SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-70072; File No. S7-08-07

RIN 3235-AJ85

Financial Responsibility Rules for Broker-Dealers

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting amendments to the net capital, customer protection, books and records, and notification rules for broker-dealers promulgated under the Securities Exchange Act of 1934 ("Exchange Act"). These amendments are designed to address several areas of concern regarding the financial responsibility requirements for broker-dealers. The amendments also update certain financial responsibility requirements and make certain technical amendments.

DATES: Effective Date: [insert date 60 days after publication in the Federal Register].

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I. BACKGROUND

The Commission is adopting amendments to the broker-dealer net capital rule (Rule 15c3-1),[1] customer protection rule (Rule 15c3-3),[2] books and records rules (Rules 17a-3 and 17a-4), and notification rule (Rule 17a-11).[3] The Commission proposed these rule changes on March 9, 2007.[4] The Commission re-opened the public comment period on May 3, 2012.[5] The Commission received a total of 97 comment letters on the proposed amendments.[6] Sixty comment letters were received prior to the re-opening of

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1 17 CFR 240.15c3-1.

2 17 CFR 240.15c3-3.

3 17 CFR 240.17a-3; 17 CFR 240.17a-4; and 17 CFR 240.17a-11.

4 See Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 55431 (Mar. 9, 2007), 72 FR 12862 (Mar. 19, 2007) ("Amendments to Financial Responsibility Rules"). As part of this release, the Commission also requested comment on three additional matters: reducing the Rule 17a-11 (17 CFR 240.17a-11) early warning level for broker-dealers that carry over $10 billion in debits; harmonization of the net capital deductions required by paragraph (c)(2)(iv)(B) of Rule 15c3-1 for securities lending and borrowing transactions with the deductions required under paragraph (c)(2)(iv)(F) for securities repurchase and reverse repurchase agreement transactions (17 CFR 240 240.15c3-1(c)(2)(iv)(B) and (c)(2)(iv)(F), respectively); and accounting for third-party liens on customer securities held at a broker-dealer. As discussed below in section III. of this release, the Commission received comments in response to these requests but has determined to defer consideration of actions with respect to these specific matters at this time.

5 Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 66910 (May 3, 2012), 77 FR 27150 (May 9, 2012).

6 Comments on the amendments are available at http://www.sec.gov/comments/s7-08-07/s70807.shtml. See also letter dated April 22, 2007 from Peter G. Crane, President, Crane Data LLC ("Crane Data Letter"); letter dated April 22, 2007 from David Michael Bishop ("Bishop Letter"); letter dated April 27, 2007 from Ted Beer, Broker/Dealer Principal ("Beer Letter"); letter dated April 28, 2007 from Ted Beer, Broker/Dealer Principal ("Beer 2 Letter"); letter dated April 29, 2007 from R.A. Lowenstein, FinOps Compliance Consultant ("Lowenstein Letter"); letter dated April 29, 2007 from G. Kirk Ellis ("Ellis Letter"); letter dated May 1, 2007 from Stuart J. Kaswell and David J. Harris, Dechert LLP on behalf of Federated Investors ("Federated Letter"); letter dated May 2, 2007 from Daniel R. Levene, President, small NASD broker-dealer ("Levene Letter"); letter dated May 4, 2007 from Gerard J. Quinn, Vice President and Associate General Counsel, SIFMA ("SIFMA Letter"); letter dated May 7, 2007 from Michael Bell, President and CEO, Curian Clearing, LLC ("Curian Clearing Letter"); letter dated May 10, 2007 from Richard B. Franz II, Senior Vice-President, Treasurer and Chief Financial Officer, Raymond James & Associates ("Raymond James Letter"); letter dated May 16,

2007 from Steven R. Gerbel, Chicago Capital Management LP ("Chicago Capital Letter"); letter dated May 17, 2007 from Jeffrey L. Kiss, Principal, PackerKiss Securities, Inc. ("PackerKiss Letter"); letter dated May 17, 2007 from Josephine Wang, General Counsel, SIPC ("SIPC Letter"); letter dated May 18, 2007 from Kimberly Taylor, Managing Director and Clearing House President, Chicago Mercantile Exchange Inc. ("CME Letter"); letter dated May 18, 2007 from Diane V. Esheleman, Executive Vice President, JP Morgan Chase Bank, N.A. ("JP Morgan Letter"); letter dated May 21, 2007 from Faith Colish, Carter Ledyard Milburn LLP ("Colish Letter"); letter dated May 23, 2007 from Charles R. Manzoni, Jr., General Counsel, FAF Advisors, Inc. ("FAF Advisors Letter"); letter dated May 27, 2007 from Joyce Glenn ("Glenn Letter"); letter dated May 28, 2007 from William Bare ("Bare Letter"); letter dated May 29, 2007 from Robert Keenan, CEO, St. Bernard Financial Services, Inc. ("St. Bernard Financial Services Letter"); letter dated May 31, 2007 from John C. Melton, Sr., Executive Vice President, Coastal Securities ("Coastal Letter"); letter dated June 3, 2007 from Anonymous ("Anonymous Letter"); letter dated June 5, 2007 from Kelly S. McEntire, Executor, Retired State Administrator/Executor of Janus Capital Investments ("McEntire Letter"); letter dated June 13, 2007 from Bruce Bent, Chairman, The Reserve ("Reserve Letter"); letter dated June 14, 2007 from Amal El Said, Accounting and Regulatory, Abbey National ("Abbey National Letter"); letter dated June 14, 2007 from Frank A. Perrone, Senior Vice President, Brown Brothers Harriman & Co. ("Brown Brothers Harriman Letter"); letter dated June 15, 2007 from James J. Angel, Ph.D., CFA, Associate Professor of Finance, McDonough School of Business, Georgetown University ("Angel Letter"); letter dated June 15, 2007 from Matthew M. Hughey, Chief Financial Officer, First Clearing, LLC ("First Clearing Letter"); letter dated June 15, 2007 from Marshall J. Levinson, Senior Managing Director, Bear, Stearns & Co. Inc., Chair, SIFMA Capital Committee ("SIFMA 2 Letter"); letter dated June 15, 2007 from Christopher Williams, Director and Senior Counsel, and Barbara Brooks, Principal Financial Officer, Dresdner Kleinwort ("Dresdner Kleinwort Letter"); letter dated June 18, 2007 from Michael Dworkin ("Dworkin Letter"); letter dated June 18, 2007 from Keith Weller, Executive Director and Senior Associate General Counsel, UBS Global Asset Management (Americas) Inc. ("UBS Letter"); letter dated June 18, 2007 from Marcelo Riffaud, Managing Director, Legal Department, Deutsche Bank Securities Inc. ("Deutsche Bank Securities Letter"); letter dated June 18, 2007 from Jill Gross and Rahat Sarmast, Pace Investor Rights Project ("Pace Letter"); letter dated June 18, 2007 from Robert E. Putney, III, Director and Senior Counsel, BlackRock, Inc. ("BlackRock Letter"); letter dated June 18, 2007 from James S. Keller, Chief Regulatory, the PNC Financial Services Group, Inc. ("PNC Letter"); letter dated June 18, 2007 from Sarah A. Miller, General Counsel, American ABA Securities Association ("ABASA Letter"); letter dated June 18, 2007 from David Hirschmann, Executive Vice President, National Chamber Foundation of U.S. Chamber of Commerce ("National Chamber Foundation Letter"); letter dated June 18, 2007 from Michael W. Fields, Chief Fixed Income Officers, American Beacon Advisors ("American Beacon Letter"); letter dated June 18, 2007 from David Lonergan, Head of U.S. Cash Management, Barclays Global Investors ("Barclays Letter"); letter dated June 18, 2007 from Howard Spindel, Senior Managing Directors, Integrated Management Solutions ("Integrated Management Letter"); letter dated June 18, 2007 from Jane G. Heinrichs, Associate Counsel, Investment Company Institute ("ICI Letter"); letter dated June 18, 2007 from Jeffrey P. Neubert, CEO, Clearinghouse Association L.L.C. ("Clearing House Letter"); letter dated June 19, 2007 from James T. McHale, Associate General Counsel, E*Trade Brokerage Holdings, Inc. ("E*Trade Letter"); letter dated June 25, 2007 from Cliff Verron, Managing Director, Deputy Chief Financial Officers and John Ramsay, Managing Director, Deputy General Counsel, Citigroup Global Markets Inc. ("Citigroup Letter"); letter dated June 25, 2007

from AMEX, CBOE, ISE, OCC, and NYSE/ARCA ("AMEX Letter"); letter dated July 3, 2007 from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association ("American Bar Association Letter"); letter dated July 23, 2007 from Charles S. Morrison, Senior Vice President and Money Market Group Leader, Fidelity Management & Research Company, and John Valenti, Vice President, National Financial Securities LLC ("Fidelity/NFS Letter"); letter dated August 6, 2007 from Stuart Kaswell, Dechert LLP, on behalf of Federated Investors, Inc. ("Federated 2 Letter"); letter dated October 9, 2007 from Stuart Kaswell, Dechert LLP on behalf of Federated Investors, Inc. ("Federated 3 Letter"); letter dated November 16, 2007 from Marshall J. Levinson, Chair, Capital Committee, SIFMA ("SIFMA 3 Letter"); letter dated January 7, 2008 from Stuart J. Kaswell, Dechert LLP, on behalf of Federated Investors, Inc. ("Federated 4 Letter"); letter dated August 7, 2008 from Stuart J. Kaswell, Bryan Cave LLP, on behalf of Federated Investors, Inc. ("Federated 5 Letter"); letter dated November 10, 2008 from Lee A. Pickard, Pickard & Djinis LLP on behalf of Federated Investors ("Federated 6 Letter"); letter dated November 25, 2008 from Lee A. Pickard, Pickard & Djinis LLP on behalf of Federated Investors ("Federated 7 Letter"); letter dated December 18, 2008 from Lee A. Pickard, Pickard & Djinis LLP on behalf of Federated Investors ("Federated 8 Letter"); letter dated July 28, 2009 from Richard J. McDonald, Chief Regulatory Counsel, Susquehanna International Group LLP ("SIG Letter"); letter dated June 8, 2010 from The Honorable Gregory W. Meeks ("Meeks Letter"); letter dated October 14, 2011 from The Honorable Gregory W. Meeks ("Meeks 2 Letter"); letter dated May 5, 2012 from Edward P. Cernocky ("Cernocky Letter"); letter dated May 11, 2012 from Chris Barnard ("Barnard Letter"); letter dated May 15, 2012 from Helen M. Saarinen ("Saarinen Letter"); letter dated May 18, 2012 from Laura H. Hearne ("Hearne Letter"); letter dated May 24, 2012 from Dick Fuld ("Fuld Letter"); letter dated May 30, 2012 from Bruce J. Womack ("Womack Letter"); letter dated June 1, 2012 from Lee A. Pickard, Pickard & Djinis LLP, on behalf of Federated Investors ("Federated 9 Letter"); letter dated June 4, 2012 from Michael Scillia, Director, National Investment Banking Association ("NIBA Letter"); letter dated June 7, 2012 from Anthony Fitzgerald ("Fitzgerald Letter"); letter dated June 7, 2012 from Tom Vincent, Senior V.P., Corporate Governance and Wealth Management Compliance, BOK Financial Corporation ("BOK Letter"); letter dated June 8, 2012 from Denise Dolphin ("Dolphin Letter"); letter dated June 8, 2012 from Colin W. McKechnie, Managing Director, JP Morgan Chase Bank, N. A ("JP Morgan 2 Letter"); letter dated June 8, 2012 from William A. Jacobson, Associate Clinical Professor, Cornell Law School, and Director, Cornell Securities Law Clinic, Ithaca, New York ("Cornell Letter"); letter dated June 8, 2012 from Ryan K. Bakhtiari, Aidikoff, Uhl & Bakhtiari, on behalf of the Public Investors Arbitration Bar Association ("PIABA Letter"); letter dated June 8, 2012 from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA ("SIFMA 4 Letter"); letter dated June 8, 2012 from Sarah A. Miller, Chief Executive Officer, Institute of International Bankers ("IIB Letter"); letter dated June 8, 2012 from James T. McHale, Global Head of Compliance, E*TRADE Financial Corporation ("E*Trade 2 Letter"); letter dated June 11, 2012 from Steve M. Brewer, Sr., ASG Securities, LLC, Houston, Texas ("ASG Securities Letter"); letter dated June 25, 2012 from Gene L. Finn ("Finn Letter"); letter dated June 26, 2012 from Cindy Walsh ("Walsh Letter"); letter dated July 12, 2012 from Michael Scillia, Director, National Investment Banking Association ("NIBA 2 Letter"); letter dated July 18, 2012 from Gene L. Finn ("Finn 2 Letter"); letter dated July 30, 2012 from David Waddell ("Waddell Letter"); letter dated August 6, 2012 from Gene Finn ("Finn 3 Letter"); letter dated August 15, 2012 from Echeal R. Sigan ("Sigan Letter"); letter dated August 26, 2012 from Mark Irwin ("Irwin Letter"); letter dated September 17, 2012 from Gene L. Finn ("Finn 4 Letter"); letter dated September 27, 2012 from Jeff S. Clark ("Clark Letter"); letter dated September 28, 2012 from Robert LaPlante, M.P.A.

the comment period, and 37 were received after it. The Commission carefully considered all of the comment letters, and as discussed in detail below, modified the amendments in certain respects in light of the comments received. In addition, the Commission has determined to defer consideration of action at this time with respect to certain of the proposed amendments.

II. AMENDMENTS

A. Amendments to the Customer Protection Rule

1. Background

The Commission adopted Rule 15c3-3 in 1972 in response to a congressional directive to strengthen the financial responsibility requirements for broker-dealers that hold securities and cash for customers.[7] In particular, Rule 15c3-3 is designed "to give more specific protection to customer funds and securities, in effect forbidding brokers and dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers; e.g., a firm is virtually precluded from using customer funds to buy securities for its own account."[8] To meet this objective, Rule 15c3-3 requires a broker-dealer that maintains custody of customer securities and cash (a

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("LaPlante Letter"); letter dated October 19, 2012 from Rick Louderbough ("Louderbough Letter"); letter dated October 24, 2012 from Paul L. Matecki, Senior Vice President, General Counsel, Raymond James Financial, Inc. ("Raymond James 2 Letter"); letter dated October 25, 2012 from Eric Gamble, Ph.D. ("Gamble Letter"); letter dated November 1, 2012 from Percy R. Moorman, Esq. ("Moorman Letter"); letter dated January 4, 2013 from Marquis Wilkins ("Wilkins Letter"); letter dated January 5, 2013 from Anonymous SEC Fan ("Anonymous SEC Letter"); letter dated January 24, 2013 from Robert Fournier ("Fournier Letter"); and letter dated January 28, 2013 from Scott E. Shjefte ("Shjefte Letter"). Comment letters and specific comments outside the scope of this rulemaking are not addressed in this release.

7 See Broker-dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 9856 (Nov. 10, 1972), 37 FR 25224 (Nov. 29, 1972).

8 See Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 21651 (Jan. 11, 1985), 50 FR 2690, 2690 (Jan. 18, 1985). See also Broker-Dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 9856 (Nov. 10, 1972), 37 FR 25224, 25224 (Nov. 29, 1972).

"carrying broker-dealer") to take two primary steps to safeguard these assets. The steps are designed to protect customers[9] by segregating their securities and cash from the broker-dealer's proprietary business activities. If the broker-dealer fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed broker-dealer is liquidated in a formal proceeding under the Securities Investor Protection Act of 1970 ("SIPA"), the securities and cash would be isolated and readily identifiable as "customer property" and, consequently, available to be distributed to customers ahead of other creditors.[10]

The first step required by Rule 15c3-3 is that a carrying broker-dealer must maintain physical possession or control over customers' fully paid and excess margin securities.[11] Physical possession or control means the broker-dealer must hold these

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[9] Rule 15c3-3 defines customer as "any person from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of that person." The rule excludes certain categories of persons from the definition, including broker-dealers, municipal securities dealers, and government securities broker-dealers. It also excludes general partners, directors, and principal officers of the broker-dealer and any other person to the extent that the person has a claim for property or funds which by contract, agreement or understanding, or by operation of law, is part of the capital of the broker-dealer or is subordinated to the claims of creditors of the broker-dealer. 17 CFR 240.15c3-3(a)(1).

[10] See 15 U.S.C. 78aaa et seq.

