forwards on commodities (other than foreign currencies) is set forth in Appendix B of Rule 15c3–1. Broker-dealers must deduct 20% of the market value of uncovered forward contracts to account for market risk. Broker-dealers incur no market risk deduction if the forward is currently registered as deliverable on a contract market and is covered by an open futures contract or by a commodity option on a physical. Broker-dealers incur a market risk deduction of 10% for other forward contracts to purchase or sell commodities which are not registered as deliverable that are covered by an open futures contract.

[33] For example, an interest rate swap under which a firm is receiving payments based on a floating rate interest and paying based on a fixed interest rate would be treated as a long position in a floating rate instrument with a maturity equivalent to the period until the Next Interest Reset Date and a short position in a fixed rate instrument with a maturity equivalent to the residual life of the swap.

[34] A repurchase agreement, or repo, is an agreement between a buyer and a seller, usually of U.S. government securities, where the seller agrees to repurchase the securities from the buyer at an agreed upon price and, usually, on a stated date. In a reverse repurchase agreement, the broker-dealer has purchased the securities from the counterparty and has agreed to resell them at the agreed upon price.

[35] 17 CFR 240.15c3–1(a)(9).

[36] 17 CFR 240.15c3–1(c)(2)(iv)(F)(*2*).

[37] 17 CFR 240.15c3–1(c)(2)(iv)(F)(*3*).

the Commission seeks comment on how these instruments could be incorporated into the Proposed Amendments.

1. Mortgage-Backed Securities and Certain Non-Qualified Mortgage Pass-Through Securities

As noted, the Commission believes it is desirable to include all mortgage securities into a unified haircut methodology to give more recognition to hedging strategies employed by broker-dealers. Nonetheless, the Commission's proposal does not include certain mortgage securities, such as collateralized mortgage obligations (''CMOs''), interest-only mortgage securities (''IOs''), principal-only mortgage securities (''POs''), and mortgage pass-through securities that are not collateralized by level payment loans on one to four family homes.

There have been several alternatives suggested by broker-dealers to deal with these securities. One would slot CMOs into the maturity bands for interest rate products based on one day less than one-half the stated maturity of the CMO. While this proposal may provide adequate levels of capital for unhedged positions, the proposal does not appear to address the varied hedging strategies associated with CMOs. The second suggestion would slot CMO's into the various categories based on price, third party prepayment forecast systems, and historical volatility for the various classes of CMOs. This method would reflect more closely the various hedging strategies involving CMOs, but is both complex and based on subjective judgements regarding prepayments of principal. A third alternative would be to allow some type of internal modelling to serve as the basis for calculating haircuts on these instruments. This presents substantial examination burdens and might lead to excessive leverage and inadequate capital levels. Each alternative, however, deserves consideration, and the Commission solicits comment on each of these alternatives.

2. Non-Investment Grade Debt

The Proposed Amendments also do not include high-yield bonds (also known as ''junk'' bonds). Under the current Rule, non-investment grade bonds having a ready market are treated as if they were equity securities requiring a capital charge of at least 15 percent. In a no-action letter, the Division stated that whether these securities had a ready market depended on the amount of the initial issuance, whether the securities can be publicly sold without registration with the Commission, and whether there is currently available public information.[38]

The Commission preliminarily believes that it is inappropriate to permit non-investment grade bonds to be offset, or hedged, with other debt instruments because non-investment grade bond prices are much more dependent on issuer-specific risk factors, similar to those important in the pricing of equity securities, than on general market risk factors.[39] However, the Commission seeks comment on alternative methods of determining haircuts for non-investment grade bonds and whether those securities should be used to offset positions in other securities.

3. Interest Rate Instruments Denominated in Foreign Currencies

Under this proposal, instruments denominated in different currencies would not be permitted to be offset against one another. Thus, broker-dealers would have to calculate their market risk haircut for Fixed Income Products separately for each currency in which those instruments are denominated. Available evidence suggests that while correlations of interest rate products denominated in different currencies are often positive, they are relatively low when compared with correlations for securities denominated in the same currency. The Commission solicits comment on the appropriateness of permitting different currency interest rate instruments to offset one another. The Commission also requests comment on methods for addressing the foreign exchange risk of these securities.

4. Forward Rate Agreements and Eurodollar Futures

In a forward rate agreement, two parties agree on a fixed interest rate that is to be paid on a notional deposit of a specified maturity commencing at a future date. A Eurodollar future is a U.S. dollar denominated, cash settled futures contract where the underlying instrument is a Eurodollar[40] time deposit commencing on a specific forthcoming date. These instruments are commonly used to offset future payment streams stemming from obligations of current interest rates, including interest rate swaps. The Commission seeks comment on how these instruments may be incorporated into the net capital rule.

5. Fixed Income Options

Options on U.S. Treasury Securities and certain debt instruments issued by agencies of the U.S. Government and options on futures on these securities (''Fixed Income Options'') can comprise an important element of a broker-dealer's interest rate book. As discussed earlier, the Commission recently adopted amendments to the net capital rule that permit an options pricing model to be used to determine capital charges for listed options and their related positions. The Commission is seeking comment on whether it may be possible to use a similar approach to determine haircuts on over-the-counter Fixed Income Options.

One alternative would be to reprice the option, as with listed options, after changing the price of the underlying security based on specific market ''shocks'' specified by the Commission. For example, for domestic interest rate products, the entire universe of underlying securities could be represented by the U.S. Treasury yield curve, which includes market yields for 3-month to 30-year securities. The broker-dealer would then subject its Fixed Income Options portfolio to different types of shocks. One type of shock could be obtained by imposing a parallel shift in the yield curve. A second type of shock could be obtained by changing the slope of the yield curve. Third, the implied volatilities along the yield curve could also be increased or decreased.

The Commission seeks comment on the feasibility of using an options pricing model with prescriptive shocks for over-the-counter Fixed Income Options as well as suggestions for other methods for calculating haircuts on Fixed Income Options.

