June 25, 2007

**VIA EMAIL**
Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**RE: Proposed Amendments to the Financial Responsibility Rules for Broker-Dealers (File No. S7-08-07)**

Dear Ms. Morris:

Citigroup Global Markets Inc. ("CGMI") is pleased to respond to the SEC's proposed amendments to its financial responsibility rules under the Securities Exchange Act of 1934 (the "Proposal"). CGMI applauds the SEC for pursuing the laudable goal of improving customer protection. However, as detailed below, we believe there are certain aspects of the Proposal which do not accomplish, and may actually run counter to, accomplishing this goal.

CGMI participated in the preparation of the letters by the Securities Industry Financial Markets Association (the "SIFMA Letter"), and The Clearing House (the "TCH Letter" and collectively, the "Trade Association Letters") in response to the Proposal. We generally support the analysis and views set forth in the Trade Association Letters, and are writing separately to highlight certain comments made therein.

**Restrictions on the Ability of Broker-Dealers to Meet Reserve Requirements**

The Proposal would exclude deposits at an affiliated bank of a broker-dealer for the purposes of meeting customer or PAB reserve requirements under Rule 15c3-3 and place limitations on the amount of cash a broker-dealer could maintain in a customer or PAB special reserve bank account at one unaffiliated bank. For the reasons set out below, CGMI strongly opposes this aspect of the Proposal.

*Prohibition on Deposits at Affiliated Banks Meeting the Reserve Requirement*

In the Proposal, the SEC states its proposed exclusion of deposits held at an affiliated bank stems from the reduced lack of diligence that a broker-dealer may conduct on an affiliated bank, as well as concerns that customers may not derive any significant protection from the

reserve requirement in the event of the parent's insolvency. The SEC cites no empirical – or even anecdotal - evidence to support these reasons, nor is CGMI aware of any studies or evidence that would lend such support.

CGMI believes these concerns overlook the rigorous standards and reviews banks are subject to by bank regulators, which include imposition of capital adequacy requirements, periodic reviews of internal risk management controls, monitoring of banks' capital levels, and other robust measures designed to ensure banks' overall financial health. The SEC's concerns also discount the operational efficiencies to be gained between an affiliated broker-dealer and its bank, including commonality between certain policies and procedures; greater ease in communication internally; and greater operational efficiencies leading to reduced operational risk in the transfer of funds to and from the bank.

*Limitations on Deposits with Unaffiliated Banks*

The Proposal also prohibits a broker-dealer from counting towards its reserve account requirements any cash deposited at an unaffiliated bank to the extent such deposit exceeds the lesser of 50% of the broker-dealer's excess net capital or 10% of the bank's equity capital. As with the Proposal's prohibition on reserve deposits at affiliated banks, CGMI believes that this aspect of the Proposal disregards the rigorous review banks are subject to by bank regulators. In addition, we agree with the Trade Association Letters that this aspect of the Proposal underestimates the time and cost that would be incurred by requiring the opening of new reserve accounts that would be precipitated by the proposed limitations on reserve deposits at unaffiliated banks.

*Alternative Proposal*

We believe that the SEC's concern of ensuring the accessibility of reserve deposits upon a broker-dealer's insolvency is a valid one. However, we further believe that the SEC's prohibition on meeting PAB or customer reserve requirements through deposits at affiliated banks, and its limitations on meeting such requirements at unaffiliated banks, are unnecessarily draconian. Given that the SEC's concern is ultimately the creditworthiness of the bank at which deposits are kept, CGMI would suggest that it revise the Proposal so that, at a minimum, no restrictions apply to broker-dealers meeting their reserve requirements through deposits at "well capitalized" banks (as defined by congressionally mandated banking regulations), whether affiliated or unaffiliated. At a minimum, any limitations imposed on meeting reserve requirements should apply equally to affiliated and unaffiliated banks. We respectfully submit that this approach is better tailored to meeting the SEC's stated concerns.

**Allocation of Short Positions**

The Proposal would add new paragraph (d)(4) to Rule 15c3-3, which would require a broker-dealer to obtain physical possession or control over securities of the same issue and class as those included on the broker-dealer's books as a proprietary short position or as a short position for another person. This "buy-in" of securities would take place if the short position had

aged more than 10 business days (or more than 30 calendar days if the broker or dealer is a market maker in the securities).