[11] See 17 CFR 240.15c3-3(b) and (d). The term fully paid securities includes all securities carried for the account of a customer in a special cash account as defined in Regulation T promulgated by the Board of Governors of the Federal Reserve System, as well as margin equity securities within the meaning of Regulation T which are carried for the account of a customer in a general account or any special account under Regulation T during any period when section 8 of Regulation T (12 CFR 220.8) specifies that margin equity securities shall have no loan value in a general account or special convertible debt security account, and all such margin equity securities in such account if they are fully paid: provided, however, that the term fully paid securities shall not apply to any securities which are purchased in transactions for which the customer has not made full payment. 17 CFR 240.15c3-3(a)(3). The term margin securities means those securities carried for the account of a customer in a general account as defined in Regulation T, as well as securities carried in any special account other than the securities referred to in paragraph (a)(3) of Rule 15c3-3. 17 CFR 240.15c3-3(a)(4). The term excess margin securities means those securities referred to in paragraph (a)(4) of Rule 15c3-3 carried for the account of a customer having a market value in excess of 140 percent of the total of the debit balances in the customer's account or accounts encompassed by paragraph

securities in one of several locations specified in Rule 15c3-3 and free of liens or any other interest that could be exercised by a third party to secure an obligation of the broker-dealer.[12] Permissible locations include a bank, as defined in section 3(a)(6) of the Exchange Act, and a clearing agency.[13]

The second step is that a carrying broker-dealer must maintain a reserve of cash or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers, including cash obtained from the use of customer securities.[14] The account must be titled "Special Reserve Bank Account for the Exclusive Benefit of Customers."[15] The amount of net cash owed to customers is computed pursuant to a formula set forth in Exhibit A to Rule 15c3-3.[16] Under the customer reserve formula, the broker-dealer adds up customer credit items (e.g., cash in customer securities accounts and cash obtained through the use of customer margin securities) and then subtracts from that amount customer debit items (e.g., margin loans).[17] If credit items exceed debit items, the net amount must be on deposit in the customer reserve account in the form of

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(a)(4) of Rule 15c3-3 which the broker-dealer identifies as not constituting margin securities. 17 CFR 240.15c3-3(a)(5). As discussed in section II.F. of this release, the Commission is adopting technical amendments to the definitions of the terms fully paid securities and margin securities under Rule 15c3-3. See paragraphs (a)(3) and (4) of Rule 15c3-3, as adopted.

12 See 17 CFR 240.15c3-3(c). Customer securities held by the carrying broker-dealer are not assets of the firm. Rather, the carrying broker-dealer holds them in a custodial capacity and the possession and control requirement is designed to ensure that the carrying broker-dealer treats them in a manner that allows for their prompt return.

13 Id.

14 17 CFR 240.15c3-3(e). The term qualified security is defined in Rule 15c3-3 to mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States. See 17 CFR 240.15c3-3(a)(6).

15 See 17 CFR 240.15c3-3(e)(1). The purpose of giving the account this title is to alert the bank and creditors of the broker-dealer that this account is to be used to meet the broker-dealer's obligations to customers (and not the claims of general creditors) in the event the broker-dealer must be liquidated in a formal proceeding.

16 17 CFR 240.15c3-3a.

17 Id.

cash and/or qualified securities.[18] A broker-dealer cannot make a withdrawal from the customer reserve account until the next computation and even then only if the computation shows that the reserve requirement has decreased.[19] The broker-dealer must make a deposit into the customer reserve account if the computation shows an increase in the reserve requirement.

In addition, the customer reserve formula permits the broker-dealer to offset customer credit items only with customer debit items.[20] This means the broker-dealer can use customer cash to facilitate customer transactions such as financing customer margin loans and borrowing securities to make deliveries of securities that customers have sold short.[21] Broker-dealer margin rules require securities customers to maintain a

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[18] 17 CFR 240.15c3-3(e). Customer cash is a balance sheet item of the carrying broker-dealer (i.e., the amount of cash received from a customer increases the amount of the carrying broker-dealer's assets and creates a corresponding liability to the customer). The customer reserve formula is designed to isolate these broker-dealer assets so that an amount equal to the net liabilities to customers is held as a reserve in the form of cash or qualified securities. The requirement to establish this reserve is designed to effectively prevent the carrying broker-dealer from using customer funds for proprietary business activities such as investing in securities. The goal is to put the carrying broker-dealer in a position to be able to readily meet its cash obligations to customers by requiring the firm to make deposits of cash and/or qualified securities into the customer reserve account in the amount of the net cash owed to customers. Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70213, 70277 n.671 (Nov. 23, 2012).

[19] See 17 CFR 240.15c3-3(e). Under paragraph (e), broker-dealers are generally required to perform the customer reserve computation as of the close of business on the last business day of the week. Broker-dealers from time to time may perform a mid-week computation if it would permit them to make a withdrawal. 17 CFR 240.15c3-3(g).

[20] See 17 CFR 240.15c3-3a.

[21] For example, if a broker-dealer holds $100 for customer A, the broker-dealer can use that $100 to finance a security purchase of customer B. The $100 the broker-dealer owes customer A is a credit in the formula and the $100 customer B owes the broker-dealer is a debit in the formula. Therefore, under the customer reserve formula there would be no requirement to maintain cash and/or U.S. government securities in the customer reserve account. However, if the broker-dealer did not use the $100 held in customer A's account for this purpose, there would be no offsetting debit and, consequently, the broker-dealer would need to have on deposit in the customer reserve account cash and/or qualified securities in an amount at least equal to $100.

minimum level of equity in their securities accounts.[22] In addition to protecting the broker-dealer from the consequences of a customer default, this equity serves to over-collateralize the customers' obligations to the broker-dealer and thereby protect customers whose cash was used to facilitate the broker-dealer's financing of securities purchases and short sales by other customers. For example, if the broker-dealer fails, the customer debits, because they generally are over-collateralized, should be attractive assets for another broker-dealer to purchase or, if not purchased by another broker-dealer, they should be able to be liquidated to a net positive equity.[23] The proceeds of the debits sale or liquidation can be used to repay the customer cash used to finance the customer obligations. This cash plus the funds and/or qualified securities held in the customer reserve account should equal or exceed the total amount of customer credit items (i.e., the total amount owed by the broker-dealer to its customers).[24]

2. Proprietary Accounts of Broker-Dealers

A carrying broker-dealer may carry accounts that hold proprietary securities and cash of other broker-dealers ("PAB accounts"). As noted above, broker-dealers are not within the definition of customer for purposes of Rule 15c3-3.[25] Accordingly, a carrying broker-dealer that carries PAB accounts is not required to treat these accounts as

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22 Broker-dealers are subject to margin requirements in Regulation T promulgated by the Federal Reserve (see 12 CFR 220.1, et seq.), in rules promulgated by the self-regulatory organizations ("SROs") (see, e.g., FINRA Rules 4210–4240), and with respect to security futures, in rules jointly promulgated by the Commission and the CFTC (see 17 CFR 242.400–406).

23 The attractiveness of the over-collateralized debits facilitates the bulk transfer of customer accounts from a failing or failed broker-dealer to another broker-dealer.

24 See Net Capital Requirements for Broker-Dealers; Amended Rules, Exchange Act Release No. 18417 (Jan. 13, 1982), 47 FR 3512, 3513 (Jan. 25, 1982) ("The alternative method is founded on the concept that if the debit items in the Reserve Formula can be liquidated at or near their contract values, these assets, along with any cash required to be on deposit under the [customer protection] rule, will be sufficient to satisfy all customer-related liabilities (which are represented as credit items in the Reserve Formula").

25 17 CFR 240.15c3-3(a)(1).

customer accounts for the purposes of Rule 15c3-3. This means the carrying broker-dealer is not required to maintain possession or control of the securities of PAB account holders that are not securing margin loans to the account holders ("non-margin securities") or include credit and debit items associated with those accounts in its customer reserve computation. The definition of customer in SIPA, however, is broader than the definition in Rule 15c3-3 in that the SIPA definition does not exclude broker-dealers.[26] Customers under SIPA ("SIPA customers") generally are entitled to a number of protections, including the right to share pro rata with other SIPA customers in the customer property held by the broker-dealer and, if the customer property is insufficient to make each SIPA customer whole, the entitlement to receive an advance from the Securities Investor Protection Corporation ("SIPC") of up to $500,000 (of which $250,000 currently can be used to cover cash claims).[27] Broker-dealers as SIPA customers have the right to a pro rata share of the customer property, but are not entitled to receive an advance from the SIPC fund.[28] Consequently, when a carrying broker-dealer is liquidated in a SIPA proceeding, each customer (including a SIPA customer that is a broker-dealer) has a claim on the customer property. Because the possession and control and customer reserve account provisions of Rule 15c3-3 do not apply to PAB account holders by virtue of the definition of customer in the rule, the carrying broker-

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[26] See 15 U.S.C. 78lll(2).

[27] See 15 U.S.C. 78fff-2(c) and 15 U.S.C. 78fff-3(a), respectively. Under SIPA, customer property includes "cash and securities (except customer name securities delivered to the customer) at any time received, acquired, or held by or for the account of the debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." 15 U.S.C. 78lll(4). Therefore, customer property includes those securities positions that are held for customers and the cash that is owed to customers.

[28] See 15 U.S.C. 78fff-2(c); see also 15 U.S.C. 78fff-3(a).

dealer is not restricted by Rule 15c3-3 from using the securities and cash in these accounts for its own business purposes.

The treatment of PAB account holders as SIPA customers but not as customers for the purposes of Rule 15c3-3 increases the risk that, in the event a carrying broker-dealer is liquidated under SIPA, the claims of SIPA customers (i.e., customers and PAB account holders) will exceed the amount of customer property available and, thereby, expose the SIPC fund and potentially SIPA customers to losses. In addition, if the customer property is insufficient to fully satisfy all SIPA customer claims and losses are incurred, the PAB account holders could be placed in financial distress causing adverse impacts to the securities markets beyond those resulting from the failure of the carrying broker-dealer.[29]

To address the disparity in treatment between customers and PAB account holders, the Commission proposed amendments to Rules 15c3-3 and 15c3-3a that would have required a broker-dealer that carries PAB accounts to perform a PAB reserve computation with respect to those accounts, generally as of the close of business on the last business day of the week.[30] The amendments, as proposed, would have required the carrying broker-dealer to add up the debits and credits relating to PAB accounts – including credits arising from the use of securities held in PAB accounts – and maintain cash or qualified securities in a PAB reserve account in an amount equal to or greater than the amount that the credits exceed the debits.

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[29] As noted above, while broker-dealers are customers for the purposes of SIPA, they are not entitled to the advances from the SIPC fund to make up for shortfalls after the pro rata distribution of customer property. 15 U.S.C. 78fff-3(a)(5).

[30] See Amendments to Financial Responsibility Rules, 72 FR at 12863. A broker-dealer that does not carry an account of a customer as defined under Rule 15c3-3 or conduct a proprietary trading business would be permitted to make the computation monthly rather than weekly. See paragraph (e)(3)(iii) of Rule 15c3-3, as adopted.

Seven commenters responded to the Commission's request for comment on the proposed amendments.[31] As discussed below, the Commission has modified the final rule in certain respects to address, among other things, issues raised by commenters. As adopted, the Commission's amendments to Rules 15c3-3 and 15c3-3a require carrying broker-dealers to: (1) perform a separate reserve computation for PAB accounts (in addition to the customer reserve computation currently required for Rule 15c3-3 customer accounts); (2) establish and fund a separate reserve account for the benefit of PAB account holders; and (3) obtain and maintain physical possession or control of non-margin securities carried for PAB accounts unless the carrying broker has provided written notice to the PAB account holders that it will use those securities in the ordinary course of its securities business, and has provided opportunity for the PAB account holder to object to such use.[32]

These amendments, in part, incorporate many of the provisions of a no-action letter regarding PAB accounts issued by Commission staff in 1998.[33] The PAIB Letter stated that the staff would not recommend enforcement action to the Commission if a broker-dealer did not take a net capital deduction under Rule 15c3-1 for cash held in a securities account at another broker-dealer,[34] provided the other broker-dealer agrees to:

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31 See SIFMA 2 Letter; SIFMA 4 Letter; Dresdner Kleinwort Letter; Deutsche Bank Securities Letter; SIPC Letter; Abbey National Letter; First Clearing Letter; Cornell Letter.

32 See infra section II.A.2.ii. of this release for a discussion of the Commission's rationale for the change in the final rule to require a carrying broker-dealer provide notice to, rather than obtain written permission from, a PAB account holder in order for its securities to be used in the ordinary course of the carrying firm's securities business.

33 See Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Raymond J. Hennessy, Vice President, NYSE, and Thomas Cassella, Vice President, NASD Regulation, Inc. (Nov. 3, 1998) ("PAIB Letter").

34 Under Rule 15c3-1, broker-dealers are generally required to deduct unsecured receivables from their net worth when computing their net capital.

(1) perform a reserve computation for PAB accounts;[35] (2) establish a separate special reserve bank account; and (3) maintain cash or qualified securities in the reserve account equal to the computed reserve requirement ("PAIB agreement"). Broker-dealers that carry PAB accounts have the incentive to enter into PAIB agreements to prevent their PAB account holders from choosing to open an account or enter into a clearing agreement with another broker-dealer. Because many of the provisions in the PAIB Letter are being incorporated in this rulemaking, the Commission is directing the Commission staff to withdraw the PAIB Letter as of the effective date of these rule amendments.

i. Definition of "PAB account" under Rule 15c3-3(a)(16)

The Commission proposed, among other things, to add paragraph (a)(16) to Rule 15c3-3 that would have defined the term PAB account as "a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer), but shall not include an account where the account owner is a guaranteed subsidiary of the carrying broker or dealer, the account owner guarantees all liabilities and obligations of the carrying broker or dealer, or the account is a delivery-versus-payment account or receipt-versus-payment account."[36] Two commenters raised concerns about the proposed definition because – by including proprietary accounts of foreign broker-dealers and foreign banks acting as broker-dealers within the term PAB account – it differed from provisions in the PAIB Letter, which excluded such accounts

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35 Under new paragraph (e)(3), broker-dealers will be required to perform the PAB reserve account computation (and its customer reserve account computation, if applicable) on a weekly basis, as of the close of business on the last business day of the week. With regard to PAB accounts, a broker-dealer that does not carry an account of a customer as defined under Rule 15c3-3 or conduct a proprietary trading business may make the PAB reserve account computation monthly rather than weekly. See new paragraph (e)(3)(iii) of Rule 15c3-3.

36 See Amendments to Financial Responsibility Rules, 72 FR at 12895.

from a PAIB computation.[37] One of these commenters stated that broker-dealers (including foreign banks acting as broker-dealers) should be allowed to opt-out of PAB account treatment because they do not require the same protections as customers as defined in Rule 15c3-3.[38] The commenter stated that broker-dealers are able to understand the insolvency risk of the broker-dealers at which they maintain proprietary accounts.[39] This commenter noted that broker-dealer customers often self-insure or otherwise account for such exposure regardless of their status under SIPA.[40] The second commenter stated that foreign broker-dealers and foreign banks acting as broker-dealers should be allowed to subordinate their claims to customers and creditors of the broker-dealer in order to remove their accounts from PAB account treatment because under SIPA foreign broker-dealers and foreign banks acting as broker-dealers, under certain circumstances, will not be deemed customers and, therefore, would not be entitled to a pro rata share of the estate of customer property in a SIPA liquidation.[41] More specifically, the commenter suggested that the Commission modify the definition of PAB account, to exclude "any foreign broker-dealer and foreign bank to the extent that such entity has a claim for cash or securities that is subordinated to the claims of creditors of the carrying broker-dealer" in order to parallel the language in SIPA.[42] This commenter

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37 See Dresdner Kleinwort Letter; Deutsche Bank Securities Letter. Though SIFMA initially raised concerns about the proposed definition, it later withdrew its recommendation that proprietary accounts of affiliated non-U.S. broker-dealers and non-U.S. banks be excluded from the PAB account definition. See SIFMA 2 Letter; SIFMA 4 Letter.

38 See Dresdner Kleinwort Letter.

39 Id.

40 See Dresdner Kleinwort Letter.

41 See Deutsche Bank Securities Letter.

42 The definition of customer in SIPA excludes any person, to the extent that "such person has a claim for cash or securities which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor, or is subordinated to the claims of

also recommended requiring the "subordinating" broker-dealer to follow the requirements for non-conforming subordinated loans to remove an account from PAB account treatment.[43]

Another commenter stated that the Commission's desire to close the gap between Rule 15c3-3 and SIPA must be balanced against the potentially significant practical issues the Commission's proposal would raise in the case of accounts carried for affiliated entities operating in non-U.S. jurisdictions.[44] In a subsequent letter, this commenter stated that while it would prefer a more flexible solution that would allow broker-dealers and non-U.S. banks acting as broker-dealers (especially non-U.S. affiliates) to opt to have their accounts treated as neither customer accounts under SIPA nor PAB accounts, the commenter recognized that there is a clear need for an immediate solution that cannot be delayed until appropriate amendments to SIPA are adopted.[45] Consequently, the commenter withdrew its recommendation that the proprietary accounts of affiliated non-U.S. broker-dealers and affiliated non-U.S. banks be excluded from the "PAB account" definition, but continued to endorse its previous comments to achieve the

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any and all creditors of the debtor, notwithstanding that some grounds exist for declaring such contract, agreement, or understanding void or voidable in a suit between the claimant and the debtor." See 15 U.S.C. 78lll(2)(C)(iii).

43 See Deutsche Bank Securities Letter. See also SIFMA 4 Letter. Under Rule 15c3-1, a broker-dealer can exclude liabilities that are subordinated to the claims of creditors pursuant to a satisfactory subordination agreement, as defined in Appendix D to Rule 15c3-1, for purposes determining its net capital. See 17 CFR 240.15c3-1(c)(2)(ii) and 17 CFR 240.15c3-1d. See also 17 CFR 240.15c3-1(c)(i)(x). A non-conforming subordination agreement generally would not meet all the requirements of Appendix D to Rule 15c3-1, and, therefore, a broker-dealer could not exclude the liability resulting from the loan agreement in computing its net capital. See 17 CFR 240.15c3-1(c)(2)(ii).

