



DIVISION OF
MARKET REGULATION

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

February 19, 2004

Mr. Marshall J. Levinson
Chair
Capital Committee
The Securities Industry Association
120 Broadway
New York, NY 10271

Dear Mr. Levinson:

This is in response to your letter (the "Letter"), dated February 18, 2004, from the Capital Committee of The Securities Industry Association ("SIA") to the Division of Market Regulation ("Division") of the U.S. Securities and Exchange Commission ("Commission"). In your Letter, you request temporary relief from certain provisions of the Commission's net capital rule, Securities Exchange Act Rule 15c3-1,¹ with respect to the anticipated impact of Statement of Financial Accounting Standards No. 150 ("FAS 150"), promulgated by the Financial Accounting Standards Board ("FASB"), on broker-dealers that are non-public entities.²

FAS 150 generally states that an issuer must classify a financial instrument within its scope as a liability for purposes of Generally Accepted Accounting Principles ("GAAP"). A financial instrument issued in the form of shares³ is mandatorily redeemable and, therefore, within the scope of FAS 150 if it, "embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event certain to occur." For example, under FAS 150, broker-dealers that have issued shares that must be sold back to the company upon the holder's death or termination of employment must record those shares as liabilities because the shares are mandatorily redeemable upon an event certain to occur.

¹ 17 CFR 240.15c3-1.

² FAS 150 generally became effective for the mandatorily redeemable financial instruments of publicly traded companies, including publicly traded broker-dealers, for the first interim period beginning after June 15, 2003.

³ According to FAS 150, the term "[s]hares includes various forms of ownership that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form."

You state that FAS 150 requires broker-dealers, as SEC registrants,⁴ to treat mandatorily redeemable financial instruments as liabilities, rather than equity, as they previously were treated under GAAP for non-public entities, and that this treatment, in turn, could cause certain broker-dealers to have insufficient net capital under Rule 15c3-1. In the Letter, you note that, “many broker-dealers have agreements such as partnership agreements, limited liability company operating agreements or shareholder agreements that contain mandatory redemption clauses.” Accordingly, these agreements are mandatorily redeemable financial instruments and treated as liabilities under FAS 150. You are concerned that application of FAS 150, therefore, might: (i) cause a broker-dealer to fall below its minimum net capital requirements under Rule 15c3-1(a), or (ii) cause its subordinated debt to debt-equity total to increase above the 70% limit set forth in Rule 15c3-1(d). Because FAS 150 only recently became applicable to non-public broker-dealers, you suggest that they may need time to amend partnership, limited liability company, shareholder, or other agreements to avoid potential adverse impacts of FAS 150 on net capital.

Based on the foregoing, the Division will not recommend enforcement action to the Commission if a broker-dealer that is a non-public entity, in calculating net capital under Rule 15c3-1, adds to its regulatory net worth the carrying value of mandatorily redeemable financial instruments that FAS 150 excludes from the firm’s GAAP equity. The limitations on withdrawal of equity capital contained in paragraph (e) of Rule 15c3-1 still would apply. The amount added back to net worth also could be treated as equity in determining a broker-dealer’s compliance with the debt to debt-equity total in paragraph (d) of Rule 15c3-1, provided it otherwise meets requirements of that paragraph. This relief would not affect the treatment of properly subordinated debt under Appendix D to Rule 15c3-1. This relief shall apply to broker-dealers that are non-public entities only through the end of the first annual period beginning after December 15, 2003, but no longer shall apply for fiscal periods beginning after December 15, 2004. For the fiscal periods beginning after December 15, 2004, broker-dealers that are non-public entities no longer will be permitted to add mandatorily redeemable financial instruments recorded as liabilities under FAS 150 to regulatory net worth for purposes of calculating net capital. This temporary relief applies only to the calculation of net capital and does not extend to the treatment of mandatorily redeemable financial instruments in broker-dealer financial statements prepared in accordance with GAAP. Finally, a broker-dealer that wishes to take advantage of this relief must advise its designated examining authority of its intent.

⁴ Under FASB Staff Position FAS 150-3, an “SEC registrant” includes any entity that must file financial statements with the SEC, such as a non-public broker-dealer.

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

Sincerely,

A handwritten signature in cursive script, appearing to read "Michael A. Macchiaroli".

Michael A. Macchiaroli
Associate Director

cc: Salvatore Pallante, New York Stock Exchange, Inc.
Susan DeMando, NASD Regulation, Inc.