CGMI opposes this aspect of the Proposal; we believe that it will have the unintended consequence of adversely impacting legitimate short selling activities, as well as conflicting with existing short-sale regulations. As noted in the SIFMA Letter, certain aspects of the Proposal may conflict with Regulation SHO.[1] In addition, the questionable benefits to be obtained by the addition of paragraph (d)(4) would be outweighed by the potentially disruptive effect this aspect of the Proposal would have by forcing buy-ins of the security.

For the reasons stated above and further detailed in the SIFMA Letter, we believe this aspect of the Proposal should be dropped. However, should the SEC determine to adopt this aspect of the Proposal, it should be modified so that the grace period runs from the date the possession or control deficit is identified, not the date of the execution of the short sale. In addition, the grace period should be harmonized at 30 calendar days for all broker-dealers, regardless of whether they act as market-makers in the relevant security. Finally, short sales subject to Regulation M should be excluded; as noted in the SIFMA Letter, Regulation M is specifically tailored to address the regulation of secondary market transactions by underwriters and other distribution participants, including "syndicate covering transactions." Therefore, the Proposal should exclude an underwriter's short position created in connection with a distribution of securities until after the later of the completion of such underwriter's participation in the distribution (as defined in Rule 100 of Regulation M) or the delivery date for securities acquired in the exercise of any overallotment option.

**Portfolio Margin**

The Proposal reflects recent amendments by the New York Stock Exchange (NYSE) and the Chicago Board Options Exchange (CBOE) to their margin rules that would permit a broker-dealer to calculate certain customer margin requirements based on a portfolio margin methodology. Specifically, the Proposal would amend Rule 15c3-1 to allow the market value of futures contracts held within a portfolio margin account to be included in calculating a customer's net equity in the account if the broker-dealer at which the account is held becomes subject to a SIPA liquidation. In addition, in the event the broker-dealer is placed in a SIPA liquidation, the Proposal would include as "customer property" the customer's margin deposit at a futures clearing organization related to futures positions carried in a securities account pursuant to an SRO portfolio margin rule.

CGMI supports this aspect of the Proposal. We believe that the Proposal represents a positive step forward in resolving certain regulatory obstacles in connection with the inclusion of futures contracts in a portfolio margin account. We further agree with the SIFMA Letter that the

[1] ". . .a customer's short sale effected in compliance with Regulation SHO and Rule 10a-1 may be settled by the broker-dealer's delivery of margin securities as to which the broker-dealer does not have a possession or control requirement. If a customer whose margin securities were delivered in this manner pays off its margin debit balance, thereby creating a possession or control requirement with respect to such securities, the broker-dealer is not currently required to borrow the security or buy-in another customer's short position. Under proposed paragraph (d)(4), however, the broker-dealer would be subject to such a requirement, which could either increase the cost of maintain the short position (especially if the security has become hard to borrow) or require the short position to be bought in.", SIFMA Letter, p. 13.

SEC should work with SIPC and CFTC not only to achieve greater legal certainty regarding a customer's claim to assets in a portfolio margin account in a SIPA proceeding, but also to resolve those remaining regulatory obstacles to including futures positions in a portfolio margin account.

**Presumption of Principal Status in Securities Lending Transactions**

The Proposal would amend 15c3-1 to clarify that a broker-dealer "participating" in a securities lending transaction would be presumed to be acting as a principal unless it took specific steps to disclaim principal liability, including disclosing the identities of the underlying borrower and lender to each other, and clarifying that the broker-dealer is acting exclusively as an agent. The SEC notes that this aspect of the Proposal was precipitated by the insolvency of MJK Clearing in 2001.

CGMI opposes this aspect of the Proposal. We concur with the SEC that legal certainty as to the principal or agency status of counterparties to a securities lending transaction is integral to the smooth and efficient functioning of the securities lending market. However, we believe that such legal certainty currently exists in the securities lending markets, as evidenced by court decisions surrounding the insolvency of MJK Clearing, which rejected the claims of "conduit" lenders that they were acting as agent instead of principal.[2] We further believe that the recent agent lender disclosure initiative has brought further legal certainty in connection with the roles of agents and principals in the securities lending markets.

We concur with the SIFMA Letter that this requirement be dropped from the Proposal. If the SEC retains this aspect of the Proposal, we agree with SIFMA that its scope should be narrowed to make clear that it applies only to a broker-dealer executing a securities lending agreement as agent on behalf of a principal, and also that pre-trade disclosure of such principal would not need to be made until the next business day.

**Reporting Requirement**

The Proposal would require broker-dealers to notify the SEC whenever the total amount of money payable against all securities loaned or subject to a repurchase agreement, or the contract value of all securities borrowed or subject to a reverse repurchase agreement exceeds 2500% of tentative net capital, excluding transactions involving government securities.