44 See SIFMA 2 Letter. This commenter specifically raised concerns that it would be cumbersome to subject transactions between a carrying broker-dealer and its foreign affiliates to the proposed PAB requirements because of the integrated securities processing and settlement activities of these entities, which would limit the ability of the group as a whole to provide competitive services to U.S. investors.

45 See SIFMA 4 Letter.

goal of correcting the gap between Rule 15c3-3 and SIPA without creating undue or unintended burdens.[46]

The goal of the proposed amendments is to create a process that protects Rule 15c3-3 customers and PAB account holders of a failed carrying broker-dealer. The amendments are designed to provide such protection by mitigating the risk that there will be insufficient customer property to fully satisfy all customer claims in a SIPA liquidation. The entitlement of PAB account holders to a pro rata share of the fund of customer property places all SIPA customers at risk if the carrying firm does not establish a PAB reserve account for excess credits owed to PAB account holders.

At the same time, the Commission appreciates the need to consider both the practical issues raised by commenters and its objective to eliminate the inconsistency between Rule 15c3-3 and SIPA.[47] Accordingly, in response to commenters, the final rule adopted by the Commission excludes from the definition of PAB account in paragraph (a)(16) of Rule 15c3-3 "an account that has been subordinated to the claims of creditors of the carrying broker or dealer."[48] A PAB account holder that has subordinated its claims with respect to that account to claims of creditors of the carrying broker-dealer will not be entitled to SIPA protection for that account.[49] Consequently, this provision will provide flexibility to carrying broker-dealers and their broker-dealer affiliates to structure their PAB account relationships in a manner that permits operational

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46 See SIFMA 4 Letter. Among other things, the commenter suggested that the Commission modify the proposed definition of PAB account to exclude any customer as defined in Rule 15c3-3 and also to exclude the other types of persons who are specifically excluded from the definition of customer. This suggestion included excluding accounts whose claims are subordinated to the claims of other creditors of the carrying broker-dealer. Id.

47 See Amendments to Financial Responsibility Rules, 72 FR at 12863.

48 The agreement would not need to be conforming for purposes of Exchange Act Rule 15c3-1d (Satisfactory Subordination Agreements).

49 See 15 U.S.C. 78lll(2).

efficiencies (i.e., the ability to exclude these accounts from the PAB reserve computation) while still promoting the goal of the amendments to have a consistent treatment of these accounts under Rule 15c3-3 and SIPA, and thereby protect accounts holders that are "customers" under SIPA.[50] If a U.S. broker-dealer, however, chooses to subordinate its claims to assets in that account to the claims of other creditors of the carrying broker-dealer, it will not be able to include those assets as allowable for its own net capital computation.[51]

Further, as was proposed, the definition of PAB account in the final rule excludes accounts that operate on a delivery-versus-payment or a receipt-versus-payment basis, or "DVP/RVP" basis, because these accounts generally hold securities and cash for short durations.[52] The provision relating to DVP/RVP accounts is being adopted substantially as proposed, though paragraph (a)(16), as adopted, has been modified by splitting the text into two sentences. As adopted, the reference to the DVP/RVP accounts provision was moved to the first sentence. The Commission is not adopting the proposed exclusions from the PAB reserve computation requirement related to accounts established by a PAB account holder that fully guarantee the obligations of, or whose accounts are fully guaranteed by, the carrying broker-dealer. Rather than create a specific exemption for such account holders, the Commission believes the better approach is to allow these accounts to enter into subordination agreements with the carrying broker-dealer, in order

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50 See 17 CFR 240.15c3-3(a)(1) and 15 U.S.C. 78lll(2)(C)(ii). These accounts will be excluded from both the definition of PAB account, as well from the definition of customer under SIPA. See Amendments to Financial Responsibility Rules, 72 FR at 12863. Consequently, these account holders will not be entitled to the protections in SIPA applicable to customers.

51 See 17 CFR 240.15c3-1(c)(2)(iv)(E).

52 See Amendments to Financial Responsibility Rules, 72 FR at 12863, n.17 ("[T]he amendment would exclude delivery-versus-payment and receipt-versus-payment accounts. These types of accounts pose little risk of reducing the estate of customer property in a SIPA liquidation since they only hold assets for short periods of time.").

for these accounts to be excluded from the definition of PAB account. This approach simplifies the final rule, while continuing to provide a means for these account holders to be excluded from its scope. Consequently, as adopted, paragraph (a)(16) to Rule 15c3-3 defines the term PAB account to mean "a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer) other than a delivery-versus-payment account or a receipt-versus-payment account."[53] The definition of PAB Account does not include accounts that have been subordinated to the claims of a carrying broker-dealer's creditors.[54]

ii. Written Permission to Use PAB Account Securities

Because PAB account holders are not customers for purposes of Rule 15c3-3, a carrying broker-dealer is not required to maintain possession or control of their non-margin securities. Consequently, it has been a long-standing industry practice for carrying broker-dealers to use these PAB securities in their business activities. Under the final rule, a carrying broker-dealer that uses these PAB securities will need to include the market value of the securities as a credit in the formula when performing the PAB reserve computation. Thus, the amount that the carrying broker-dealer must maintain in its PAB reserve account will increase by the amount of these credits because there would be no corresponding debit item.[55]

Using non-margin securities of PAB account holders presents the risk that securities may increase in market value between PAB reserve computations and, therefore, the amount of the credit items in the formula may be less than the value of the securities for a short period of time. To accommodate industry practice, however, the

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53 See paragraph (a)(16) to Rule 15c3-3, as adopted.

54 Id.

55 17 CFR 240.15c-3-3a.

Commission did not propose amending Rule 15c3-3 to apply the possession or control requirements to PAB accounts. The Commission proposed adding paragraph (b)(5) to Rule 15c3-3 that would have required the carrying broker-dealer to obtain written permission from a PAB account holder before it could use the PAB account holder's securities in the ordinary course of its securities business. In this way, the Commission proposed increasing the protections for PAB account holders without interfering with long-standing industry practice of carrying broker-dealers using the securities of their broker-dealer account holders. However, securities not being used by the broker-dealer must be maintained in accordance with the possession or control requirements of Rule 15c3-3.

One commenter stated that this provision should be eliminated from the proposed amendments, arguing that "[t]he proposal interferes unnecessarily in the contractual arrangements between broker-dealers, which are capable of understanding the terms of standard industry custodial relationships."[56] The commenter also noted that the PAIB Letter did not contain any such requirement.[57] The Commission agrees with the commenter that broker-dealers should be able to understand the implications of granting another broker-dealer the ability to use their non-margin securities and, therefore, the final rule requires written notice rather than written permission. An appropriate level of protection for the PAB account holder may be achieved without requiring the carrying broker-dealer to maintain possession or control of securities carried for a PAB account,

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[56] See SIFMA 2 Letter.

[57] Id.

provided that the carrying broker-dealer gives written notice to its PAB account holders that it may use their non-margin securities.[58]

The Commission acknowledges that this change, as compared to the proposed rule, will shift the burden to the PAB account holder to proactively object to the carrying broker-dealer using the account holder's securities. However, the new written notice requirement increases the protections for PAB account holders from the status quo without imposing substantial burdens on existing account relationships. The revised rule is intended to provide to the PAB account holders the opportunity to negotiate different terms if they do not want their securities used, while eliminating the need for, and the costs that would result from, carrying broker-dealers reworking existing contracts.

As adopted, the Commission is modifying the final rule to add the phrase "and has provided an opportunity for the account holder to object" following the phrase "ordinary course of its securities business."[59] This language was added to the final rule to impose a requirement that the carrying broker-dealer provide the PAB account holders an opportunity to object to the use of their non-margin securities after they receive the written notice from the carrying broker-dealer. The rule does not prescribe the form in which a PAB account holder must provide notice to the carrying broker-dealer of its objection. This will provide the PAB account holder with flexibility to communicate the objection in a manner the account holder determines is most effective in terms of conveying such objection to the carrying broker-dealer. If the PAB account holder objects, the carrying broker-dealer could not use the securities. Further, the PAB account

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[58] The Commission has deleted the phrase "obtained the written permission of the account owner to use the securities in the ordinary course of its securities business" from paragraph (b)(5) of the final rule and replaced it with "provided written notice to the account holder that the securities may be used in the ordinary course of its securities business, and has provided an opportunity for the account holder to object."

[59] See paragraph (b)(5) of Rule 15c3-3, as adopted.

holder could seek to move the account to another carrying broker-dealer or negotiate different terms with the carrying broker-dealer with regard to the use of its securities.

Finally, the Commission has modified proposed paragraph (b)(5) to clarify in the final rule that a broker-dealer is affirmatively required to maintain possession and control of non-margin securities unless the broker-dealer has provided written notice to the PAB account holder.[60] As modified, paragraph (b)(5) reads: "A broker or dealer is required to obtain and thereafter maintain the physical possession or control of securities carried for a PAB account, unless the broker or dealer has provided written notice to the account holder that the securities may be used in the ordinary course of its securities business, and has provided an opportunity for the account holder to object."[61]

iii. PAB Reserve Bank Accounts

The Commission proposed amendments to paragraph (e) of Rule 15c3-3 to require a carrying broker with PAB accounts to establish and maintain a PAB reserve account for PAB accounts, perform a separate PAB reserve computation for PAB accounts, and maintain cash or qualified securities in the PAB reserve account in an amount equal to the PAB reserve requirement.[62] The Commission also proposed amendments to paragraph (f) of Rule 15c3-3 to require carrying broker-dealers with PAB accounts to notify the bank about the status of the PAB reserve account and obtain an agreement and notification from the bank that the PAB reserve account will be maintained for the benefit of the PAB account holders.[63] The Commission is adopting

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60 The modifications replaced the phrase "shall not be required" with the phrase "is required" and replaced the phrase "provided that" with the word "unless."

61 See paragraph (b)(5) of Rule 15c3-3, as adopted.

62 See section II.A.3. of this release for a discussion of changes to paragraph (e)(5) of Rule 15c3-3 with respect to banks where customer or PAB reserve accounts may be held.

63 17 CFR 240.15c3-3(f).

these amendments to paragraphs (e) and (f) of Rule 15c3-3 substantially as proposed, with some technical modifications suggested by one commenter, including making terminology consistent throughout the paragraphs.[64] In addition, the Commission is adopting substantially as proposed the amendments to paragraph (g) of Rule 15c3-3 which specifies when the carrying broker-dealer can make withdrawals from a PAB reserve account.[65] Finally, the Commission is adopting, as proposed, new paragraph (e)(4) to Rule 15c3-3, which allows a carrying broker-dealer to use credits related to PAB accounts to finance Rule 15c3-3 customer debits, but does not allow a carrying broker-dealer to use Rule 15c3-3 customer credits to finance PAB debits.

iv. Other PAB Issues Raised by Commenters

In addition to specific comments on the proposed rule language, one commenter had other interpretive questions and comments about the proposed PAB requirements.[66] The commenter requested that the Commission clarify whether PAB account holders must obtain from their carrying broker-dealers a written agreement to perform the calculation as required by the PAIB Letter.[67] Under the amendments, there is no requirement that PAB account holders obtain a written agreement from the carrying firm that it will perform the PAB reserve computation. Rule 15c3-3, as amended, requires the carrying firm to perform the PAB reserve computation. As stated above, Rule 15c3-3

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64 See SIFMA 2 Letter.

65 17 CFR 240.15c3-3(g). In this paragraph, the Commission deleted the phrase "his Reserve Bank Accounts" and replaced it with the phrase "a Customer Reserve Bank Account and PAB Reserve Bank Account." The Commission also deleted the phrase "each Reserve Bank Account" and replaced it with the phrase "the Customer Reserve Bank Account and PAB Reserve Bank Account." These were the only changes made to the final rule in paragraph (g) of Rule 15c3-3.

66 See SIMFA 2 Letter.

67 Id.

prescribes the requirements for carrying firms with respect to PAB accounts, and the PAIB Letter is being withdrawn.[68]

In addition, the commenter requested the Commission to clarify that existing PAIB reserve accounts need not be re-titled to comply with the proposed amendments.[69] Item 4 of the PAIB Letter required that a carrying broker-dealer, "establish and maintain a separate 'Special Reserve Account for the Exclusive Benefit of Customers' with a bank in conformity with the standards of paragraph (f) of Rule 15c3-3." Paragraph (e)(1) of Rule 15c3-3, however, requires that a carrying broker-dealer establish and maintain a "Special Reserve Bank Account for Brokers and Dealers." Given the small differences in nomenclature and the time and expense associated with broker-dealers re-titling these accounts, a carrying broker-dealer that has properly established PAB reserve account in the manner described in Item 4 of the PAIB Letter need not re-title the account and obtain a new notification from the bank.[70] However, all PAB reserve accounts established on or after the effective date of these amendments must title the account in accordance with paragraph (e)(1) of Rule 15c3-3.

Finally, the commenter urged the Commission to clarify whether, for purposes of Rule 15c3-1, the term aggregate debit items means total aggregate debit items computed in accordance with the customer reserve formula or the total aggregate debit items computed in accordance with both the customer reserve formula and the PAB reserve formula.[71] Aggregate debit items are used in the net capital rule to determine the minimum net capital requirement for broker-dealers that elect to use the alternative

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68 As discussed above in this section II.A.2., the Commission is directing the staff to withdraw the PAIB Letter as of the effective date of these rules.

69 See SIFMA 2 Letter.

70 See PAIB Letter.

71 See SIFMA 2 Letter; SIFMA 4 Letter.

standard in computing their minimum net capital requirement. Specifically, the net capital rule requires broker-dealers using the alternative standard to maintain net capital of at least the greater of $250,000 or 2% of aggregate debit items.[72] Including PAB aggregate debit items in this computation would significantly increase net capital requirements for broker-dealers that use the alternative method. The intended purpose of this rule change is to address the inconsistencies between Rule 15c3-3 and SIPA – not to increase net capital requirements. Consequently, the requirements in Rules 15c3-1, 15c3-1d, and 17a-11 that refer to aggregate debit items continue to be based only on aggregate debit items computed in accordance with the customer reserve computation, and do not include aggregate debit items computed in accordance with the PAB reserve computation.[73]

v. Amendment to Rule 15c3-1(c)(2)(iv)(E) Related to PAB Accounts

Finally, the Commission proposed an amendment to Rule 15c3-1[74] that would have required a broker-dealer, when calculating net capital, to deduct from net worth cash and securities held in a securities account at another broker-dealer if the other broker-dealer does not treat the account, and the assets therein, in compliance with the applicable

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72 17 CFR 240.15c3-1(a)(1)(ii). In addition, certain other financial responsibility rules require that a broker-dealer that computes net capital pursuant to the alternative method either report to the Commission, limit its ability to obtain, pre-pay, or repay subordinated debt, or limit its business if its net capital falls below a certain level based on a percentage of aggregate debit items (see, e.g., Rules 15c3-1(e)(2)(vi), 15c3-1d(b)(6)(iii), 15c3-1d(b)(7), 15c3-1d(b)(8)(i)(A), 15c3-1d(b)(10)(ii)(B), 15c3-1d(c)(2), 15c3-1d(c)(5)(ii)(A), and 17a-11(c)(2)).

73 Under paragraph (e)(4) to Rule 15c3-3, a carrying broker-dealer will be permitted to use credits related to PAB accounts to finance Rule 15c3-3 customer debits. This rule, however, does not affect the use of aggregate debit items in computing a broker-dealer's net capital under the alternative standard pursuant to paragraph (a)(1)(ii) of Rule 15c3-1.

74 17 CFR 240.15c3-1(c)(2)(iv)(E).

PAB reserve account requirements of Rules 15c3-3 and 15c3-3a.[75] A commenter suggested modifying this proposed amendment,[76] arguing that "[a]lthough the Proposing Release states that the Commission 'would not expect broker-dealers to audit or examine their carrying broker-dealers to determine whether the carrying broker-dealer is in compliance with [the proposed rules],' the text of the proposed amendment suggests that they in fact would have such an obligation."[77] The commenter also stated that a broker-dealer should not be deemed to have violated Rule 15c3-1 merely because its carrying firm fails to properly perform requirements solely applicable to the carrying firm and that paragraph (c)(2)(iv)(E) under Rule 15c3-1 should be explicitly modified to clarify that cash and securities held in a securities account at another broker-dealer are not subject to the deduction specified in that paragraph.[78]

While the Commission did not intend to impose any monitoring requirement on the PAB account holder, the Commission recognizes that the language, as proposed, could have implied such a requirement and agrees with the commenter that a broker-dealer should not be deemed to have violated Rule 15c3-1 with respect to requirements that are solely applicable to the carrying broker-dealer. To address this concern, the Commission has modified the language in paragraph (c)(2)(iv)(E) under Rule 15c3-1 to eliminate the proposed capital charge of Rule 15c3-1 that would have resulted from a failure of a carrying broker-dealer to comply with the PAB requirements in Rule 15c3-3.[79]

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75 See Amendments to Financial Responsibility Rules, 72 FR at 12864.