E. Non-Model Based Alternatives to the Proposed Amendments

The Commission believes that the maturity-based Proposed Amendments for Fixed Income Products meet two important objectives. First, the Proposed Amendments are an objective method for calculating regulatory net capital

[38] See Letter Regarding Ready Marketability of Noninvestment Grade Debt (February 14, 1994).

[39] As indicated by a number of studies, movements in most non-investment grade bonds are not highly correlated with movements of high-quality bonds. One study found a higher correlation between a long-term high-yield (*i.e.*, junk bond) index and the S&P 500 index than it found between the high-yield index and U.S. Treasuries or investment grade corporate bonds. (See Paul H. Ross, et al., High-Yield Corporate Bonds: An Asset Class for the Allocation Decision, Salomon Brothers (February 1989)). The study found a 0.93 correlation between AA-rated corporate bonds and U.S. Treasuries, but only a 0.45 correlation between the high-yield index and U.S. Treasuries. The correlation of the high-yield index with the S&P 500 was 0.63.

[40] A Eurodollar is U.S. currency held in banks outside the United States, mainly in Europe, and commonly used for settling international transactions.

whose results apply consistently to all broker-dealers. Second, the application and results of the Proposed Amendments can be readily verified by examiners and independent auditors. Importantly, the Proposed Amendments would differ from the current net capital rule in allowing broker-dealers to receive greater hedging benefits among a wider variety of interest rate instruments. Nonetheless, the Commission is aware that different entities may favor modifications or alternatives to the Proposed Amendments. The Commission solicits comment on the viability and the advantages and disadvantages of the Proposed Amendments, the alternative approaches described below, and any alternatives not discussed by the Commission in this release. In a separate release, the Commission is soliciting comments on the use of value-at-risk models for capital purposes.[41]

1. Duration

One alternative to the Proposed Amendments could be to use duration bands, instead of residual maturity bands, in determining the capital charges to be applied to specific positions in interest rate products. Duration is a mathematical concept which attempts to measure the sensitivity of bond prices to general interest rate changes. Generally, duration-based formulas express the weighted average time to payment of the cash flows of a bond (both interest and principal) where the weights are the present values of the cash flows themselves. Each cash flow is reduced to its present value. The point in time at which half of the cash flows (expressed in present value) would be received is commonly referred to as the duration of the bond.[42]

The Commission initially believes that a duration band analysis may be too complicated for calculating regulatory capital requirements; it requires examiners to re-calculate, on a daily basis, the duration of each Fixed Income Product in a firm's portfolio to reflect daily changes in interest rates. By basing haircuts on residual maturity instead of a daily duration calculation, the current net capital rule and the Proposed Amendments are computationally less intensive than a duration band approach. Nonetheless, the residual maturity method used in the current Rule and the Proposed Amendments are relatively close approximations to the duration method in determining capital charges for a hedged portfolio.[43] Consequently, the nominal increase in the precision of the price sensitivity estimate under the duration analysis over the residual maturity method may be outweighed by the costs associated with the greater complexity of the duration method.

2. Rolling Time-Band

One modification to the Proposed Amendments could be to eliminate the zones and instead determine offsets according to a ''rolling band approach'' between the fifteen different sub-zones, or maturity bands. Under this approach, the charge, or degree of offset, between opposite positions in different maturity bands would be computed based on the number of maturity bands that separate the long and short positions. For example, positions in adjacent maturity bands might be subject to a 20 percent charge, while positions separated by two maturity bands might be subject to a 30 percent charge, and so on. There would be a limit to how far apart the positions could be in the maturity bands and still be subject to an offset. While this approach refines the Proposed Amendments, the different ways a particular position could be offset may make this haircut calculation more complicated to program and to audit.

3. Cash-Flow Buckets

Another alternative to the Proposed Amendments would be to employ a cash flow-based approach. For example, a thirty-year Treasury bond would have 61 cash flows: 60 semi-annual interest payments for thirty years and a principal payment in the final year. Each cash flow theoretically could be inserted into the sub-zone corresponding to the time when that payment or receipt would be made. To the extent the expected payments and receipts in a particular sub-zone would not offset each other completely, a capital charge would be assessed on the net position. As with the current proposal, this approach also would require a charge on the matched position within a sub-zone to account for basis risk.

* * * * *

The Commission solicits comment on whether the potential benefits of each of these approaches outweigh their complexity, and encourages commenters to submit analysis or data on the likely costs of the alternative approaches. The Commission specifically requests comment on how the expected cash flows in Alternative 3 could be determined, especially for products whose cash flows are more difficult to predict, such as CMOs.

III. Costs and Benefits of the Proposed Rule Amendments and Their Effects on Competition

To assist the Commission in its evaluation of the costs and benefits that may result from the Proposed Amendments, commenters are requested to provide analyses and data relating to the costs and benefits associated with any of the proposals herein. In particular, the Commission requests comments on the potential costs for any necessary modifications to accounting, information management, and recordkeeping systems required to implement the proposed rule changes. The Commission estimates that approximately 1,350 broker-dealers will be affected by the Proposed Amendments. The Proposed Amendments have been tailored to minimize their burden on affected small broker-dealers while at the same time protecting the markets and investors. The Commission estimates that of the approximately 5,300 small broker-dealers registered with the Commission, only approximately 370 have proprietary positions in Fixed Income Products and are subject to the Rule. The Commission believes that the burden imposed upon broker-dealers will be significantly outweighed by the potential savings to broker-dealers from reduced capital requirements and increased efficiencies. The Commission requests comment on the extent to which the Proposed Amendments will reduce capital requirements. Commenters should provide estimates of the reduction in their capital requirements.

The Proposed Amendments provide broker-dealers the opportunity to reduce their capital charges. The Proposed Amendments change the haircuts applied to Fixed Income Products by combining different interest rate instruments into one haircut calculation that recognizes hedging among many more types of interest rate products than permitted under the current Rule. By recognizing more types of hedging

[41] Securities Exchange Release No. 34–39456 (December 17, 1997).

[42] The concept of modified duration is also commonly used. Modified duration is the price elasticity of a bond (*i.e.*, the percentage change in price for a one percent change in yield).