CGMI agrees with the SIFMA Letter that such information be provided to the SEC through monthly reporting on a broker-dealer's FOCUS reports. Such reporting would enable the SEC and the SROs to identify excessive leverage and would further prevent signaling to the market that a broker-dealer was experiencing financial difficulties even when this would not be the case.

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[2] See, e.g., *Nomura Sec. Int'l, Inc. v. E*Trade Sec., Inc.*, 280 F. Supp.2d 184, 195 (S.D.N.Y. 2003) (noting that the standard form Master Securities Lending Agreement explicitly provides that each party acts as principal in all transactions unless expressly stated otherwise in a specified written form).

## Documentation of Risk Management Practices

The Proposal would require certain large broker-dealers to document their internal risk management controls over risks arising from its business activities. The Proposal would not impose any minimum qualitative requirements for such procedures. CGMI agrees with the SEC that documentation of internal controls is important to ensuring that adequate measures are in place to manage risks and prevent significant losses. However, this aspect of the Proposal is so broad as to create uncertainty as to whether such standard could ever be met, even by a broker-dealer that extensively documents its risk controls.

We agree with the SIFMA Letter that the Proposal should be modified in several respects. First, it should be narrowed so that the documentation requirement be limited to internal controls that address market, credit and liquidity risk. In addition, the text of the amendment to Rule 17a-4 should make clear that the amendment does not impose any minimum qualitative elements. We also believe that the amendment should make clear that policies which apply to several entities or business lines within a financial services company, including the broker-dealer, would be sufficient to satisfy the requirements of the Proposal.

## Aggregate Debit Items Charge

The Proposal would conform the treatment of broker-dealers using the "alternative standard" to those using the "basic method" under the Net Capital Rule with respect to required reductions to their debit balances. Specifically, a broker-dealer using the "basic method" of computing net capital under the Net Capital Rule is required to reduce by 1% the total debits in Item 10 of the formula (i.e. debit balances in customer's cash and margin accounts). A broker-dealer using the "alternative standard" must reduce aggregate debit items by 3%. As a result, the deduction applicable to alternative standard firms can result in an even larger reserve deposit requirement. The Proposal would lower the debit reduction applicable to alternative standard firms to 1%.

CGMI supports this aspect of the Proposal. We agree with the SEC that the 1% reduction should provide broker-dealers with an adequate capital cushion, given firms' current increased debit items which constitute larger cushions of capital than when the Net Capital Rule was adopted in 1975 or amended in 1982. We also agree with the SIFMA Letter that this increase in debits has not resulted in a proportionate increase in risk for broker-dealers, since there is a diversification of risk inherent across debits for different customers.

## Requests for Comment: Conforming Repo and Securities Lending Net Capital Charges / Third Party Liens

In addition to proposed amendments to specific financial responsibility rules, the Proposal also solicits comment on whether other aspects of such rules should be amended. Specifically, the SEC asks whether net capital charges for repo and securities lending transactions should be harmonized. Further, the SEC requests comment on how third-party liens

against customer fully paid securities carried by a broker-dealer should be treated under the financial responsibility rules, including Rule 15c3-3, Rule 17a-3 and Rule 17a-4.

We agree with the SIFMA Letter that neither of these changes should be implemented without further and more in-depth dialogue between the industry and the SEC. Without reiterating the numerous reasons set out in the SIFMA Letter for the need to proceed cautiously with regard to these areas, CGMI would highlight that any action in these areas without further careful and deliberate study could unnecessarily and adversely impact the financial markets. CGMI stands ready to work with the SEC, either directly or through SIFMA, to address any questions or concerns the SEC may have regarding these areas.

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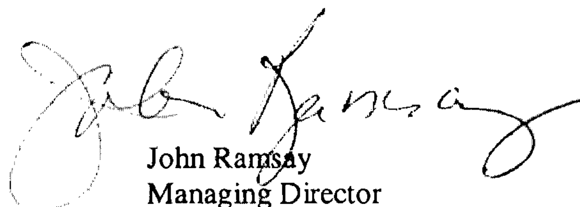
We thank the SEC for its continuing efforts to bolster the financial soundness of broker-dealers and thereby bolster investor protection. CGMI would welcome the opportunity to discuss our comments in further detail. If you have any questions, please do not hesitate to contact John Conway at 212.816.0034 or Omer Oztan at 212.816.2101.

Sincerely,

Cliff Verron
Managing Director
Deputy Chief Financial Officer



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