76 See SIFMA 2 Letter.

77 Id.

78 Id.

79 More specifically, the Commission has deleted the proposed language referring to "cash and securities held in a securities account at another broker-dealer if the other broker-

Instead, the Commission has adopted amendments to Rule 15c3-1 providing that a broker-dealer need not deduct cash and securities held in a securities account at a carrying broker-dealer except where the account has been subordinated to the claims of creditors of the carrying broker-dealer.[80] This provision is intended to prevent broker-dealers from including assets in their net capital that may not be readily available to be returned because they would not be subject to the PAB account provisions discussed above. Accordingly, the amendments to paragraph (c)(2)(iv)(E) of Rule 15c3-1 are consistent with the exclusions from the definition of PAB account in paragraph (a)(16) of Rule 15c3-3.[81]

3. Banks Where Special Reserve Deposits May Be Held

As amended, paragraph (e) of Rule 15c3-3 requires a broker-dealer to deposit cash or qualified securities into the customer or PAB reserve account,[82] which must be maintained at a bank.[83] While cash deposits at a bank are fungible and may be used by the bank in its lending and investment activities, paragraph (f) of Rule 15c3-3 requires that a broker-dealer obtain a written contract from the bank wherein the bank agrees not to re-lend or hypothecate securities deposited into the reserve account.[84] This means the bank cannot use the securities in its business, which provides a measure of protection by requiring that the securities will be available to the broker-dealer if the bank falls into

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dealer does not treat the account, and the assets therein in compliance with paragraphs (b)(5) and (e) of § 240.15c3-3 . . . ."

80 17 CFR 240.15c3-1(c)(2)(iv)(E).

81 17 CFR 15c3-3(a)(16).

82 The PAB reserve account and the customer reserve account are collectively referred to as the "reserve accounts" or a "reserve account."

83 The term bank is defined in paragraph (a)(7) of Rule 15c3-3 as a "bank as defined in section 3(a)(6) of the Exchange Act and will also mean any building and loan, savings and loan or similar banking institution subject to the supervision by a Federal banking authority." See paragraph (a)(7) to Rule 15c3-3, as adopted.

84 See 17 CFR 240.15c3-3(f).

financial difficulty. Cash deposits, however, may be freely used in the course of the bank's commercial activities.[85] Therefore, to the extent a broker-dealer deposits cash in a reserve account, there is a risk the cash could become inaccessible if the bank experiences financial difficulties.[86] This could adversely impact the broker-dealer and its customers.[87] To limit these risks, the Commission proposed amendments to Rule 15c3-3 that would have: (1) prohibited a broker-dealer from maintaining cash deposits in the reserve accounts for customers and PAB account holders if the bank was affiliated; and (2) limited the amount of cash that could be deposited in both types of reserve accounts at non-affiliated banks.[88] These restrictions would not have applied to securities held in the reserve accounts because, as noted above, the bank must agree not to use the securities in its business. The goal of the proposals was to limit cash reserve account deposits to reasonably safe amounts as measured against the capitalization of the broker-dealer and the bank.[89]

Specifically, as proposed, paragraph (e)(5) of 15c3-3 provided that a carrying broker-dealer would have been required to exclude the amount of cash deposited into reserve accounts at affiliated banks when determining whether it maintained the minimum amount required to be on deposit in the reserve accounts for its customers and PAB account holders. In addition, the proposed amendment would have required a carrying broker-dealer to exclude cash deposited in a reserve account at an unaffiliated bank to the extent the amount of the cash deposited exceeded: (1) 50% of the broker-dealer's excess net capital (based on the broker-dealer's most recently filed FOCUS

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85 See Amendments to Financial Responsibility Rules, 72 FR at 12864.

86 Id.

87 Id.

88 Id.

89 Id.

Report);[90] or (2) 10% of the bank's equity capital (based on the bank's most recently filed Call Report or Thrift Financial Report).[91]

The Commission is adopting the amendments with modifications designed to address issues identified by commenters. Twenty-three commenters addressed the proposed amendments.[92] Fifteen commenters urged the Commission not to adopt the proposed prohibition on broker-dealers maintaining cash in reserve accounts at affiliated banks.[93] These commenters generally stated that, with regard to cash in reserve accounts, affiliated banks should be treated the same as unaffiliated banks because both groups are subject to the same financial regulation.[94] These commenters noted that banks are subject to safety and soundness requirements of their respective banking regulators and,

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90 Under Rule 17a-5, broker-dealers must file periodic reports on Form X-17a-5 (Financial and Operational Combined Uniform Single Reports) ("FOCUS Reports"). See 17 CFR 240.17a-5(a). The FOCUS Report requires, among other financial information, a balance sheet, income statement, and net capital and customer reserve computations. Excess net capital is the amount that a broker-dealer's net capital exceeds its minimum requirement.

91 See Amendments to Financial Responsibility Rules, 72 FR at 12864. On July 21, 2011, supervisory responsibility for federal savings associations was transferred from the Office of Thrift Supervision ("OTS") to the Office of the Comptroller of the Currency ("OCC"). As of the quarter ending March 31, 2012, savings associations were required to file a Call Report in lieu of a Thrift Financial Report. See Proposed Agency Information Collection Activities; Comment Request, 76 FR 7082 (Feb. 8, 2011). The Call Report includes a line item for total bank equity capital. A report for a specific institution is available at https://cdr.ffiec.gov/public/. See also, FINRA, Interpretations of Financial and Operational Rules, Interpretations 15c3-3(e)(1)/01 and /011 (establishing similar threshold restrictions on using money market deposit accounts or time deposits, respectively, to meet customer reserve account requirements), and Interpretation 15c3-3(e)(3)/051 (establishing similar threshold restrictions with respect to meeting the customer reserve requirement by depositing cash at an affiliated bank).

92 See Federated Letter; Curian Clearing Letter; Raymond James Letter; JP Morgan Letter; Reserve Letter; Dresdner Kleinwort Letter; SIFMA 2 Letter; SIFMA 4 Letter; First Clearing Letter; Clearing House Letter; ICI Letter; Barclays Letter; ABASA Letter; PNC Letter; BlackRock Letter; Deutsche Bank Securities Letter; E*Trade Letter; Citigroup Letter; American Bar Association Letter; Fidelity/NFS Letter; BOK Letter; JP Morgan 3 Letter; IIB Letter; Raymond James 2 Letter.

93 See Federated Letter; JP Morgan Letter; Dresdner Kleinwort Letter; SIFMA 4 Letter; First Clearing Letter; ICI Letter; ABASA Letter; E*Trade Letter; Citigroup Letter; American Bar Association Letter; Fidelity/NFS Letter; Curian Letter; BOK Letter; JP Morgan 2 Letter; IIB Letter.

94 Id.

therefore, the commenters argued that the proposed restriction with respect to affiliated banks is unwarranted.

One commenter also stated that the Commission's distinction between affiliated and unaffiliated banks was not sufficiently supported in the proposing release.[95] More specifically, this commenter stated that the Commission's "bare statement that a broker-dealer 'may not exercise due diligence with the same degree of impartiality when assessing the soundness of an affiliate bank as it would with a non-affiliate...' does not suffice to justify the disparate treatment" with regard to the treatment of affiliated banks under the proposed rule.[96] This commenter also stated that it is just as easy to argue that broker-dealers are in a much better position to know about the soundness of an affiliated bank then to learn about the soundness of a unaffiliated bank, which may not be willing to provide complete and accurate information.[97] In addition, another commenter stated that the Commission cited no empirical or anecdotal evidence to support its reasons for prohibiting cash reserve deposits at an affiliated bank.[98] This commenter also stated that the Commission's concerns 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.[99]

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95 See Dresdner Kleinwort Letter.

96 Id.

97 Id.

98 See Citigroup Letter.

99 Id.

One commenter stated that it took no issue with the proposed restriction on affiliated banks.[100] Another commenter noted that the financial industry has seen a remarkable consolidation of the banking and securities industries, and, as a result, the number of broker dealers affiliated with banks has increased, along with the number of those broker-dealers maintaining deposits at affiliated banks.[101] This commenter stated that broker-dealers would be required to move deposits from one institution and divide that amount among several banks, resulting in credit risk to the broker-dealer, as well as an increase in operational risk.[102] Finally, the commenter observed that the Commission did not provide any specific examples of bank failures impacting affiliated broker-dealers, which led the commenter to question whether there is any realistic benefit to offset the increased risk that broker-dealers would be required to take on as a result of the proposal to place restrictions on cash deposits in reserve accounts at affiliated and unaffiliated banks.[103]

The Commission recognizes that all banks, whether or not affiliated with a broker-dealer, are subject to regulation by their respective banking regulators. The Commission's continuing concern, however, is that a carrying broker-dealer may not exercise due diligence with the same degree of impartiality and care when assessing the financial soundness of an affiliated bank as it would with an unaffiliated bank.[104] Moreover, the goal of protecting the carrying broker-dealer's customers through the Rule

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100 See Raymond James Letter. In a subsequent comment letter, this commenter stated that if this proposal is adopted, registered broker-dealers holding customer funds may be required to move their reserve accounts if those accounts are currently held at affiliated banks, which would increase costs. See Raymond James 2 Letter.

101 See BOK Letter.

102 Id.

103 Id.

104 See Amendments to Financial Responsibility Rules, 72 FR at 12864.

15c3-3 reserve requirement may be undermined in the event a holding company becomes insolvent, with corresponding adverse consequences to both the bank and broker-dealer subsidiaries.

In some cases, a broker-dealer may have access to more information about an affiliated bank in comparison to an unaffiliated bank for purposes of conducting due diligence. However, having more information would not be of benefit if the individuals making the decision on where to maintain the reserve account are not objective in their decision making. The Commission is concerned that a broker-dealer's decision to hold cash in a reserve account at an affiliated bank may be driven in part by profit or reasons based on the affiliation, regardless of any due diligence it may conduct or the overall safety and soundness of the bank.

In addition, in response to the comments regarding affiliated banks, the Commission notes that substantial numbers of banks have failed or required government assistance in recent years.[105] While a particular bank failure may not have materially impacted an affiliated broker-dealer to date,[106] the risk remains that the financial difficulty of an entity that is part of a holding company structure may adversely impact other affiliated entities, including affiliated broker-dealers and banks.[107] Therefore, the final rule retains the prohibition on maintaining customer reserve cash deposits at an affiliated bank.[108]

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105 According to the FDIC, the number of FDIC-insured institutions that failed in the U.S. over the last four years are: (1) 140 in 2009; (2) 157 in 2010; (3) 92 in 2011; and (4) 51 in 2012. A complete list of failed banks since October 1, 2000, is available at www.fdic.gov/bank/individual/failed/banklist.html.

106 See BOK Letter; Dresdner Kleinwort Letter.

107 See, e.g., Lehman Brothers Inc. – Trustee's Preliminary Investigation Report and Recommendations (Case No. 08-01420 (JMP) SIPA), available at http://bankrupt.com/misc/sipareport0904.pdf.

108 Id.

This prohibition does not apply to securities on deposit at an affiliated bank, but only cash deposits because, as noted above, the latter are fungible with other deposits carried by the bank and may be freely used in the course of the bank's commercial activities.[109] Consequently, to the extent that operational or other efficiencies can be achieved through the use of an affiliated bank, the carrying broker-dealer can use qualified securities held at an affiliated bank to meet its reserve deposit requirements.[110] The ability to use qualified securities alleviates concerns that a broker-dealer would be required to take deposits from one institution and divide that amount among several banks, resulting in credit risk to the broker-dealer, as well as an increase in operational risk.[111]

In summary, while the Commission acknowledges concerns raised by commenters, the Commission continues to believe that it is appropriate to exclude cash deposited in affiliated banks from the calculation to determine whether a broker-dealer has met its reserve account requirements. Therefore, the final rule excludes the amount of any cash on deposit in an affiliated bank of the broker-dealer from being used to meet the reserve requirements.[112] Broker-dealers that use affiliated banks for holding cash

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109 See Federal Reserve, Division of Banking Supervision and Regulation, Commercial Bank Examination Manual, Section 3000.1, Deposit Accounts (stating that deposits are the primary funding source for most banks and that banks use deposits in a variety of ways, primarily to fund loans and investments), available at http://www.federalreserve.gov/boarddocs/supmanual/cbem/3000.pdf. See also OCC Banking Circular (BC-196), Securities Lending (May 7, 1985) (stating securities should be lent only pursuant to a written agreement between the lender institution and the owner of the securities specifically authorizing the institution to offer the securities for loan), available at http://www.occ.gov/static/news-issuances/bulletins/pre-1994/banking-circulars/bc-1985-196.pdf.

110 See Citigroup Letter.

111 See BOK Letter. Based on FOCUS Report data, as of December 31, 2011, 79% of the total customer reserve requirement across all carrying broker-dealers was met using qualified securities.

112 See paragraph (e)(5) of Rule 15c3-3, as adopted.

customer reserve accounts will need to either deposit qualified securities into the accounts or move their accounts to non-affiliated banks.

As for the limits on the amounts of cash that could be deposited in one unaffiliated bank, some commenters argued that the proposed thresholds were too restrictive. One commenter urged the Commission to reconsider the proposed limits, noting that the proposed amendment will impose significant costs on broker-dealers and potentially adversely impact the broker-dealers' customers.[113] Several commenters suggested that the Commission allow cash reserve deposits without the percentage restrictions at unaffiliated banks that are well-capitalized or for which the broker-dealer has performed due diligence.[114] One commenter suggested that the Commission consider higher percentages for cash deposits at large money-center banks.[115] This commenter stated that this would strike a better balance between the Commission's concerns regarding the safety of cash deposits and the costs imposed on broker-dealers arising from having to use qualified securities (as opposed to cash) to meet deposit requirements or having to maintain reserve accounts at multiple banks.[116] This commenter also stated that the percentage thresholds would negatively impact smaller broker-dealers because they would exceed the 50% of excess net capital threshold at lower deposit levels.[117] Two commenters noted that the proposed 10% bank equity capital limitation appears to be derived from a 1988 NYSE staff interpretation, which stated that customer reserve accounts may be maintained in money market deposit accounts if the total of such

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113 See Raymond James 2 Letter.

114 See Raymond James Letter; JP Morgan Letter; Clearing House Letter; ABASA Letter; PNC Letter; Deutsche Bank Securities Letter; E*Trade Letter; JP Morgan 2 Letter.

115 See SIFMA 2 Letter; SIFMA 4 Letter.

116 See SIFMA 2 Letter.

117 Id.

deposits in any one bank does not exceed 50% of the broker-dealer's excess net capital or 10% of the bank's equity capital.[118] These commenters pointed out that significant changes have taken place with respect to federal bank regulatory agency oversight of the safety and soundness of banks since 1988, including the imposition of prompt corrective action provisions.[119] These commenters stated that the concerns that gave rise to the 1988 interpretation have been mitigated by current statutes and regulations requiring prompt corrective action in the event that a bank's capital position deteriorates.[120]

As stated above, substantial numbers of banks have failed or required government assistance in recent years.[121] Consequently, the rule, as adopted, establishes requirements designed to avoid the situation where a carrying broker-dealer's cash deposits constitute a substantial portion of the bank's deposits. At the same time, the proposal has been modified to mitigate concerns raised by commenters that broker-dealers would have to maintain reserve accounts at multiple banks. First, the Commission has eliminated the provision that would have excluded the amount of a cash deposit that exceeds 50% of the broker-dealer's excess net capital. As noted by comments, this provision likely would have disproportionately impacted small and mid-size broker-dealers when they deposited cash into large commercial banks since they would exceed the excess net capital threshold well before exceeding the bank equity capital threshold.[122] Also, based on staff experience monitoring larger broker-dealers, firms that maintain large amounts of cash in their customer reserve accounts generally use more than one non-affiliated bank to maintain these accounts.

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118 See PNC Letter; ABASA Letter.

119 See PNC Letter; ABASA Letter.

120 Id.

121 See www.fdic.gov/bank/individual/failed/banklist.html.

122 See SIFMA 2 Letter; JP Morgan 2 Letter.

The bank equity capital threshold is the more important metric since it relates directly to the financial strength of the bank, which is the entity holding the account. Thus, this metric more directly addresses the risk at issue: the potential impairment of the bank's ability to quickly return the customer reserve deposit to the broker-dealer.

Second, with respect to the bank equity capital threshold, in response to comments, the Commission has increased the threshold from 10% to 15% of the bank's equity capital. The increase of the threshold to 15% is designed to address concerns raised by commenters that the proposed percentage tests were unduly restrictive in certain respects and should be modified, particularly with respect to large broker-dealers with large deposit requirements. Consequently, the increase from 10% to 15% is designed to mitigate commenters' concerns that the 10% threshold would require broker-dealers to spread out cash deposits over a number of banks, while still providing adequate protection against the risk that arises when a bank's deposit base is overly reliant on a single depositor.

The elimination of the 50% of excess net capital threshold and increase in the bank capital threshold from 10% to 15% is intended to address concerns raised by commenters that they would have to substantially alter their current cash deposit practices in light of the goal of the rule to promote the broker-dealer's ability to have quick access to the deposit.

As proposed, the equity capital threshold would have been based on equity capital "as reported by the bank in its most recent Call Report or Thrift Financial Report." Under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),[123] the supervision of savings associations was transferred from the OTS to the

[123] Pub. L. No. 111–203, 124 Stat. 1376 (2010).

OCC (for federal savings associations) and the FDIC (for state savings associations).[124] Also, beginning in the period ending March 31, 2012, savings associations began to file a Call Report in lieu of a Thrift Financial Report, thereby ending the use of the Thrift Financial Report.[125] Therefore, due to the passage of the Dodd-Frank Act and the elimination of the Thrift Financial Report, as well as to provide more flexibility with regard to any successor reports that may be required to be filed by a bank, the Commission is modifying the phrase "Call Report or Thrift Financial Report" to read "Call Report or any successor form the bank is required to file by its appropriate Federal banking agency (as defined by section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813))".