[43] If two securities have similar durations but different residual maturities, under the duration method they would receive a comparatively small haircut. Under the Proposed Amendments, the security with a longer residual maturity would tend to have a greater market value and would receive a comparatively larger haircut than the security with the shorter residual maturity. The residual amounts available for offset under the Proposed Amendments would tend to be roughly equal. Therefore, under the Proposed Amendments, the two positions would receive a capital charge similar to the charge under the duration method.

techniques, the Proposed Amendments should lower the haircuts for firms with well-hedged portfolios of Fixed Income Products and reduce a broker-dealer's incentive to fractionalize its business between the broker-dealer and its unregistered affiliate. Reducing a broker-dealer's need to fractionalize its securities business should allow a broker-dealer to increase its operational efficiency. Finally, by expanding the types of hedging recognized in the Rule, the Proposed Amendments should better reflect the hedging strategies currently used by broker-dealers.

The Commission preliminarily believes that the Proposed Amendments will promote both efficiency and capital formation. As previously discussed, the Proposed Amendments should provide broker-dealers the opportunity to increase operational efficiency by reducing the need to fractionalize its securities business. In addition, the Proposed Amendments should promote capital formation by reducing capital charges for well-hedged portfolios and by better reflecting the hedging strategies actually used by broker-dealers. This should allow broker-dealers greater freedom to invest assets or support underwritings thus promoting capital formation. Finally, a broker-dealer's operational efficiency should be increased as a result of allowing its current hedging strategies to be used in its calculation of required capital.

Section 23(a) of the Exchange Act [44] requires the Commission, when adopting or amending rules under the Exchange Act, to consider the impact the rule would have on competition and to refrain from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission has preliminarily considered the Proposed Amendments in light of this standard and believes that, if adopted, they would not impede competition. As previously discussed, the net capital rule is intended to ensure that broker-dealers have sufficient liquid capital to protect the assets of customers and to meet their responsibilities to other broker-dealers. When calculating its net capital, a broker-dealer reduces the market value of the securities it owns by certain percentages, or ''haircuts.'' Reducing the value of these securities provides a capital cushion should the securities portfolio decline in value. The Proposed Amendments change the haircuts applicable to the Fixed Income Products for all broker-dealers equally and, therefore, does not impede competition. The Proposed Amendments provide the same opportunities to all broker-dealers to improve the efficiency of their securities business. However, the Commission does recognize that these benefits come at the cost of greater computational complexity and it requests comment on the competitive impacts of this increased complexity.

IV. Summary of Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with the Regulatory Flexibility Act (''RFA''). [45] The analysis set forth in the IRFA relates to the Proposed Amendments. The IRFA states that the Proposed Amendments continue the Commission's efforts to revise Rule 15c3–1 by lowering haircuts on Fixed Income Products for a firm with a well hedged portfolio of Fixed Income Products and by reducing a broker-dealer's incentive to fractionalize its business between itself and an unregistered affiliate. Finally, the IRFA states that by expanding the types of hedges recognized in the Rule, the Proposed Amendments should better reflect the hedging strategies currently used by broker-dealers.

The IRFA sets forth the statutory authority for the Proposed Amendments Under Section 15(c)(3) of the Securities Exchange Act of 1934. [46] The IRFA also discusses the effect of the Proposed Amendments on small entities. Of the approximately 5,300 small broker-dealers registered with the Commission, approximately 370 are subject to the net capital rule that have proprietary positions in Fixed Income Products. Accordingly, the IRFA states that the Proposed Amendments would have a direct effect on approximately 370 out of 5,300 small broker-dealers. The IRFA also states that these small broker-dealers would have to adjust their processes and procedures for calculating net capital and that this would likely involve amending their computer information systems.

More specifically, some broker-dealers' computer information systems may not have the capability to capture and classify the information required to implement the changes as to certain instruments. For example, pass-through mortgage-backed securities are included in the Proposed Amendments provided that they are based on fixed rate residential mortgage loans on one to four family homes. Multifamily, adjustable rate, commercial, and mobile home mortgage loans are not included in the Proposed Amendments. Consequently, broker-dealers may need to modify their computer information systems to identify mortgage-backed securities by the criteria necessary to use the Proposed Amendments. The IRFA states that the Commission preliminarily believes that the modifications needed to comply with the Proposed Amendments should not be unduly burdensome, however, it does not currently have the information to quantify the costs associated with making these changes. Consequently, the IRFA requests comment on the costs associated with changing the computer information systems to comply with the Proposed Amendments. Commenters should provide detailed estimates of the costs to change their computer information systems.

The IRFA states that the Commission preliminarily believes that after affected broker-dealers change their processes, procedures, and computer information systems to reflect the Proposed Amendments, there will not be any continuing impact on these broker-dealers. However, the IRFA requests comments on any ongoing costs associated with complying with the Proposed Amendments. Commenters should provide detailed estimates of any ongoing costs they expect to incur.

The IRFA states that the Commission considered whether viable alternatives to the proposed rulemaking exist that accomplish the stated objectives of applicable statutes and that minimize any significant economic impact of proposed rules on small entities. More specifically, the Commission considered the following alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

The Commission believes that it would be inconsistent with the purposes of Rule 15c3–1 to exempt small entities from the Proposed Amendments or to provide an alternative net capital requirement including allowing small entities to continue to use the current capital requirements. Rule 15c3–1 is intended to protect the investing public by ensuring that broker-dealers have

[44] 15 U.S.C. 78w(a)(2).

[45] 5 U.S.C. 603.

[46] 15 U.S.C. 78o(c)(3)

sufficient liquid capital to protect the assets of customers and to meet their responsibilities to other broker-dealers. The Commission believes that the Proposed Amendments will enhance Rule 15c3–1's objectives by establishing more precise haircut charges that better reflect the risks associated with broker-dealers' Fixed Income Products positions and related hedging practices while ensuring that registered broker-dealers hold sufficient capital to maintain adequate liquidity to satisfy obligations to customers and other broker-dealers.

The IRFA states that the Commission preliminarily believes that the Proposed Amendments will not adversely affect small entities because they tend to own relatively few Fixed Income Products. As previously discussed, the Commission estimates that of the 5,300 small broker-dealers registered with the Commission, only 370 have proprietary positions in Fixed Income Products. In addition, the Proposed Amendments change the haircuts applicable to Fixed Income Products for all broker-dealers equally and thus provide the same opportunities to all broker-dealers to improve the efficiency of their securities business. However, the IRFA does request comment on whether the computational complexity of the amendments impedes a small business' ability to compete.

The IRFA includes information concerning the solicitation of comments with respect to the IRFA generally, and in particular, the cost of compliance with the proposed amendments and the number of small entities that would be affected by the Proposed Amendments. In addition, the IRFA solicits information for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, regarding the potential impact of the Proposed Amendments on the economy on an annual basis. Commentators are asked to provide empirical data to support their views. A copy of the IRFA may be obtained by contacting Christopher M. Salter, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 2–2, Washington, D.C. 20549.

V. Paperwork Reduction Act

Certain sections of Rule 15c3–1 contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'') (44 U.S.C. 3501 *et seq.*). The Commission has previously submitted the rule to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d), and OMB has assigned the rule OMB control number 3235–0200. Because the proposed rule changes should not materially affect the collection of information obligations under the rule, there is no requirement that the Commission resubmit the rule with the proposed amendments to OMB for review under the PRA.

VI. Statutory Analysis

Pursuant to the Act and particularly Section 15(c)(3), (15 U.S.C. 78o(c)(3)) thereof, the Commission is adopting amendments to § 240.15c3–1 of Title 17 of the Code of Federal Regulations in the manner set forth below.

List of Subjects in 17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule

In accordance with the foregoing, Title 17, chapter II, part 240 of the Code of Federal Regulations is proposed to be amended as follows:

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

1. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*(d), 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

2. Section 240.15c3–1 is amended by revising paragraph (a)(1)(ii)(C), the introductory text of paragraph (c)(2)(vi), and paragraphs (c)(2)(vi)(A), (D)(*3*), and (G); removing and reserving paragraphs (c)(2)(vi)(E) and (F); and adding undesignated section headings before paragraphs (c)(2)(vi)(A), (c)(2)(vi)(D)(*3*) and (c)(2)(vi)(G) to read as follows:

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

(a) * * *

(1) * * *

(ii) * * *

(C) Exclude credit balances in accounts representing amounts payable for government securities, commercial paper, bankers acceptances, certificates of deposit included within the scope of paragraph (c)(2)(vi)(A) of this section not yet received from the issuer or its agent, and any related debit items from the Exhibit A requirements for 3 business days; and

* * * * *

(c) * * *

(2) * * *

(vi) Deducting the percentages of the market value of all securities, money market and other instruments, or options in the proprietary or other accounts of the broker or dealer or making such other charges as are determined pursuant to paragraphs (c)(2)(vi)(A) through (M) of this section or set forth in appendix A (§ 240.15c3–1a).

Fixed Income Products

(A)(*1*) The charge from market value for all Government Securities; Synthetic Bond Positions; nonconvertible debt securities (other than municipal securities), that have fixed maturity dates, are not traded flat or in default as to principal or interest, and are rated in one of the four highest rating categories by at least two nationally recognized statistical rating organizations; Money Market Debt Instruments; and futures or forward contracts for the purchase or sale of instruments covered by this paragraph (c)(2)(vi)(A) shall be equal to the sum of the Specific Market Risk Charges specified in paragraph (c)(2)(vi)(A)(*2*) of this section and the General Market Risk Charges specified in paragraph (c)(2)(vi)(A)(*3*) of this section.

(*2*) For all Government Securities and all Synthetic Bond Positions, the Specific Market Risk Charge shall be zero. For all other securities or instruments covered by paragraph (c)(2)(vi)(A) of this section, the broker or dealer shall compute a Specific Market Risk Charge equal to the market value of the net position in each security multiplied by the applicable percentage specified below:

Residual maturity of product	Percentage fixed rate	Percentage adjustable rate
Less than 6 months	0.25	0.75
6 months but less than 2 years	1.00	1.50
2 years or more	1.60	2.10

(*3*) The General Market Risk Charge shall be equal to the aggregate of the Sub-Zone Charge, the Zone Charge, the Between Zone Charge, and the Residual Charge.

(*i*) To determine its General Market Risk Charge for securities covered by paragraph (c)(2)(vi)(A) of this section, a broker or dealer shall place the market value of each security in its appropriate sub-zone in accordance with the following:

(*A*) The market value of each security shall be placed in one of the sub-zones listed below based upon its residual maturity, except for those instruments described in paragraphs (c)(2)(vi)(*3*)(*i*)(*B*), (c)(2)(vi)(*3*)(*i*)(*C*) and (c)(2)(vi)(*3*)(*i*)(*D*) of this section.

Residual maturity	Sub-zone	Sub-zone per-cent-age
Zone 1:		
1 month or less	(i)	0
More than 1 month but not more than 3 months.	(ii)	0.20
More than 3 months but not more than 6 months.	(iii)	0.40
More than 6 months but not more than 1 year.	(iv)	0.70
Zone 2:		
More than 1 year but not more than 2 years.	(v)	1.25
More than 2 years but not more than 3 years.	(vi)	1.75
More than 3 years but not more than 4 years.	(vii)	2.25
Zone 3:		
More than 4 years but not more than 5 years.	(viii)	2.75
More than 5 years but not more than 7 years.	(ix)	3.25
More than 7 years but not more than 10 years.	(x)	3.75
Zone 4:		
More than 10 years but not more than 15 years.	(xi)	4.50
More than 15 years but not more than 20 years.	(xii)	5.25
More than 20 years	(xiii)	6.00
Zone 5:		
Deep Discount Bonds with more than 15 years but not more than 20 years.	(xiv)	9.00
Deep discount bonds with more than 20 years.	(xv)	12.00

(*B*) An Adjustable Rate Security shall be deemed to have a residual maturity equal to the remaining time to the effectiveness of its Next Interest Rate Reset Date.