Two commenters expressed concern about the use of a Call Report to determine a bank's "equity capital" under the rule.[126] These commenters noted that there is no equity capital line item in the Call Reports of U.S. branches of foreign banks due to these branches not being separately incorporated legal entities.[127] Therefore, the proposed Call Report provision potentially excluded U.S. branches of foreign banks from holding reserve accounts. The commenters stated that for foreign banks, the equity capital can be found in other forms, such as Form FR Y-7, Form FR Y-70, Form 6-K, and Form F-20, among other financial statements filed with U.S. regulators.[128] One commenter suggested the Commission revise the proposed provision to read: "The amount of the

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124 Id. at §§ 300–378. See also List of OTS Regulations to be Enforced by the OCC and the FDIC Pursuant to the Dodd-Frank Act, OCC, FDIC, (June 14, 2011), 76 FR 39246 (July 6, 2011). Supervision of savings and loan holding companies and their subsidiaries (other than depository institutions) was transferred from the OTS to the Federal Reserve.

125 See Proposed Agency Information Collection Activities; Comment Request, 76 FR 7082 (Feb. 8, 2011).

126 See IIB Letter; SIFMA 4 Letter.

127 Id.

128 Id.

deposit exceeds 10% of the bank's equity capital (as reported by the bank in its most recent Call Report or Thrift Financial Report if such report includes a line item for 'equity capital')."[129] Alternatively, these commenters suggested that in lieu of a Call Report a U.S. branch of a foreign bank could periodically obtain a certificate from the bank stating its equity capital (or stating that its equity capital exceeds a specified level).[130]

The Commission recognizes that the U.S. branches of some foreign banks may meet the definition of bank under section (3)(a)(6) of the Exchange Act and, therefore, also under paragraph (a)(7) of Rule 15c3-3.[131] However, the Commission is retaining the requirement that the bank's equity be determined using its most recent Call Report because U.S. branches of foreign banks generally are not FDIC-insured.[132]

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129 See IIB Letter.

130 See IIB Letter; SIFMA 4 Letter.

131 The term bank as defined in section 3(a)(6) of the Exchange Act is limited to banks directly regulated by U.S. state or federal bank regulators. The determination whether any particular financial institution meets the requirements of section 3(a)(6) is the responsibility of the financial institution and its counsel. See 15 U.S.C. 78c(a)(6); cf. Securities Issued Or Guaranteed By United States Branches Or Agencies of Foreign Banks; Interpretive Release, Securities Act Release No. 6661 (Sept. 23, 1986), 51 FR 34460 (Sept. 29, 1986) (determination as to whether branch or agency of foreign bank falls within the definition of bank under section 3(a)(2) of Securities Act of 1933, 15 U.S.C. 77c(a)(2), is responsibility of issuers and their counsel). However, section 4(d) of the International Banking Act, 12 U.S.C. 3102(d), expressly prohibits agencies of foreign banks established under federal law from receiving deposits or exercising fiduciary powers, criteria necessary for qualification as a bank under section 3(a)(6)(C) of the Exchange Act. See 12 U.S.C. 3102(d); see also Conference of State Bank Supervisors v. Conover, 715 F.2d 604 (D.C. Cir. 1983), cert. denied, 466 U.S. 927 (1984) (stating that federally-chartered agencies of foreign banks are prohibited from receiving deposits from foreign, as well as domestic, sources).

132 The FDIC protects depositors' funds in the event of the financial failure of their bank or savings institution. FDIC deposit insurance covers the balance of each depositor's account, dollar-for-dollar, up to the insurance limit, including principal and any accrued interest through the date of the insured bank's closing. No depositor has suffered a loss of insured deposits since the FDIC was created in 1933. See FDIC, When a Bank Fails – Facts for Depositors, Creditors, and Borrowers, available at http://fdic.gov/consumers/banking/facts/index.html. See also Federal Reserve, Structure

Consequently, deposits at these institutions would not receive the protections of FDIC insurance in the event of a bank failure. FDIC insurance provides additional protections to cash deposited in a reserve account at a bank in the event of a bank failure that would not be available at an uninsured bank.[133] The Commission, however, will consider requests for exemptive relief from broker-dealers that wish to hold a reserve account at a U.S. branch of a foreign bank.

For these reasons, the Commission is adopting the final rule to exclude, when determining whether a broker-dealer maintains the minimum deposits required under paragraph (e) of Rule 15c3-3, cash deposited with an affiliated bank as well as cash deposited with an unaffiliated bank "to the extent that the amount of the deposit exceeds 15% of the bank's equity capital as reported by the bank in its most recent Call Report or any successor form the bank is required to file by its appropriate Federal banking agency (as defined by section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813))."[134] As discussed above, the Commission is deleting from the final rule the provision that would have excluded the amount of cash on deposit that exceeds 50% of the broker-dealer's excess net capital.

4. Allocation of Customers' Fully Paid and Excess Margin Securities to Short Positions

Paragraph (d) of Rule 15c3-3 currently sets forth steps a broker-dealer must take to retrieve securities from non-control locations if there is a shortfall in the fully paid or

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and Share Data for U.S. Offices of Foreign Banks, available at http://www.federalreserve.gov/releases/iba/.

133 Id. Therefore, the availability of FDIC insurance could also be a contributing factor to mitigating the risk that an impairment of the reserve deposit at an unaffiliated bank will have a material negative impact on the broker-dealer's ability to meet its obligations to customers and PAB account holders. See Amendments to Financial Responsibility Rules, 72 FR at 12864.

134 See paragraph (e)(5) of Rule 15c3-3, as adopted.

excess margin securities it is required to hold for its customers. The actions prescribed in the rule do not include a requirement that the broker-dealer obtain possession or control of a fully paid or excess margin security that is reflected on the broker-dealer's stock record as a long position of a customer that allocates to a broker-dealer or non-customer short position. In the simplest case, this occurs when the carrying broker-dealer as principal sells short a security to its own customer. Currently, in such a case, the broker-dealer is not required to have possession or control of the security even though its customer has paid for the security in full. Rather, the broker-dealer must include the mark-to-market value of the security as a credit item in the reserve formula. The broker-dealer can use the cash paid by the customer to purchase the security to make any increased deposit requirement caused by the credit item.[135] As the Commission stated in the proposing release, this permits the broker-dealer, in effect, to partially monetize the customer's security.[136] This result is contrary to the customer protection goals of Rule 15c3-3, which seek to ensure that broker-dealers do not use customer assets for proprietary purposes.[137]

To address these concerns, the Commission proposed an amendment to Rule 15c3-3 that would have required a broker-dealer to obtain physical possession or control of customer fully paid and excess margin securities that allocate to a broker-dealer short position.[138] Specifically, the proposed amendment would have added a fifth step to take when a deficit arose in the amount of securities the broker-dealer was required to

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135 In effect, the broker-dealer has monetized the customer's security and has to purchase or borrow it, at a future date, to return the customer's fully paid securities.

136 See Amendments to Financial Responsibility Rules, 72 FR at 12865.

137 See, e.g., Customer Protection Rule, Exchange Act Release No. 22499 (Oct. 3, 1985), 50 FR 41337 (Oct. 10, 1985).

138 See Amendments to Financial Responsibility Rules, 72 FR at 12865.

maintain in possession or control; namely that for "[s]ecurities included on [the broker-dealer's] books or records as a proprietary short position or as a short position for another person, excluding positions covered by paragraph (m) of this section, for more than 10 business days (or more than 30 calendar days if the broker or dealer is a market maker in the securities), […] the broker or dealer shall, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities."[139]

Eleven commenters addressed this proposed amendment.[140] Three commenters urged the Commission to disallow naked short selling of securities and one argued that the Commission should force short sellers to pre-borrow.[141] Three commenters generally opposed the proposed rule. They argued that the credit item added to the reserve formula computation when a customer's fully paid or excess margin security allocates to a short position provides the customer with adequate protection.[142] Two of these commenters requested that the 30 calendar days allowed for a broker-dealer acting as a market maker to obtain possession or control over securities allocating to a short position be expanded to include all situations where a broker-dealer must act pursuant to the rule (i.e., not be

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139 Id. at 12895.

140 See Glenn Letter; Bare Letter; Anonymous Letter; SIFMA 2 Letter; First Clearing Letter; Hearne Letter; Deutsche Bank Securities Letter; Citigroup Letter; AMEX Letter; SIFMA 4 Letter; Federated 6 Letter; Raymond James 2 Letter.

141 See Glenn Letter; Bare Letter; Anonymous Letter; Hearne Letter. The Commission has taken a number of measures to strengthen investor protections against potentially abusive "naked" short selling, including adopting rules requiring that fails to deliver resulting from short sales immediately be closed-out and expressly targeting fraud in short selling transactions. See Amendments to Regulation SHO, Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266 (July 31, 2009); "Naked" Short Selling Antifraud Rule, Exchange Act Release No. 58774 (Oct. 14, 2008), 73 FR 61666 (Oct. 17, 2008). In addition, the Commission adopted a short sale-related price test that, if triggered, imposes a restriction on the prices at which securities may be sold short. See Amendments to Regulation SHO, Exchange Act Release No. 61595 (Feb. 26, 2010), 75 FR 11232 (Mar. 10, 2010).

142 See First Clearing Letter; Deutsche Bank Securities Letter; Citigroup Letter.

limited to market maker positions).[143] These commenters argued that it would be difficult to distinguish between market maker and non-market maker positions in complying with the proposed rule. Another commenter requested that the Commission reevaluate the proposed amendment because of its potential effects on investment and hedging strategies in addition to the heavy burden it will impose on short sales.[144] One commenter supported the amendments noting that it had "come to believe . . . that the Commission's proposal is consistent with the direction of the Commission's other short sale regulations . . . ."[145]

As discussed above in section II.A.2.ii. of this release, the Commission has determined that a credit item is sufficient to protect PAB account holders if the carrying broker-dealer provides them with notice that it may be using their non-margin securities, as well as the opportunity to object to such use. The use of the non-margin securities of PAB account holders is a long-standing industry practice. In contrast, customers under Rule 15c3-3, which include the carrying broker-dealer's retail customers, have an expectation that the fully paid and excess margin securities reflected on their account statements are, in fact, in the possession or control of the carrying broker-dealer. However, as described above, this expectation may be frustrated where the securities are allocated to a short position carried by the broker-dealer, as the securities are not in the possession or control of the broker-dealer.

This gap in the existing rule, in effect, permits the broker-dealer to partially monetize the customer's security. Also, under some circumstances (e.g., a change in the market value of the securities), the amount the broker-dealer may have on deposit in the

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143 See Citigroup Letter; Deutsche Bank Securities Letter.

144 See Raymond James 2 Letter.

145 See SIFMA 4 Letter. SIFMA originally opposed the proposed amendments. See SIFMA 2 Letter.

customer reserve account as a consequence of the credit item may be less than the value of the securities. Consequently, if the broker-dealer fails, sufficient funds may not be readily available to purchase the securities to return them to customers. The use of customer securities in this manner is contrary to the customer protection goals of Rule 15c3-3 and the expectations of a broker-dealer's customers.[146] For these reasons, the Commission is adopting the amendment.[147] The Commission agrees, however, that the proposed distinction based upon a broker-dealer's market maker status could present operational challenges and, consequently, the final rule has been modified to allow a uniform period of 30 calendar days before the possession and control requirement is triggered.

Specifically, as adopted, paragraph (d)(4) of Rule 15c3-3 requires a broker-dealer to take prompt steps to obtain physical possession or control over securities of the same issue and class as those included "on the broker's or dealer's books or records that allocate to a short position of the broker or dealer or a short position for another person, excluding positions covered by paragraph (m) of this section, for more than 30 calendar days . . . ."[148] The Commission does not believe that lengthening the time from 10 business days to 30 calendar days for non-market maker positions will significantly

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146 See supra notes 12 and 18, and accompanying text.

147 Current paragraph (d)(4) of Rule 15c3-3 is being re-designated paragraph (d)(5), as proposed.

148 See Amendments to Financial Responsibility Rules, 72 FR at 12865–12866. The amendment will not apply to securities that are sold long for a customer but not obtained from the customer within ten days after the settlement date. This circumstance is addressed by paragraph (m) of Rule 15c3-3, which requires the broker-dealer to close the transaction by purchasing securities of like kind and quantity. 17 CFR 240.15c3-3(m).

diminish the protections provided by the new rule.[149] Therefore, the Commission is adopting a uniform 30 calendar day time period in the final rule.

Three commenters requested that the Commission clarify that the aging process begins when the Rule 15c3-3 possession and control deficit arises and not when the short transaction is executed.[150] The proposed amendment was designed to require that the aging process commence at the time a deficit in securities allocating to a short position arises. One commenter[151] also requested that the Commission modify the proposed amendment to specifically 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)[152] or the delivery date for securities acquired in the exercise of any overallotment option (or

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149 For example, the rule currently has a thirty calendar day time period for securities failed to receive and a forty-five calendar day time period for securities receivable as a result of corporate actions (e.g., stock splits) before the broker-dealer must take prompt steps to obtain possession or control of such securities. See 17 CFR 240.15c3-3(d)(2)–(3).

150 See Deutsche Bank Securities Letter; Citigroup Letter; SIFMA 2 Letter.

151 See SIFMA 2 Letter. The commenter stated: "Regulation M embodies a carefully crafted scheme for the regulation of secondary market transactions by underwriters and other distribution participants, including the regulation of 'syndicate covering transactions,' which should not be disrupted by proposed paragraph (d)(4)." Id. In addition, SIFMA commented that where an underwriter sells short to a customer in anticipation of obtaining the securities through the exercise of an overallotment option, paragraph (d)(4) should not require the premature exercise of the overallotment option or the use of secondary market purchases instead of the overallotment option. Id.

152 17 CFR 242.100 through 242.105. More specifically, Rule 100 of Regulation M provides: "For purposes of regulation M . . . the following definitions shall apply: . . . Completion of participation in a distribution. . . . A person shall be deemed to have completed its participation in a distribution as follows: . . . (2) [a]n underwriter, when such person's participation has been distributed, including all other securities of the same class that are acquired in connection with the distribution, and any stabilization arrangements and trading restrictions in connection with the distribution have been terminated; Provided, however, that an underwriter's participation will not be deemed to have been completed if a syndicate overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of such exercise . . . ." 17 CFR 242.100(b).

"Green Shoe").[153] The Commission agrees with the commenter that there should be consistency between the final rule and Regulation M.[154] Consequently, the Commission has added a sentence to the final rule to clarify that the 30 calendar day period with respect to a syndicate short position established in connection with an offering does not begin to run until the underwriter's participation in the distribution is complete as determined pursuant to Rule 100(b) of Regulation M.[155] Finally, the Commission is adopting the revision to paragraph (n) as proposed to permit broker-dealers to apply to their designated examining authority ("DEA") for extensions of time related to paragraph (d)(4).[156]

5. Importation of Rule 15c3-2 Requirements into Rule 15c3-3 and Treatment of Free Credit Balances

i. Importation of Rule 15c3-2

Rule 15c3-2 requires a broker-dealer holding free credit balances to provide its customers (defined as any person other than a broker-dealer) at least once every three months with a statement of the amount due the customer and a notice that: (1) the funds are not being segregated, but rather are being used in the broker-dealer's business; and (2) the funds are payable on demand. The rule was adopted in 1964, before the adoption

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153 A green shoe or overallotment option is a provision contained in an underwriting agreement that gives the underwriting syndicate the right to purchase additional shares from the issuer or selling security holders (in addition to those initially underwritten by the syndicate) for the purpose of covering any overallotments that are made on behalf of the syndicate in connection with an offering of securities.

154 Rule 100 of Regulation M also provides that an underwriter's participation will not be deemed to have been completed if a syndicate overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of exercise. 17 CFR 242.100(b).

155 17 CFR 242.100(b).

156 SROs generally have procedures in place for broker-dealers to apply for extensions of time under paragraph (n) of Rule 15c3-3. See, e.g., FINRA Rule 4230.

of Rule 15c3-3 in 1972.[157] Since the adoption of Rule 15c3-3, broker-dealers have been limited in their use of customer free credit balances. The Commission proposed importing requirements in Rule 15c3-2[158] into Rule 15c3-3 and eliminating Rule 15c3-2 as a separate rule in the Code of Federal Regulations.[159] The Commission received two comments supporting the proposal.[160]

The Commission is adopting the amendments substantially as proposed – deleting Rule 15c3-2 and adding paragraph (j)(1) to Rule 15c3-3. The Commission believes it is appropriate to eliminate Rule 15c3-2 as a separate rule because it is largely irrelevant in light of the requirements in Rule 15c3-3. Further, the provisions in Rule 15c3-2 that the Commission wishes to retain are being re-codified in Rule 15c3-3. These provisions include the requirement that broker-dealers inform customers of the amounts due to them and that such amounts are payable on demand.[161] Consequently, the Commission is amending Rule 15c3-3 to add new paragraph (j)(1), which provides that "[a] broker or dealer must not accept or use any free credit balance carried for the account of any customer of the broker or dealer unless such broker or dealer has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent, together with or as part of the customer's statement of account, whenever sent but not less frequently than once every three months, a written statement

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157 See Customers' Free Credit Balances, Exchange Act Release No. 7266 (Mar. 12, 1964), 29 FR 7239 (June 3, 1964).

158 17 CFR 240.15c3-2.

159 See Amendments to Financial Responsibility Rules, 72 FR at 12867.

160 See SIFMA 2 Letter; SIFMA 4 Letter.

161 Rule 15c3-2 contains an exemption for broker-dealers that also are banking institutions supervised by a Federal authority. This exemption will not be imported into Rule 15c3-3 because there are no broker-dealers left that fit within the exemption. Further, the definition of customer for purposes of the imported 15c3-2 requirements will be the definition of customer in Rule 15c3-3, which is somewhat narrower than the definition in Rule 15c3-2.

informing the customer of the amount due to the customer by the broker or dealer on the date of the statement, and that the funds are payable on demand of the customer."[162]

ii. Treatment of Free Credit Balances

Free credit balances are funds payable by a broker-dealer to its customers on demand.[163] They may result from cash deposited by the customer to purchase securities, proceeds from the sale of securities or other assets held in the customer's account, or earnings from dividends and interest on securities and other assets held in the customer's account. Broker-dealers may, among other things, pay interest to customers on their free credit balances or offer to routinely transfer ("sweep") them to a money market fund or bank account. On occasion, broker-dealers have changed the product to which a customer's free credit balances are swept – in recent years, most frequently from a money market fund to an interest bearing bank account. Because of differences in these two types of products, including the type of protection afforded the customer in the event of insolvency, there may be investment consequences to the customer when changing from one product to the other. The money market shares – as securities – would receive up to $500,000 in SIPA protection in the event the broker-dealer failed. The bank deposits – as cash – would receive up to $250,000 in protection from the FDIC in the event the bank failed. On the other hand, the money market fund shares may incur market losses; whereas, the full amount of the bank deposit would be guaranteed up to the FDIC's $250,000 limit. There also may be differences in the amount of interest earned from the two products. In short, there may be consequences to moving a customer's free credit

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162 See paragraph (j)(1) of Rule 15c3-3, as adopted. The Commission also modified the phrase "[i]t shall be unlawful for a broker or dealer to" to the phrase "[a] broker or dealer must not" in order to avoid using the term "unlawful." Any violation of the rules and regulations promulgated under the Exchange Act is unlawful and therefore it is unnecessary to use this phrase in the final rule.

163 See 17 CFR 240.15c3-3(a)(8).

balances from one product to another, and, accordingly, customers should have a sufficient opportunity to make an informed decision.[164]

The Commission proposed amendments to Rule 15c3-3 that would have established conditions required to be met in order for a broker-dealer to use or transfer free credit balances in a customer's securities account.[165] More specifically, as initially proposed, the amendments would have structured the new rule to make it unlawful for a broker-dealer to convert, invest, or otherwise transfer to another account or institution free credit balances held in a customer's account except as provided in the proposed rule.[166] The proposed rule then prescribed three conditions to address three different scenarios involving the use or transfer of customer free credit balances. The first scenario involved the use or transfer of free credit balances outside the context of a routine sweep to a money market fund or bank. As discussed below, proposed paragraph (j)(2)(i) would have prohibited the use or transfer of free credit balances in this scenario unless the customer had specifically ordered or authorized the transaction. The second and third scenarios involved the use or transfer of free credit balances in the context of a program to routinely sweep them to a money market fund or bank account (a "sweep program"). As discussed below, proposed paragraph (j)(2)(ii) would have addressed sweep program requirements for accounts opened after the effective date of the rule ("new accounts") and proposed paragraph (j)(2)(iii) would have addressed sweep program requirements for accounts existing as of the effective date of the rule (existing accounts). The Commission is adopting new paragraph (j)(2) to Rule 15c3-3 with

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164 See Amendments to Financial Responsibility Rules, 72 FR at 12866.

165 Id. at 12866–12867.

166 Id. at 12866.

substantial modifications from the proposed rule in response to comments and to clarify certain portions of the rule.[167]

As proposed, the first sentence of paragraph (j)(2) of the rule would have established the prohibition with respect to the treatment of free credit balances by providing that "[i]t shall be unlawful for a broker or dealer to convert, invest, or otherwise transfer to another account or institution, free credit balances held in a customer's account except as provided in paragraphs (j)(2)(i), (ii) and (iii)."[168] The Commission received one comment in response to the proposed text of this first sentence.[169] The commenter expressed concern that the proposed text in the first sentence of paragraph (j)(2) could be construed broadly, in effect, to prohibit a broker-dealer from using, investing, or transferring cash deposits that are not swept to other investments or products (and are included as credits in the reserve formula) in the normal course of the broker-dealer's business, as is currently permitted by Rule 15c3-3. The commenter suggested that the text be revised to clarify the scope of the proposed rule by prohibiting a broker-dealer from deducting a free credit balance from the customer's account at the broker-dealer and transferring it to another institution and investing it in another instrument on behalf of the customer, except as permitted under paragraph (j)(2).[170]

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167 In 2005, the NYSE addressed the issue of disclosure in a sweep program context by issuing an information memo to its members discussing, among other things, the disclosure responsibilities of a broker-dealer offering a sweep program to its customers. See Information Memo 05-11 (Feb. 15, 2005). The memo stated that broker-dealers should disclose material differences in interest rates between the different sweep products and, with respect to the bank sweep program, further disclose the terms and conditions, risks and features, conflicts of interest, current interest rates, manner by which future interest rates will be determined, and the nature and extent of FDIC and SIPC protection.

168 See Amendments to Financial Responsibility Rules, 72 FR at 12896.

169 See SIFMA 2 Letter.

170 Id.

In response to the comment, as a preliminary matter, cash balances in customer securities accounts must be included as credits in the customer reserve formula. Further, the net amount of the credits over debits must be deposited in a customer reserve account in the form of cash or qualified securities. However, cash credit items that are net of debit items can be used by the broker-dealer for the limited purpose of facilitating transactions of its customers.[171] The commenter suggested that proposed paragraph (j)(2) of Rule 15c3-3 could be interpreted to impose new limits on a broker-dealer's ability to use cash that is an asset on the firm's balance sheet. In response to this concern, the Commission notes that the prohibition in the first sentence of proposed paragraph (j)(2) of Rule 15c3-3 is intended to place conditions only on the broker-dealer's ability to convert the cash asset of the customer (i.e., a receivable from the broker-dealer) into a different type of asset (e.g., a security or an obligation of another institution outside the context of a sweep program) or to transfer the customer's cash asset to another account.

The Commission is adopting paragraph (j)(2) of Rule 15c3-3 with certain technical modifications.[172] As adopted paragraph (j)(2) reads: "A broker or dealer must

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171 See 17 CFR 240.15c3-3(e)(2) ("It shall be unlawful for any broker or dealer to accept or use any of the amounts under items comprising Total Credits under the formula referred to in paragraph (e)(1) of this section except for the specified purposes indicated under items comprising Total Debits under the formula, and, to the extent Total Credits exceed Total Debits, at least the net amount thereof shall be maintained in the Reserve Bank Account pursuant to paragraph (e)(1) of this section.").

172 Specifically, the Commission is replacing the phrase "[i]t shall be unlawful for a broker or dealer to" with the phrase "[a] broker or dealer must not" because – as noted above – any violation of the rules and regulations promulgated under the Exchange Act is unlawful and therefore it is unnecessary to use this phrase in the final rule. The Commission also is replacing the phrase "free credit balance" with the phrase "credit balances" to clarify that this provision covers both free credit balances and other credit balances. See 17 CFR 240.15c3-3(a)(8)–(9) (defining free credit balances and other credit balances). The Commission is deleting the word "otherwise" because it would be redundant. Finally, the rule text does not include a reference to paragraph (j)(2)(iii), as proposed, because this paragraph was deleted from the final rule text.

not convert, invest, or transfer to another account or institution, credit balances held in a customer's account except as provided in paragraphs (j)(2)(i) and (ii) of this section."[173]

a. Treatment of Free Credit Balances Outside of a Sweep Program

As proposed, paragraph (j)(2)(i) of Rule 15c3-3 would have permitted a broker-dealer to convert, invest or otherwise transfer to another account or institution free credit balances held in a customer's account only upon a specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization, or draft.[174] This catchall provision would have applied to any use or transfer of customer free credit balances outside the context of a sweep program.

The Commission proposed paragraph (j)(2)(i) in order to comprehensively cover the range of possibilities with respect to the disposition of free credit balances in a customer account other than pursuant to a sweep program. The Commission received two comments recommending that proposed paragraph (j)(2)(i) be clarified to permit a broker-dealer to obtain a one-time consent to ongoing transfers of any free credit balances to a customer to another account, entity or product (outside of a sweep program).[175] The commenters noted that customers, for example, may prefer that free credit balances be regularly transferred to a linked account in their name at another broker-dealer or bank that is not part of a sweep program, and that this clarification would enable a broker-dealer to efficiently handle such customer requests by eliminating the need to obtain individual "specific orders" for repeated transfers that are substantially

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173 See paragraph (j)(2) of Rule 15c3-3, as adopted.

174 See Amendments to Financial Responsibility Rules, 72 FR at 12866.

175 See SIFMA 2 Letter; E*Trade 2 Letter.

identical.[176] The Commission agrees with the commenters that a customer may consent to ongoing routine transfers from the customer's account outside of a sweep program without obtaining the customer's specific consent for each individual transfer, provided the customer has consented to the ongoing transfers under paragraph (j)(2)(i) of Rule 15c3-3. This scenario would already be covered by the proposed rule, and, therefore, the Commission is adopting paragraph (j)(2)(i) substantially as proposed, with certain technical modifications.[177] As adopted, paragraph (j)(2)(i) of Rule 15c3-3 reads: "A broker or dealer is permitted to invest or transfer to another account or institution, free credit balances in a customer's account only upon a specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization, or draft."[178]

Finally, one commenter stated that both regulators and firms need the flexibility to remove funds from a reserve account to cover extraordinary requests for payment of customer free credit balances.[179] However, the commenter noted that "in light of recent market events, we withdraw our earlier proposal to allow such withdrawals under specified conditions and instead recommend that such withdrawals be permitted only by approval of Commission staff or a broker-dealer's [DEA]."[180] Broker-dealers currently

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176 Id.

177 See paragraph (j)(2)(i) of Rule 15c3-3, as adopted. The technical changes delete the words "convert" and "otherwise" from the final rule because a broker-dealer would be prohibited from "converting" a customer's free credit balances and, therefore, it is not necessary to include the word in the final rule. The word "otherwise" is redundant.

178 Id.

179 See SIFMA 4 Letter.

180 Id. In its June 15, 2007 comment letter, SIFMA urged "the Commission to consider allowing a broker-dealer to remove funds from a reserve account to cover a large same-day request for payment of a free credit balance, as long as the free credit balance was included in the latest Rule 15c3-3 reserve computation and the broker-dealer begins a new reserve computation as of that date." See SIFMA 2 Letter.

may make withdrawals under paragraph (g) of Rule 15c3-3.[181] In light of the risks that could arise to customer funds, the Commission does not believe it would be appropriate at this time to expand a firm's ability to make additional withdrawals from its reserve account.

b. Treatment of Free Credit Balances in a Sweep Program

The second and third set of conditions in the proposed rules addressed using or transferring free credit balances in the context of a sweep program.[182] In particular, the Commission proposed four conditions with respect to using or transferring free credit balances in a sweep program. A broker-dealer would have been required to meet: (1) all four conditions with respect to free credit balances in new accounts;[183] and (2) the second, third, and fourth conditions with respect to free credit balances in existing accounts.[184] The four conditions were:

1. The customer has previously affirmatively consented to such treatment of the free credit balances after being notified of the different general types of money market mutual fund and bank account products in which the broker or dealer may transfer the free credit balances and the applicable terms and conditions that would apply if the broker or dealer changes the product or type of product in which free credit balances are transferred;

2. The broker or dealer provides the customer on an ongoing basis with all disclosures and notices regarding the investment and deposit of free credit balances as required by the self-regulatory organizations for which the broker or dealer is a member;

3. The broker or dealer provides notice to the customer as part of the customer's quarterly statement of account that the money market mutual funds or bank deposits to which the free credit balances have been transferred can be liquidated on the customer's demand and held as free credit balances; and

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181 17 CFR 240.15c3-3(g).

182 See Amendments to Financial Responsibility Rules, 72 FR at 12866.

183 See paragraph (j)(2)(ii)(A)–(D) of Rule 15c3-3, as adopted.

184 See paragraph (j)(2)(iii)(A)–(C) of Rule 15c3-3, as adopted.

4. The broker or dealer provides the customer with at least 30 calendar days notice before the free credit balances would begin being transferred to a different product, different product type, or into the same product but under materially different terms and conditions. The notice must describe the new money market fund, bank deposit type, or terms and conditions, and how the customer can notify the broker or dealer if the customer chooses not to have the free credit balances transferred to the new product or product type, or under the new terms and conditions.

Commenters generally agreed with the fundamental principle embodied in the proposal – that customer free credit balances should not be transferred from an obligation of the broker-dealer to an obligation of another entity without the customer's authorization.[185] Other commenters supported the proposed disclosures but suggested additional disclosures be made to customers, including clarification with respect to other protections available to the customer.[186] Two commenters stated that the practice of sweep programs should be banned entirely or that the Commission should adopt a "harder stance" and require more than just disclosure.[187] One commenter responded to the Commission's request for comment as to the cost burdens that would result if the first condition (set forth in proposed paragraph (j)(2)(ii)(A)) to obtain a new customer's prior agreement were to be applied to existing customers. The commenter stated that such costs would be substantial because broker-dealers would be required to amend their agreements with all existing customers.[188] One commenter stated that the amendments in the proposing

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185 See SIFMA 2 Letter; First Clearing Letter; Pace Letter.

186 See SIPC Letter.

187 See Ellis Letter; Dworkin Letter. One commenter stated that broker-dealers profit from "excessive" fees charged to clients who opt out of the sweep programs. See Ellis Letter. The second commenter suggested that the broker-dealer's "customer has been effectively denied the opportunity to opt out of bank account sweeps by [the broker-dealer] preventing him or her from utilizing any other vehicle to park his or her free credit balances . . . ." See Dworkin Letter. The commenter noted that by opting out of the sweep, the customer is "confined to a situation where the free credit balance cannot earn any kind of return at all[.]" Id.

188 See SIFMA 2 Letter.

release did not adequately address situations in which broker-dealers change customer account elections without first obtaining customer authorization.[189]

In adopting the final rule, the Commission has made some modifications to the language in the proposed rule in response to commenters and to clarify its application. For clarification and in response to comments, the Commission has defined the term Sweep Program in paragraph (a)(17) of Rule 15c3-3 to identify the types of transactions and products to which the new provisions apply.

Commenters raised concerns about limitations on the types of products broker-dealers could use for sweep arrangements under the proposed amendments. Three commenters suggested that the Commission should not limit the types of products broker-dealers can use for sweep arrangements to money market funds and bank deposit products.[190]

Sweep programs provide a mechanism for excess cash in a customer's securities account to be held in a manner that allows the customer to earn interest on the funds but retain the flexibility to quickly access that cash to purchase securities or withdraw it.[191] In effect, transferring this excess cash to a bank account or money market fund is an alternative to retaining a credit balance in the customer's securities account. The final rule is designed to accommodate this alternative by providing broker-dealers with flexibility in the operation of sweep programs. The Commission believes it is appropriate to confine this flexibility to products that approximate the holding of a customer's excess cash in a securities account. The Commission does not view sweep accounts as a mechanism for investing customers' excess cash without their specific consent in longer

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189 See Waddell Letter.

190 See SIFMA 2 Letter; First Clearing Letter; Raymond James 2 Letter.

191 See Ellis Letter; Dworkin Letter.

term or more volatile assets. For these reasons, the Commission does not believe it would be appropriate to expand the products covered by the final rule beyond money market funds as described in Rule 2a-7 under the Investment Company Act of 1940 or an account at an insured bank as described in paragraph (a)(17) of Rule 15c3-3.

Consequently, paragraph (a)(17) of Rule 15c3-3, as adopted, states "[t]he term Sweep Program means a service provided by a broker or dealer where it offers to its customers the option to automatically transfer free credit balances in the securities account of the customer to either a money market mutual fund product as described in [Rule 2a-7] or an account at a bank whose deposits are insured by the Federal Deposit Insurance Corporation."[192] The Commission intended that the definition of Sweep Program provide that the bank to which free credits are swept be insured by the FDIC.[193] The revised text of the rule makes this explicit. Finally, under this definition, a one-time or other special transfer of a customer's free credit balances would not qualify as a Sweep Program.

Three commenters raised the issue of bulk transfers.[194] They argued that the rule should allow broker-dealers to process bulk transfers of customer assets between, for instance, one money market fund and another money market fund or a bank deposit product and a money market fund. These commenters identify a potential ambiguity in the rule as proposed; namely, how transfers from one Sweep Program product to another Sweep Program product are to be handled under the rule if they do not involve passing

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192 See paragraph (a)(17) of Rule 15c3-3, as adopted.

193 See Amendments to Financial Responsibility Rules, 72 FR at 12866 ("[T]he bank deposit would be guaranteed up to the FDIC's $100,000 limit."). FDIC insurance covers all deposit accounts, including checking and savings accounts, money market deposit accounts and certificates of deposit. The standard insurance amount is currently $250,000 per depositor, per insured bank, for each account ownership category. 12 CFR 330.1(o).