(*C*) The market value of a Pass-Through Mortgage-Backed Security shall be placed into one of the sub-zones in accordance with the following table based on its market value relative to its par value:

PASS-THROUGH MORTGAGE-BACKED SECURITIES

Sub-zone	30-year pass-throughs	15-year pass-throughs	5- and 7-year balloons
(iv)	>108%	NA	NA.
(vi)	>105% but less than or = 108%	>103%	>102%.
(vii)	>102% but less than or = 105%	>100% but less than or = 103%	>94% but less than or = 102%.
(viii)	>98% but less than or = 102%	100% or less	94% or less.
(x)	98% or less	NA	NA.

(*D*) The market value of a Deep Discount Bond with a residual maturity of no more than six years shall be placed in one of the sub-zones in accordance with its residual maturity. The market value of a Deep Discount Bond with a residual maturity of more than six years shall be placed in one of the sub-zones based upon its residual maturity as follows:

Residual maturity	Sub-zone
More than 6 years but not more than 7½ years.	(x)
More than 7½ years but not more than 9 years.	(xi)
More than 9 years but not more than 12 years.	(xii)
More than 12 years but not more than 15 years.	(xiii)
More than 15 years but not more than 20 years.	(xiv)
More than 20 years	(xv)

(*E*) A broker or dealer that has entered into a futures or forward contract for the purchase or sale of a security covered by paragraph (c)(2)(vi)(A) of this section shall include in one of the sub-zones specified in paragraphs (c)(2)(vi)(A)(*2*) and (*3*) of this section the market value of a long or short position in any security that is specified as deliverable under the terms of the contract, in accordance with the residual maturity of the security. The market value of any positions included pursuant to this paragraph shall be equivalent to the market value of the corresponding future or forward contract. The provisions of appendix B (§ 240.15c3–1b) will in any event apply to the positions in futures contracts.

(*F*) A broker or dealer that has entered into a Swap Agreement shall include it in one or more of the sub-zones as follows. If the broker or dealer has entered into a Swap Agreement that obligates it to pay or receive scheduled interest cash flows at an adjustable rate of interest, the broker or dealer shall include in one of the sub-zones the market value of a short or long position, respectively, in a Synthetic Bond reflecting a principal amount equal to the notional amount of the Swap Agreement with residual maturity equal to the period until the effective date of the Next Interest Rate Reset Date. If a broker or dealer has entered into a Swap Agreement that obligates it to pay or receive scheduled interest cash flows at a fixed interest rate, it shall include in one of the sub-zones the market value of a short or long position, respectively, in a Synthetic Bond reflecting a principal amount equal to the notional amount of the Swap Agreement with residual maturity equal to the period until the maturity of the Swap Agreement.

(*G*) A broker or dealer that has entered into a repurchase or reverse repurchase agreement involving a security covered by paragraph (c)(2)(vi)(A) of this section, shall include in one of the sub-zones the market value of a short or long position in a Synthetic Bond with a principal amount equal to that of the funds received or provided, respectively, and a maturity equal to that of the residual maturity of the contract or equal to the period until the effective date of the Next Interest Rate Reset Date, whichever is less.

(*H*) A separate General Market Risk Charge calculation must be made for positions denominated in each different currency.

(*ii*) *Sub-Zone Charge.* The Sub-Zone Charge shall equal the sum of the charge for offsetting Swap Agreements plus the charge for other securities covered by paragraph (c)(2)(vi)(A) of this section for each sub-zone calculated as follows:

(*A*) The charge for offsetting Swap Agreements shall equal the lesser of the aggregate long or short swap positions in each sub-zone multiplied by the applicable sub-zone percentage set forth in paragraph (c)(2)(vi)(A)(*3*)(*i*)(*A*) of this section (the ''Sub-Zone Percentage'') multiplied by 1%. The net of all the long and short swap positions in each sub-zone (*i.e.,* non-offsetting swap positions) shall be added to the long or short position in other securities covered by paragraph (c)(2)(vi)(A) of this section in that sub-zone for the purpose of calculating the remaining charges in this paragraph.

(*B*) The charge for securities other than offsetting Swap Agreements in each sub-zone covered by paragraph (c)(2)(vi)(A) of this section shall equal the lesser of the aggregate long or short positions in each sub-zone (which shall include any non-offsetting swap positions carried forward as calculated in accordance with paragraph (c)(2)(vi)(A)(*3*)(*ii*)(*A*) of this section) multiplied by the applicable Sub-Zone Percentage, multiplied by 5%.

(*C*) The Long or Short Sub-Zone Carry-Forward Amount for a sub-zone shall equal the net of all sub-zone long or short securities positions in that sub-zone multiplied by the applicable Sub-Zone Percentage.

(*iii*) *Zone Charge.* The Zone Charge shall equal the aggregate of the charge for each zone calculated as follows:

(*A*) The Long and Short Zone Positions for each zone shall equal, respectively, the aggregate Long Sub-Zone Carry-Forward Amounts and aggregate Short Sub-Zone Carry-Forward Amounts in each zone.

(*B*) The Zone Charge for each zone shall equal the lesser of the aggregate Long Zone Positions or aggregate Short Zone Positions for each zone multiplied by the applicable percentage set forth below:

Zone 1—25%.
Zone 2—30%.
Zone 3—35%.
Zone 4—40%.
Zone 5—50%.

(*C*) The net of the Long Zone Positions and Short Zone Positions in each Zone shall be the Long or Short Zone Carry-Forward Amount for that zone.

(*iv*) *Between Zone Charge.* The Between Zone Charge shall equal the aggregate of the charges calculated as follows:

(*A*) The Between Zone Charge shall equal the lesser of the Long or Short Zone Carry-Forward Amounts between the zones described below multiplied by the applicable percentages:

Zones	Percentage
Between Zone 1 and Zone 2	50
Between Zone 2 and Zone 3	60
Between Zone 3 and Zone 4	70
Between Zone 4 and Zone 5	80
Between Zone 1 and Zone 3	85
Between Zone 2 and Zone 4	90

That portion of a Long or Short Zone Carry-Forward Amount used to offset a Long or Short Zone Carry-Forward Amount may not be used again to offset another Long or Short Zone Carry-Forward Amount.