194 See SIFMA 2 Letter; First Clearing Letter; E*Trade 2 Letter.

funds through the customer's securities account. To address this issue, paragraph (j)(2)(ii) of Rule 15c3-3 is being modified from the proposal to clarify that the conditions for operating a Sweep Program (which are set forth in paragraphs (j)(2)(ii)(A) and (B)) will apply to: (1) the transfer of free credit balances from a customer's securities account to a product in a Sweep Program; and (2) the transfer of a customer's interest in one Sweep Program product to another Sweep Program product. This will address both bulk transfers[195] of customer positions from one product (e.g., a money market fund) to another (e.g., a bank deposit product) and transfers of individual customer positions from one product to another.

The Commission is modifying paragraph (j)(2)(ii) of Rule 15c3-3 from the proposal to delete the phrase "to either a money market mutual fund as described in § 270.2a-7 of this chapter or an interest bearing account at a bank without a specific order, authorization or draft for each such transfer, provided" and instead to use the term Sweep Program as defined in paragraph (a)(17) of the final rule. The Commission also replaced the phrase "the account of a customer" with the phrase "a customer's securities account" to clarify that paragraph (j)(2)(ii) and its required conditions apply to the transfer of free credit balances in connection with a customer's securities account, in addition to the bulk

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195 See also NASD Rule 2510 (Discretionary Accounts) (providing an exception from the NASD rule for "bulk exchanges at net asset value of money market mutual funds . . . utilizing negative response letters provided: (A) The bulk exchange is limited to situations involving mergers and acquisitions of funds, changes of clearing members and exchanges of funds used in sweep accounts; (B) The negative response letter contains a tabular comparison of the nature and amount of the fees charged by each fund; (C) The negative response letter contains a comparative description of the investment objectives of each fund and a prospectus of the fund to be purchased; and (D) The negative response feature will not be activated until at least 30 days after the date on which the letter was mailed.").

transfers described above.[196] As adopted, paragraph (j)(2)(ii) to Rule 15c3-3 reads, in pertinent part: "[a] broker or dealer is permitted to transfer free credit balances held in a customer's securities account to a product in its Sweep Program or to transfer a customer's interest in one product in a Sweep Program to another product in a Sweep Program, provided" the conditions set forth in paragraphs (j)(2)(ii)(A) and (B) are met.[197]

As adopted, paragraphs (j)(2)(ii)(A) and (B) establish four conditions that must be met to lawfully transfer a customer's free credit balances to a product in a Sweep Program or to transfer a customer's interest directly from one product in a Sweep Program to another product in a Sweep Program. The first condition – set forth in paragraph (j)(2)(ii)(A) – applies only with respect to accounts opened on or after the effective date of the rule. This addresses the burden that would have been associated with having broker-dealers re-document existing accounts. The remaining three conditions – set forth in paragraph (j)(2)(ii)(B)(1) through (3) – apply to both existing and new accounts.

Paragraph (j)(2)(ii)(A), as adopted, provides that for an account opened on or after the effective date of the rule, the customer must give prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified: (1) of the general terms and conditions of the products available through the Sweep Program; and (2) that the broker or dealer may change the products available under the Sweep Program.[198]

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196 The final rule also deletes the phrase "opened on or after the effective date of this paragraph" from paragraph (j)(2)(ii) and moves it to paragraph (j)(2)(ii)(A), as described below.

197 See paragraph (j)(2)(ii) of Rule 15c3-3, as adopted.

198 See paragraph (j)(2)(ii)(A) of Rule 15c3-3, as adopted.

As stated above, the Commission has modified paragraph (j)(2)(ii)(A) in the final rule to read "the customer gives prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified . . . ."[199] The Commission modified this paragraph to incorporate the term Sweep Program as defined in paragraph (a)(17) of the rule and the reference to the "customer's securities account" to make this paragraph consistent with other modifications to paragraph (j)(2) of the final rule. Additionally, the Commission modified this paragraph to clarify that the customer's consent must be written, consistent with the discussion in the proposing release, which noted customer consent could be given in an account opening agreement.[200]

The Commission received one comment stating that the text of proposed paragraph (j)(2)(ii)(A) that would have required the disclosure of "applicable terms and conditions that will apply if the broker or dealer changes the product or type of product" could be read to require highly specific disclosure about product terms and conditions that may only be established or modified in the future and, therefore, are unknown at the time the customer opens an account with the broker-dealer.[201] In addition, the

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199 Id. The proposed rule stated the "customer has previously affirmatively consented to such treatment of the free credit balances after being notified of . . . ." In addition, as noted above, the phrase "accounts opened on or after the effective date of this paragraph" was deleted from proposed paragraph (j)(2)(ii) and moved to paragraph (j)(2)(ii)(A), with the reference to specific paragraph (j)(2)(ii) inserted after the word "paragraph." Moving this phrase to paragraph (j)(2)(ii)(A) simplifies the final rule by eliminating the necessity of codifying two largely overlapping sets of conditions, with three of the conditions being repeated in both paragraphs. The effect of this change is to make the first condition only applicable to new accounts and the remaining conditions (paragraph (j)(2)(ii)(B)(1) through (3)) applicable to both new and existing accounts. The word "accounts" also has been replaced with the phrase "an account."

200 See Amendments to Financial Responsibility Rules, 72 FR at 12866 ("[T]he customer would need to agree prior to the change (e.g., in the account opening agreement) that the broker-dealer could switch the sweep option between those two types of products.").

201 See SIFMA 2 Letter.

commenter stated that under proposed paragraph (j)(2)(ii)(D), a broker-dealer would already be required to describe any changes to the terms and conditions it makes contemporaneously with such changes. Given this type of notice, the commenter stated that there is no need for the type of generalized (and therefore less effective) disclosure that would have been required by paragraph (j)(2)(ii)(A). The Commission agrees with the commenter and, therefore, has deleted the phrase "transfer the free credit balances and the applicable terms and conditions that will apply if the broker or dealer changes the product or type of product in which the free credit balances are transferred . . . ." In its place, the Commission is adopting language in paragraph (j)(2)(ii)(A)(2) of Rule 15c3-3 under which the broker-dealer must notify the customer that the broker or dealer may change the products available under the Sweep Program.[202]

Paragraph (j)(2)(ii)(B), as adopted, prescribes the following three conditions to sweeping the customer's free credit balances in a new or existing account:

- The broker-dealer provides the customer with the disclosures and notices regarding the Sweep Program required by each SRO of which the broker-dealer is a member; [203]

- The broker-dealer provides notice to the customer, as part of the customer's quarterly statement of account, that the balance in the bank deposit account or shares of the money market mutual fund in which the customer has a beneficial interest can be liquidated on the customer's order and the proceeds returned to the securities account or remitted to the customer;[204] and

- The broker-dealer provides the customer with written notice at least 30 calendar days before: (1) making changes to the terms and conditions of the Sweep Program; (2) making changes to the terms and conditions of a product currently available through the Sweep Program; (3) changing, adding or deleting products available through the Sweep Program; or (4) changing the customer's investment through the Sweep Program from one product to another; and the notice

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202 See paragraph (j)(2)(ii)(A)(2) of Rule 15c3-3, as adopted.

203 See paragraph (j)(2)(ii)(B) of Rule 15c3-3, as adopted.

204 Id.

describes the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product.[205]

As proposed, paragraph (j)(2)(ii)(B) of Rule 15c3-3 would have required that the broker-dealer provide these disclosures and notices "on an ongoing basis." Three commenters stated that there are no current SRO requirements that broker-dealers make disclosures concerning sweep arrangements on an "ongoing basis" and that the Commission should clarify the source and meaning of this requirement.[206] The Commission has deleted the phrase "ongoing basis" from the final rule. As adopted, the Commission has also modified the text in paragraph (j)(2)(ii)(B), now paragraph (j)(2)(ii)(B)(1), to delete the phrase "investment and deposit of free credit balances as" and inserted the phrase "Sweep Program" to incorporate the definition in paragraph (a)(17). Finally, the Commission has modified the phrase "the self-regulatory organizations" to read "each self-regulatory organization of" to clarify that the broker-dealer must provide the notices and disclosures required by each SRO of which it is a member (including an SRO that is not its DEA).[207]

As adopted, paragraph (j)(2)(ii)(B)(2) states that the broker-dealer must provide information on a quarterly basis with respect to the customer's balance in an account or fund "in which the customer has a beneficial interest."[208] The rule text has been modified to account for the fact that customers can have a beneficial interest in accounts in their

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205 Id.

206 See SIFMA 2 Letter; First Clearing Letter; Raymond James 2 Letter.

207 See 17 CFR 240.17d-1.

208 See paragraph (j)(2)(ii)(B)(2) of Rule 15c3-3, as adopted. More specifically, the Commission modified the phrase "that the money market mutual funds or bank deposits to which the free credit balances have been transferred" to read "that the balance in the bank deposit account or shares of the money market mutual fund in which the customer has a beneficial interest . . . ."

name and in omnibus accounts in the name of a custodian in which the assets of multiple customers are commingled.

The Commission also modified language in paragraph (j)(2)(ii)(B)(2) of Rule 15c3-3 to replace the phrase "on the customer's demand" with the phrase "on the customer's order" to address concerns by two commenters that the former phrase could lead customers to believe that they will receive immediate re-payment of those funds, or they could revert to holding those funds as free credit balances at the broker-dealer.[209] These commenters pointed out that the disclosed terms of most sweep programs allow the money market fund or bank up to seven days to meet requests for withdrawals. Further, there are some broker-dealers that do not allow customers to maintain free credit balances in securities accounts. In response to these comments, the Commission has deleted the phrase "demand and held as free credit balances" and replaced it with the phrase "and the proceeds returned to the securities account or remitted to the customer." This language is designed to account for broker-dealers that do not offer customers the option of having their funds held as free credit balances. In such cases, the broker-dealer would remit the funds withdrawn from the bank or derived from redeeming money market shares directly to the customer (e.g., by transferring them to the customer's bank account).

Proposed paragraphs (j)(2)(ii)(D) and (iii)(C) – now paragraph (j)(2)(ii)(B)(3) – would have required the broker-dealer to provide the customer with notice at least thirty days before the broker-dealer begins transferring the customer's free credit balances to a different product or product type, or into the same product but under materially different terms and conditions.[210] As adopted, paragraph (j)(2)(ii)(B)(3) will require broker-dealers to provide customers written notice at least 30 calendar days before the broker-

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209 See SIFMA 2 Letter.

210 See Amendments to Financial Responsibility Rules, 72 FR at 12896.

dealer: (1) makes changes to the terms and conditions of the Sweep Program; (2) makes changes to the terms and conditions of a product currently available through the Sweep Program; (3) changes, adds, or deletes products available through the Sweep Program; or (4) changes the customer's investment through the Sweep Program from one product to another.[211] This modification to the final rule is in response to commenters' requests that the Commission provide clarity with respect to when the thirty day notice requirement would be triggered.[212] In response to comments, the final rule is designed to make clear that the triggering event for the thirty day notice is not exclusively related to the transfer of the customer's free credit balances, but rather changes relating to the terms and conditions of the Sweep Program, as well as, the products available through the Sweep Program. This greater specificity should enhance the protections under the final rule by providing greater certainty that the customer will have time to evaluate available options before a change to the Sweep Program is put into effect.

In addition, paragraphs (j)(2)(ii)(B)(3)(i)(A)–(D) of Rule 15c3-3 require the broker-dealer to provide the customer with written notice at least 30 calendar days before: (1) making changes to the terms and conditions of the Sweep Program; (2) making changes to the terms and conditions of a product currently available through the Sweep Program; (3) changing, adding or deleting products available through the Sweep Program; or (4) changing the customer's investment through the Sweep Program from one product to another.[213] Collectively, these provisions provide more specificity about

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211 A broker-dealer could request exemptive relief from the rule in unusual or emergency cases where it may be impractical or contrary to investor protection for a broker-dealer to first provide customers 30 days' written notice under the rule before taking one of these actions. See, e.g., paragraph (k)(3) to Rule 15c3-3.

212 See SIFMA 2 Letter; First Clearing Letter; Cornell Letter; E*Trade Letter.

213 See paragraph (j)(2)(ii)(B)(3)(i) of Rule 15c3-3, as adopted. The requirements set forth in final paragraph (j)(2)(ii)(B)(3)(i) were proposed as paragraphs (j)(2)(ii)(D) and (iii)(C).

the types of disclosures and notices required under the final rule than under the proposal. Further, the final rule includes the word "written" before the word "notice" to make explicit that a written notice is required.

As adopted, paragraph (j)(2)(ii)(B)(3)(ii) requires that "[t]he notice must describe the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product."[214] The Commission modified the final rule in response to a comment regarding the text of proposed paragraphs (j)(2)(ii)(D) and (iii)(C).[215] The commenter stated that, as drafted, proposed paragraphs (j)(2)(ii)(D) and (iii)(C) would have required a broker-dealer to disclose "how the customer can notify the [broker-dealer] if the customer chooses not to have the free credit balances transferred to the new product or product type, or under new terms and conditions."[216] The commenter stated that these paragraphs appear to assume that the customer will have the option of continuing to have free credit balances treated as they were prior to the change to the sweep arrangement.[217] The commenter pointed out that, in fact, the broker-dealer may elect not to continue offering the prior sweep options and not to offer another sweep product.[218] To account for this possibility, the Commission has revised the text in paragraph (j)(2)(ii)(B)(3)(ii)[219] to require the broker-dealer to provide the customer with

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214 See paragraph (j)(2)(ii)(B)(ii) of Rule 15c3-3, as adopted. The final rule codifies this text in a separate paragraph in order to emphasize the specific items the notice must contain.

215 See SIFMA 2 Letter.

216 Id.

217 Id.

218 Id.

219 More specifically, paragraph (j)(2)(ii)(B)(3)(ii) provides that "the notice must describe the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product." A customer that does not accept the new terms and conditions or

a notice that contains a description of the options available to the customer if the customer does not wish to accept the new terms and conditions or product.[220] This is intended to give customers sufficient opportunity to make an informed decision in connection with a Sweep Program.

6. "Proprietary Accounts" under the Commodity Exchange Act

Some broker-dealers also are registered as futures commission merchants under the Commodity Exchange Act ("CEA"). These firms carry both securities and commodities accounts for customers. The definition of free credit balances in paragraph (a)(8) of Rule 15c3-3 does not include funds carried in commodities accounts that are segregated in accordance with the requirements of the CEA.[221] However, regulations promulgated under the CEA exclude certain types of accounts ("proprietary accounts") from the CEA's segregation requirements.[222] This exclusion from the segregation requirements under the CEA has raised a question as to whether a broker-dealer must treat payables to customers in proprietary commodities accounts as "free credit balances" when performing a customer reserve computation.[223]

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product would need to change how free credit balances are treated by, for example, selecting investments outside the Sweep Program or having the balances transferred to an account at another financial institution.

220 See Dworkin Letter.

221 17 CFR 240.15c3-3(a)(8).

222 Rule 1.20 requires a futures commission merchant to segregate customer funds. See 17 CFR 1.20. Rule 1.3(k) defines the term customer for this purpose. See 17 CFR 1.3(k). The definition of customer excludes persons who own or hold a proprietary account as that term is defined in Rule 1.3(y). See 17 CFR 1.3(y). Generally, the definition of proprietary account refers to persons who have an ownership interest in the futures commission merchant. Id.

223 See Part 241-Interpretive Releases Relating to the Securities Exchange Act of 1934 and General Rules and Regulations Thereunder, Exchange Act Release No. 9922 (Jan. 2, 1973), 38 FR 1737 (Jan. 18, 1973) (interpreting the credit balance used in Item 1 of the Rule 15c3-3a formula "to include the net balance due to customers in non-regulated commodities accounts reduced by any deposits of cash or securities with any clearing organization or clearing broker in connection with the open contracts in such accounts").

In response to this question, the Commission notes that the objective of the customer reserve requirement in Rule 15c3-3 is to require broker-dealers to hold sufficient funds or qualified securities to facilitate the prompt return of customer property to customers either before or during a liquidation proceeding if the firm fails.[224] Under SIPA, customer property generally does not include funds held in a commodities account.[225] Therefore, funds held in a proprietary commodities account generally would not constitute customer property and persons having claims to those funds would not be customers under SIPA.[226] Moreover, the regulations under the CEA similarly provide the persons having claims to funds in proprietary commodities accounts are not customers for purposes of those regulations.[227] For these reasons, the Commission proposed a specific

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224 See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70214, 70274 (Nov. 23, 2012) (describing rationale and requirements of Rule 15c3-3 segregation requirements). See also Broker-Dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 9856 (Nov. 10, 1972), 37 FR 25224, 25225 (Nov. 29, 1972) (stating that the intent of Rule 15c3-3 is, among other things, to "facilitate the liquidations of insolvent broker-dealers and to protect customer assets in the event of a SIPC liquidation through a clear delineation in Exchange Act Rule 15c3-3 of specifically identifiable property of customers."); Amendments to Financial Responsibility Rules, 72 FR at 12862, 12868.