(*B*) The Long and Short Zone Carry-Forward Amounts not offset pursuant to (c)(2)(vi)(*3*)(*iv*)(*A*) shall be the Long or Short Between Zone Carry-Forward Amounts.

(*v*) *Residual Charge.* The sum of the values of the Long and Short Between Zone Carry-Forward Amounts shall be the Residual Charge.

(*4*) *Definitions.* For the purposes of paragraph (c)(2)(vi)(A) of this section:

(*i*) *Government Securities* means all securities issued or guaranteed as to principal and interest by the United States or any agency thereof.

(*ii*) *Adjustable Rate Security* means a security covered by paragraph (c)(2)(vi)(A) of this section that has an interest rate that resets based upon an index that reflects current U.S. Treasury interest rates corresponding to the interest rate reset period of the covered security.

(*iii*) *Pass-Through Mortgage-Backed Security* means any security issued under the sponsorship of the United States or any agency thereof that represents a pro rata interest or participation in the principal and interest cash flows generated by a pool of mortgage loans of which at least 95% of the aggregate principal is composed of fixed rate residential mortgage loans on one-to-four family homes, including five and seven year mortgage loans with balloon payments at maturity. Multifamily, adjustable rate, commercial, and mobile home mortgage loans shall not be considered Pass-Through Mortgage-Backed Securities.

(*iv*) *Deep Discount Bonds* mean all securities covered by paragraph (c)(2)(vi)(A) of this section, other than Pass-Through Mortgage-Backed Securities, that either do not pay interest or are priced at 50% or less of their par value.

(*v*) *Next Interest Rate Reset Date* means, as to any Adjustable Rate Instrument, the maturity date of such instrument or, if earlier, the next date as of which the interest rate on the instrument is subject to being either increased or decreased, as applicable, by an amount that is at least 0.5% greater or lesser than the current interest rate on the instrument.

(*vi*) *Synthetic Bond Positions* mean hypothetical bond positions that are included in the maturity bands specified in paragraph (c)(2)(vi)(A)(*3*) of this section by virtue of paragraphs (c)(2)(vi)(A)(*3*)(*i*) (*F*), and (*G*) of this section.

(*vii*) *Swap Agreement* means a contractual agreement under which a broker-dealer is obligated to pay or entitled to receive from a counterparty cash flows equal to interest at a predetermined fixed rate, or at a floating rate, on a notional principal for the term of the Swap Agreement. The interest rate used to calculate parties' obligations under the Swap Agreement must be based on an index that approximates interest rates for instruments included within the scope of paragraph (c)(2)(vi)(A) of this section, and the parties' payment obligations cannot be a multiple of that interest rate index.

(*viii*) *Money Market Debt Instruments* mean, in the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, and which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited and is rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations, or in the case of any negotiable certificates of deposit or bankers acceptances or similar type of instrument issued or guaranteed by any bank as defined in Section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)).

* * * * *

(D) * * *

Certain Municipal Bond Trusts and Liquid Asset Funds

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

(E) [Reserved]

(F) [Reserved]

Convertible Debt Securities

(G) In the case of a debt security not in default that has a fixed rate of interest and a fixed maturity date and that is convertible into an equity security, the charges shall be as follows: If the market value is 100 percent or more of the principal amount, the charge shall be determined as specified in paragraph (c)(2)(vi)(J) of this section; if the market value is less than the principal amount, the charges shall be determined as specified in paragraphs (c)(2)(vi)(A)(*2*) and (*3*) of this section based on its remaining maturity, provided that the security is rated as required by paragraph (c)(2)(vi)(A) of this section.

* * * * *

Dated: December 17, 1997.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

Appendix 1—Sample Calculation of Haircuts on Fixed Income Products

This appendix demonstrates how to calculate the Specific Market Risk Charge and the General Market Risk Charge on Fixed Income Products under the Proposed Amendments. The example is not intended to replicate an actual broker-dealer portfolio or to be used as a basis to compare haircuts under the Proposed Amendments to those under the current rule, but rather the example is intended to show how the Proposed Amendments operate. The first step in calculating haircuts under the Proposed Amendments is to calculate the Specific Market Risk Charge. Next, calculate the General Market Risk Charge. To calculate the General Market Risk Charge, each of the Fixed Income Products must be categorized by assigning the position in each instrument into one of the 15 sub-zones, reflecting separately the long and short positions.

The following table illustrates how an example portfolio is categorized under the Proposed Amendments. ^Repurchase and Reverse Repurchase Agreements are categorized based upon the agreements remaining maturity. *Treasury securities are categorized into the appropriate sub-zones based upon remaining maturity. **Fixed rate interest rate swaps are categorized based upon their residual maturity. ***Two of the Nonconvertible Debt securities have variable interest rates that reset every two and three years, respectively. These securities are placed into maturity sub-zones based upon their length of time to the Next Interest Reset Date. ~Futures contracts included in the portfolio are categorized based upon the remaining maturity of the Treasury security deliverable under the contract and not the length of the contract. ‘‘The Pass-Through Mortgage security is placed into the appropriate sub-zone based upon its market value relative to par which is greater than 98% but less than or equal to 102%.

Security	Value	Type of holding	Remaining maturity	Interest reset date	Zone	Sub-zone
Residual Maturity Categorization (Section 15c3–1(c)(2)(vi)(A)(3)(i)						
Repurchase Agreement^	$2,000,000	Short	30 Days	Fixed	1	i
Reverse Repurchase Agreement^	1,000,000	Long	30 Days	Fixed	1	i
Treasury*	1,000,000	Short	6 Months	Fixed	1	iii
Treasury*	1,500,000	Long	6 Months	Fixed	1	iii
Treasury*	500,000	Long	1 Year	Fixed	1	iv
Treasury*	1,000,000	Short	1 Year	Fixed	1	iv
Interest Rate Swap**	1,000,000	Long	8 Months	Fixed	1	iv
Interest Rate Swap**	1,200,000	Short	11 Months	Fixed	1	iv
Treasury*	2,000,000	Long	2 Years	Fixed	2	v
Treasury*	1,500,000	Long	2 Years	Fixed	2	v
Treasury*	1,000,000	Short	2 Years	Fixed	2	v
Treasury*	12,000,000	Short	2 Years	Fixed	2	v
Nonconvertible Debt***	2,500,000	Short	5 Years	Variable (2 Years)	2	v
Treasury*	2,000,000	Long	3 Years	Fixed	2	vi
Treasury*	2,500,000	Short	3 Years	Fixed	2	vi
Nonconvertible Debt***	1,000,000	Long	10 Years	Variable (3 Years)	2	vi
Treasury*	1,000,000	Long	5 Years	Fixed	3	viii
Future on 5-Year Treasury~	2,000,000	Short	180 Days	Fixed	3	viii
Treasury*	2,000,000	Short	10 Years	Fixed	3	x
Pass-Through Mortgage″	2,000,000	Short	29 Years	Fixed	3	x
Nonconvertible Debt***	1,000,000	Long	10 Years	Fixed	3	x
Future on 10-Year Treasury~	7,000,000	Long	90 Days	Fixed	3	x
Treasury*	3,000,000	Long	30 Years	Fixed	4	xiii
Treasury*	2,500,000	Short	30 Years	Fixed	4	xiii
Total	54,200,000					

Note: Appendix 1 to the preamble does not appear in the Code of Federal Regulation.

To calculate the Specific Market Risk Charge, a broker-dealer first categorizes those instruments subject to the charge into maturity categories based upon residual maturity. Note that for calculating the Specific Market Risk Charge, Adjustable Rate Securities are categorized by remaining maturity, not the time until the Next Interest Reset Date. The following demonstrates how the Specific Market Risk Charge is calculated for the sample portfolio.

Line No.	Security	Fixed or variable	Remaining maturity	Value	Specific market risk calculation	Specific market risk charge
Specific Market Risk Charge (Section 15c3–1(c)(2)(vi)(A)(2))						
1	Nonconvertible Debt	Variable	5 Years	$2,500,000	× 2.1%=	$52,500
2	Nonconvertible Debt	Variable	10 Years	1,000,000	× 2.1%=	21,000
3	Nonconvertible Debt	Fixed	10 Years	1,000,000	× 1.6%=	16,000

Line No.	Security	Fixed or variable	Remaining maturity	Value	Specific market risk calculation	Specific market risk charge
	Total Specific Market Risk Charge.	....	....	....	....	89,500

To calculate the haircut for its Fixed Income Products, a firm would first take a haircut for offsetting positions within the same sub-zone. Any remaining unhedged positions could then be used to offset other residual amounts from other sub-zones within the same zone, albeit with a larger haircut. A broker-dealer would then offset unhedged amounts between zones. The largest haircut under the Proposed Amendments would be imposed on residual positions that could not be offset under this procedure. The following demonstrates how the Sub-Zone Charges are calculated under the Proposed Amendments. This example does not show the application of Appendix B of Rule 15c3–1 as it applies to Futures and Forward contracts.

Line No.	Securities	Sub-zone	Long positions	Short positions	Charge calculation	Sub-zone charge
	Sub-Zone Charge (Section 15c3–1(c)(2)(vi)(A)(3)(ii))					
1	Repurchase Agreement	i		$2,000,000		
2	Reverse Repurchase Agreement	i	$1,000,000		X 0% X 5%=	$0
3	Net Position	i		1,000,000		
4	Sub-Zone Carry Forward (Line 3 X Sub-Zone Percentage of 0%).	i		0		
5	Treasury	iii		1,000,000	X .4% X 5%=	200
6	Treasury	iii	1,500,000			
7	Net Position	iii	500,000			
8	Sub-one Carry Forward (Line 7 X Sub-Zone Percentage of .4%).	iii	2,000			
9	Interest Rate Swap	iv	1,000,000		X .7% X 1%=	70
10	Interest Rate Swap	iv		1,200,000		
11	Net Position	iv		200,000	.	
12	Treasury	iv	500,000		X .7% X 5%=.	
13	Treasury	iv		1,000,000	X .7% X 5%=	175
14	Net Swap Position From Line 11	iv		200,000		
15	Net Position	iv		700,000		
16	Sub-Zone Carry Forward (Line 15 X Sub-Zone Percentage of .7%).	iv		4,900		
17	Treasury	v	2,000,000			
18	Treasury	v	1,500,000		(2,000,000 + $1,500,000) X 1.25% X 5%=.	2,188
19	Treasury	v		1,000,00		
20	Treasury	v		12,000,000		
21	Nonconvertible Debt	v		2,500,000		
22	Net Position	v		12,000,000		
23	Sub-Zone Carry Forward (Line 22 X Sub-Zone Percentage of 1.25%).	v		150,000		
24	Treasury	vi	2,000,000			
25	Nonconvertible Debt	vi	1,000,000			
26	Treasury	vi		2,500,000	X 1.75% X 5%=	2,188
27	Net Position	vi	500,000			
28	Sub-Zone Carry Forward (Line 27 X Sub-Zone Percentage of 1.75%).	vi	8,750			
29	Treasury	viii	1,000,000		X 2.75% X 5%=	1,375
30	Future on 5-Year Treasury	viii		2,000,000		
31	Net Position	viii		1,000,000		
32	Sub-Zone Carry Forward (Line 31 X Sub-Zone Percentage of 2.75%).	viii		27,500		
33	Treasury	x		2,000,000		
34	Pass-Through Mortgage	x		2,000,000	($2,000,000 + $2,000,000) X 3.75% X 5%=.	7,500

Line No.	Securities	Sub-zone	Long positions	Short positions	Charge calculation	Sub-zone charge
35	Nonconvertible Debt	x	1,000,000			
36	Future on 10-Year Treasury	x	7,000,000			
37	Net Position	x	4,000,000			
38	Sub-Zone Carry Forward (Line 37 X Sub-Zone Percentage of 3.75%).	x	150,000			
39	Treasury	xiii	3,000,000			
40	Treasury	xiii		2,500,000	X 6% X 5%=	7,500
41	Net Position	xiii	500,000			
42	Sub-Zone Carry Forward (Line 41 X Sub-Zone Percentage of 6%).	xiii	30,000			
Total Sub-Zone Charge.						21,195

As discussed above, the Sub-Zone Carry Forward Amounts (i.e., the remaining unhedged positions after calculation of the Sub-Zone Charges) are then used to offset other Sub-Zone Carry Forward Amounts from the other sub-zones within the same zone. The following demonstrates how the Zone Charges are calculated for the example portfolio under the Proposed Amendments.

Line No.	Zones	Long positions	Short positions	Zone charge calculation	Zone charge
	Zone Charge (Section 15c3–1(c)(2)(vi)(A)(3)(iii))				
	Zone 1				
1	Carry Forward From Sub-Zone iii	$2,000			
2	Carry Forward From Sub-Zone iv		$4,900	.	
3	Total Zone Positions	2,000	4,900	$2,000×25%=	$500
4	Less Offsetting Position		2,000	.	
5	Zone Carry Forward Amount		2,900	.	
	Zone 2				
6	Carry Forward From Sub-Zone v		150,000		
7	Carry Forward From Sub-Zone vi	8,750			
8	Total Zone Positions	8,750	150,000	8,750×30%=	2,625
9	Less Offsetting Position		8,750		
10	Zone Carry Forward Amount		141,250	.	
	Zone 3				
11	Carry Forward From Sub-Zone viii		27,500		
12	Carry Forward From Sub-Zone x	150,000			
13	Total Zone Positions	150,000	27,500	27,500×35%=	9,625
14	Less Offsetting Position	27,500			
15	Zone Carry Forward Amount	122,500			
16	Zone 4				
17	Carry Forward From Sub-Zone xiii	30,000			
18	Total Zone Positions	30,000		$0×40%	0
19	Less Offsetting Position	0			
20	Zone Carry Forward Amount	30,000			
	Total Zone Charge				12,750

As discussed above, the Zone Carry Forward Amounts (i.e., the remaining unhedged positions after calculation of the Zone Charges) are then used to offset Zone Carry Forward Amounts. The following demonstrates how the Between Zone Charges are calculated for the example portfolio under the Proposed Amendments. In this example, the Between Zone Charges are calculated between Zone 1 and Zone 2; Zone 2 and Zone 3; and Zone 2 and Zone 4.

Line No.	Between zone	Long positions	Short positions	Between zone calculation	Between zone charge
	Between Zone Charge (Section 15c13–1(c)(2)(vi)(A)(3)(iv))				
1	Carry Forward From Zone 1		$2,900		

Line No.	Between zone	Long positions	Short positions	Between zone calculation	Between zone charge
2	Carry Forward From Zone 2		141,250	.	
3	Total Zone Positions		144,150	$0×50%=	$0
4	Less Offsetting Zone Positions		0		
5	Between Zone 2 Carry Forward Amount		141,250		
6	Zone 1 Residual Amount		2,900		

Note: The Zone 1 Carry Forward Amount becomes a Between Zone Carry Forward Amount because it does not offset with Zone 2 as they are both short positions. The Between Zone 1 Carry Forward Amount is not offset against Zone 3 because the Zone 3 Carry Forward Amount is eliminated through its offset with Zone 2 as calculated below. Consequently, the Between Zone 1 Carry Forward Amount becomes a Residual Charge.

Line No.	Between zone	Long positions	Short positions	Between zone calculation	Between zone charge
7	Between Zone 2 Carry Forward Amount		141,250		
8	Carry Forward From Zone 3	$122,500			
9	Total Zone Positions	122,500	141,250	$122,500×60%=	73,500
10	Less Offsetting Zone Positions		122,500		
11	Between Zone 2 Carry Forward Amount		18,750		
12	Between Zone 2 Carry Forward		18,750		
13	Between Zone 4 Carry Forward	30,000			
14	Total Between Zone Positions	30,000	18,750	18,750×90%=	16,875
15	Less Offsetting	18,750			
16	Zone 4 Residual Amount	11,250			

Note: The Zone 4 Carry Forward Amount became a Between Zone Carry Forward Amount when the Zone 3 Carry Forward Amount was eliminated. The Between Zone 4 Carry Forward Amount is partially offset by the Between Zone 2 Carry Forward Amount. Because there are no other Between Zone Carry Forward Amounts to offset against the Between Zone 4 Carry Forward Amount, it becomes a Residual Charge.

Line No.	Between zone	Long positions	Short positions	Between zone calculation	Between zone charge
Total Between Zone Charge.					90,375

Risk charge	Applicable rule section	Haircut
Total Haircut		
Specific Market Charge	15c3–1(c)(2)(vi)(A)(2)	$89,500
Sub-Zone Charge	15c3–1(c)(2)(vi)(A)(3)(ii)	21,195
Zone Charge	15c3–1(c)(2)(vi)(A)(3)(iii)	12,750
Between Zone Charge	15c3–1(c)(2)(vi)(A)(3)(iv)	90,375
Zone 1 Residual Charge	15c3–1(c)(2)(vi)(A)(3)(v)	2,900
Zone 4 Residual Charge	15c3–1(c)(2)(vi)(A)(3)(v)	11,250
Total Haircut		227,970
Total Value of Portfolio		54,200,000

[FR Doc. 97–33401 Filed 12–29–97; 8:45 am]
BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–39456; File No. S7–32–97]

RIN 3235–AH29

Net Capital Rule

AGENCY: Securities and Exchange Commission.

ACTION: Concept release; request for comments.

SUMMARY: The Securities and Exchange Commission is continuing its study of its approach to determining net capital requirements for broker-dealers. As part of its study, the Commission is considering the extent to which statistical models should be used in setting the capital requirements for a broker-dealer's proprietary positions. Accordingly, the Commission is posing a number of questions on this subject as well as soliciting views on other possible alternatives for establishing net capital requirements.

DATES: Comments must be received on or before March 30, 1998.

ADDRESSES: Interested persons should submit three copies of their written data, views, and opinions to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. Comment letters should refer to File No. S7–32–97; this file number should be included on the subject line if E-mail is used. All submissions will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (http://www.sec.gov).