225 As noted above, customer property under SIPA includes "cash and securities (except customer name securities delivered to the customer) at any time received, acquired, or held by or for the account of the debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." 15 U.S.C. 78lll(4). To receive protection under SIPA, a claimant must first qualify as a customer as that term is defined in the statute. Generally, a customer is any person who has: (1) "a claim on account of securities received, acquired, or held by the [broker-dealer];" (2) "deposited cash with the debtor for the purposes of purchasing securities;" (3) "a claim against the debtor for…[positions]…received, acquired, or held in a portfolio margin account carried as a securities account pursuant to a portfolio margining program approved by the Commission;" or (4) "a claim against the [broker-dealer] arising out of sales or conversions of such securities." See 15 U.S.C. 78lll(2)(A)–(B). The definition of security in SIPA specifically excludes commodities and non-securities futures contracts and, thus, a person with a claim for such assets (not held in a portfolio margin account carried as a securities account) would not meet the definition of customer. See 15 U.S.C. 78lll(14).

226 Id.

227 See 17 CFR 1.3(k).

amendment to the definition of the term free credit balances in paragraph (a)(8) of Rule 15c3-3 that would have clarified that funds held in a commodities account meeting the definition of a proprietary account under CEA regulations are not to be included as free credit balances in the customer reserve formula.[228] As discussed below, the Commission is adopting the amendment substantially as proposed.

The Commission received three comments in support of the proposed rule change.[229] One commenter requested that the Commission clarify that the relevant definition of proprietary account for these purposes is the definition contained in Rule 1.3(y) under the CEA. While Rule 1.3(y) under the CEA currently contains the relevant definition of proprietary account for the purpose of the amendment, the definition could be codified in a different rule in the future. Consequently, the Commission is adopting the final rule amendment to paragraph (a)(8) of Rule 15c3-3, as proposed. Thus, the final rule does not include specific references to a specific rule. Rather, the amendment to paragraph (a)(8) to Rule 15c3-3, as adopted, more generally refers to a "proprietary account as that term is defined in regulations under the Commodity Exchange Act."

As stated above, this amendment to paragraph (a)(8) of Rule 15c3-3 is designed to clarify that funds held in a commodities account meeting the definition of a proprietary account under CEA regulations are not to be included as "free credit balances" in the customer reserve formula. Under Item 1 of Rule 15c3-3a, however, cash balances that do not meet the definition of free credit balances (e.g., because they are not subject to immediate payment) are included in the customer reserve formula if they meet the

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228 See Amendments to Financial Responsibility Rules, 72 FR at 12868. The Commission proposed additional amendments to paragraph (a)(8) of Rule 15c3-3 related to portfolio margining. See also discussion below in section II.B. of this release.

229 See SIPC Letter; SIFMA 2 Letter; SIFMA 4 Letter.

definition of other credit balances under paragraph (a)(9) of Rule 15c3-3.[230] Therefore, in order to remove any ambiguity as to the proper exclusion of proprietary accounts under the CEA from Rule 15c3-3, the Commission also is amending the definition of the term other credit balances in the final rule to delete the words "as aforesaid" and insert the phrase "in accordance with the Commodity Exchange Act or in a similar manner, or funds carried in a proprietary account as that term is defined in regulations under the Commodity Exchange Act."[231] Consequently, the amendments clarify that both free credit balances and other credit balances as defined in Rule 15c3-3 do not include funds carried in proprietary accounts under the CEA.

One commenter also suggested that due to the changes to the swap markets mandated by Title VII of the Dodd-Frank Act, swap accounts (in addition to commodities accounts) are now subject to customer protection rules under the CEA.[232] This commenter suggested that the Commission make it clear that funds in swap accounts also do not constitute free credit balances, whether those funds are required to be segregated by rules under the CEA (e.g., cleared swap accounts or uncleared swap accounts that have opted for segregation) or excepted from segregation under the CEA (e.g., cleared swaps proprietary accounts or uncleared swap accounts that have not opted for segregation). The commenter noted this treatment "would be consistent with the treatment of funds in commodities accounts and with the regulation of swap accounts

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230 Item 1 of Rule 15c3-3a requires a broker-dealer to include in the customer reserve formula "free credit balances and other credit balances in customers' security accounts." Paragraph (a)(9) of Rule 15c3-3 defines other credit balances as "cash liabilities of a broker or dealer to customers other than free credit balances and funds in commodities accounts segregated as aforesaid." 17 CFR 240.15c3-3(a)(9).

231 See paragraph (a)(9) to Rule 15c3-3. See also comments and additional amendments to paragraph (a)(9) of Rule 15c3-3 discussed in section II.B. of this release.

232 See SIFMA 4 Letter.

under the CEA."[233] The Commission agrees there may be additional accounts under the CEA, as amended by the Dodd-Frank Act, that should explicitly be excluded from the definition of free credit balances under Rule 15c3-3. However, the amendments today are designed to clarify the specific question raised with respect to the treatment of funds in proprietary commodities accounts under the CEA and, consequently, the suggestions by the commenter are beyond the scope of this rulemaking.

7. Expansion of the Definition of "Qualified Securities" to Include Certain Money Market Funds

A broker-dealer is limited to depositing cash or qualified securities into the bank account it maintains to meet its customer (and now PAB account) reserve deposit requirements under Rule 15c3-3. Paragraph (a)(6) of Rule 15c3-3 defines qualified securities to mean securities issued by the United States or guaranteed by the United States with respect to principal and interest.[234] This strictly limits the types of assets that can be used to fund a broker-dealer's customer or PAB reserve account. The strict limitation is designed to further the purpose of Rule 15c3-3; namely, that customer assets be segregated and held in a manner that makes them readily available to be returned to the customer. As the Commission noted when first proposing Rule 15c3-3:

> The operative procedures of the Special [Reserve] Account are designed to protect the integrity of customer-generated funds by insulating them against inroads from the broker-dealer's firm activities, whether they be underwriting, market making, other trading, investing, or mere speculation in securities, meeting overhead or any other nature whatever. The Special [Reserve] Account should achieve a virtual 100% protection to customers with respect to the carrying and use of customers' deposits or credit

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233 Id.

234 17 CFR 240.15c3-3(a)(6).

balances which is mandated by Section 7(d) of the SIPC Act.[235]

In response to a petition for rulemaking,[236] the Commission proposed a limited expansion of the definition of qualified security to include shares of an unaffiliated money market fund that: (1) is described in Rule 2a-7 under the Investment Company Act of 1940; (2) invests solely in securities issued by the United States or guaranteed by the United States as to interest and principal; (3) agrees to redeem fund shares in cash no later than the business day following a redemption request by a shareholder; and (4) has net assets equal to at least 10 times the value of the shares deposited by the broker-dealer in its customer reserve account.[237] Twenty commenters addressed the proposed amendment.[238] A majority of commenters supported the proposal and generally argued

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235 Reserves and Related Measures Respecting the Financial Responsibility of Brokers and Dealers, Exchange Act Release No. 9388 (Nov. 8, 1971), 36 FR 22312 (Nov. 24, 1971).

236 As discussed in the proposing release, Federated submitted a petition for rulemaking on April 3, 2003, which it later amended on April 4, 2005. See Amendments to Financial Responsibility Rules, 72 FR at 12865, 12874. More specifically, Federated's petition requested that the Commission amend: (i) Rule 15c3-1 to lower the haircut for certain money market funds to 0%; and (ii) Rule 15c3-3 to: (a) permit a broker-dealer to pledge such money market funds when borrowing fully paid or excess margin securities from a customer under paragraph (b)(3); and (b) treat such money market funds as "qualified securities" that may be deposited into a broker-dealer's customer reserve account. On February 9, 2009, Federated submitted another request for rulemaking (Petition 4-577), reiterating its first petition with respect to amending Rule 15c3-3 to allow a broker-dealer to treat certain money market funds as "qualified securities" that may be deposited into a reserve account. However, this new petition changed the definition of the types of funds that could be treated as qualified securities. More specifically, the new petition proposed amending Rule 15c3-3(a)(6) to define the term qualified securities to include, "a redeemable security of an investment company registered under the Investment Company Act of 1940 and described in 17 CFR 270.2a-7, unaffiliated with the broker-dealer and which limits its investments to securities issued or guaranteed by the United States Government or its agencies or instrumentalities (including repurchase transactions)." See Amendments to Financial Responsibility Rules, 72 FR at 12874 and n.112; see also Public Petitions for Rulemaking No. 4-478 (Apr. 3, 2003) (available at http://www.sec.gov/rules/petitions/petn4-478.htm), as amended (Apr. 4, 2005) (amendment available at http://www.sec.gov/rules/petitions/petn4-478a.pdf), and No. 4-577 (Feb. 3, 2009) (available at http://www.sec.gov/rules/petitions/2009/petn4-577.pdf).

237 See Amendments to Financial Responsibility Rules, 72 FR at 12865.

238 See Federated Letter; Federated 2 Letter; Federated 3 Letter; Federated 4 Letter; Federated 5 Letter; Federated 6 Letter; Federated 7 Letter; Federated 8 Letter;

that the definition of qualified security should be expanded further to include more types of instruments. One commenter noted that permitting the use of certain money market funds to make up the required reserve account deposit would introduce "an intermediary (namely, the holding company or money market fund) at which problems might arise."[239] The commenter also noted that a number of SIPA liquidations have involved the mishandling of money market or mutual fund shares or the confirmations of purchases of nonexistent "money market funds."[240]

The Commission recently has proposed substantial amendments to its rules on money market funds.[241] In light of these proposed amendments,[242] the Commission is deferring consideration of any further expansion of the definition of qualified security in Rule 15c3-3 at this time. This will allow the Commission to assess the potential impact of any money market fund reforms it may adopt and whether any such impact would

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Meeks Letter; Meeks 2 Letter; Crane Data Letter; SIPC Letter; Curian Letter; FAF Letter; Reserve Letter; Brown Brothers Letter; SIFMA Letter; First Clearing Letter; ICI Letter; Barclays Letter; American Beacon Letter; Chamber of Commerce Letter; ABASA Letter; UBS Letter; Fidelity/NFS Letter; Barnard Letter; Federated 9 Letter; BOK Letter; Cornell Letter.

239 See SIPC Letter.

240 Id.

241 Money Market Fund Reform; Amendments to Form PF, Release No. IC-30551 (June 5, 2013), 78 FR 36834 (June 19, 2013) (The rule proposal includes two principal alternative reforms that could be adopted alone or in combination. One alternative would require a floating net asset value or "NAV" for prime institutional money market funds. The other alternative would allow the use of liquidity fees and redemption gates in times of stress. The proposal also includes additional diversification and disclosure measures that would apply under either alternative.). See also Division of Risk, Strategy, and Financial Innovation, Commission, Responses to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher (Nov. 30, 2012) (responding to questions posed by Commissioners Aguilar, Paredes, and Gallagher regarding effectiveness of the 2010 money market fund reforms, as well as how future reforms might affect demand for investments in money market fund substitutes and the implications for investors, financial institutions, corporate borrowers, municipalities, and states that sell their debt to money market funds), available at http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

242 Money Market Fund Reform; Amendments to Form PF, Release No. IC-30551 (June 5, 2013), 78 FR 36834 (June 19, 2013).

have consequences for the customer protection objective of the reserve account requirement in Rule 15c3-3.

B. Holding Futures Positions in a Securities Portfolio Margin Account

Under SRO portfolio margin rules ("portfolio margin rules"),[243] a broker-dealer can combine securities and futures positions in a portfolio margin securities account to compute margin requirements based on the net market risk of all positions in the account.[244] Until the passage of the Dodd-Frank Act, however, SIPA only protected customer claims for securities and cash, and specifically excluded from protection futures contracts that are not also securities. This fact created a potential ambiguity as to how futures positions in a portfolio margin securities account would be treated in a SIPA liquidation. Consequently, the Commission proposed amendments to Rule 15c3-3 to accommodate the holding of futures positions in a securities account that is margined on a portfolio basis.[245]

Subsequent to the Commission's proposals, the Dodd-Frank Act amended the definitions of customer, customer property, and net equity in section 16 of SIPA to take

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243 See Exchange Act Release No. 55471 (Mar. 14, 2007), 72 FR 13149 (Mar. 20, 2007) (SR-NASD-2007-013); Exchange Act Release No. 54918 (Dec. 12, 2006), 72 FR 1044 (Jan. 9, 2007) (SR-NYSE-2006-13); Exchange Act Release No. 54919 (Dec. 12, 2006), (SR-CBOE 2006-14); Exchange Act Release No. 54125 (July 11, 2006), 71 FR 40766 (July 18, 2006)(SR-NYSE-2005-93); Exchange Act Release No. 52031 (July 14, 2005), 70 FR 42130 (July 21, 2005) (SR-NYSE-2002-19); Exchange Act Release No. 52032 (July 14, 2005), 70 FR 42118 (July 21, 2005) (SR-CBOE-2002-03); see also Exchange Act Release No. 58251 (July 30, 2008), 73 FR 46111 (Aug. 7, 2008) (SR-FINRA-2008-041); Exchange Act Release No. 58243 (July 28, 2008), 73 FR 45505 (Aug. 5, 2008) (SR-CBOE-2008-73); and Exchange Act Release No. 58261 (July 30, 2008), 73 FR 46116 (Aug. 7, 2008) (SR-NYSE-2008-66) (making portfolio margin rules permanent).

244 See, e.g., FINRA Rule 4210(g) and CBOE Rule 12.4.

245 See Amendments to Financial Responsibility Rules, 72 FR at 12868–12870.

into account futures and options on futures held in a portfolio margin account carried as a securities account pursuant to a Commission-approved portfolio margining program.[246] As a result, persons who hold futures positions in a portfolio margining account carried as a securities account are now entitled to SIPA protection.

While the Dodd-Frank Act addressed the protection under SIPA of futures and futures options held in a securities portfolio margin account, the Commission's proposed amendments to Rule 15c3-3 and 15c3-3a will still serve an important purpose. In particular, they complement the Dodd-Frank SIPA amendments, and will provide additional protections to customers by requiring broker-dealers to treat these futures positions in accordance with the segregation requirements in Rules 15c3-3 and 15c3-3a. Consequently, the Commission is adopting the amendments with modifications to address, in part, comments.

To accommodate securities and futures portfolio margining, the Commission's proposals included several amendments. First, the Commission proposed amending the definition of free credit balance in paragraph (a)(8) of Rule 15c3-3 to provide that the term shall also include such liabilities carried in a securities account pursuant to an SRO portfolio margining rule approved by the Commission under section 19(b) of the Act ("SRO portfolio margining rule"), including daily marks to market, and proceeds resulting from closing out futures contracts and options thereon, and, in the event the broker-dealer is the subject of a proceeding under SIPA, the market value as of the filing date as that term is defined in SIPA (15 U.S.C. 78lll(7)) of any long options on futures contracts.

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[246] See Pub. L. No. 111–203 § 983.

In addition, the Commission proposed amendments to treat the unrealized value of a futures option in a portfolio margin account on the SIPA filing date[247] as a free credit balance for purposes of Rule 15c3-3. This amendment was designed to clarify that the market value of such assets should be included in determining a customer's net equity claim in a SIPA proceeding. Unlike futures contracts, futures options do not generate cash balances on a daily basis in the account (i.e., they have unrealized market value at the end of a trading day). Since the broker-dealer is not holding cash for the customer, there is no need to treat the futures options as a free credit balance for purposes of the reserve formula. However, if the broker-dealer was liquidated under SIPA, the unrealized gains or losses of the futures options should be included in calculating the customer's net equity in the account (along with the securities positions and all futures-related and securities-related cash balances).[248] The proposed amendments were designed to provide for this outcome by defining the market value of the futures options as a free credit balance as of the filing date of a SIPA liquidation of the broker-dealer. As free credit balances, funds originating from futures transactions (e.g., margin deposits and daily marks to market) and the market value of futures options as of the SIPA filing date would constitute claims for cash in a SIPA proceeding and, therefore, become a part of a customer's net equity claim entitling the customer to up to $250,000 in advances to make up for shortfalls.

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247 The term filing date is defined in SIPA as, generally, being the date a SIPA proceeding is commenced. See 15 U.S.C. 78lll(7).

248 See 15 U.S.C 78lll(11); see also Pub. L. No. 111–203 § 983 (revising definition of net equity).

The Commission received six comments on the proposed amendments.[249] Three commenters generally supported the amendments.[250] One commenter stated that the amendments represent a positive step forward in resolving certain regulatory obstacles in connection with the inclusion of futures contracts in a portfolio margin account.[251] Another commenter stated that it supported the Commission's efforts to facilitate the cross-margining of futures and securities in the portfolio margin account by clarifying the treatment of futures and options positions under SIPA.[252] A commenter expressed support for the development of rules for portfolio margining, and supported the Commission's effort to provide greater legal certainty regarding the SIPA treatment of futures positions in a portfolio margin account.[253] In a subsequent comment letter, however, this commenter stated that this amendment is no longer necessary in light of the Dodd-Frank Act amendments, and recommended the Commission withdraw it.[254] Another commenter stated that the Commission's proposal is premature in that including futures in a portfolio margin account, which is a securities account, would conflict with the segregation provisions under the CEA[255] and that SIPC has not determined that protection should be extended to futures.[256]

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249 See SIFMA 2 Letter; CME Letter; SIPC Letter; Citigroup Letter; American Bar Association Letter; SIFMA 4 Letter. The comment letters received as a result of the original solicitation of comment pre-date the Dodd-Frank Act. As such, these comment letters address the proposed amendments prior to the enactment of the Dodd-Frank SIPA amendments related to portfolio margining. The comment letters received subsequent to the passage of the Dodd-Frank Act address the SIPA amendments.

250 See SIFMA 2 Letter; Citigroup Letter; American Bar Association Letter.

251 See Citigroup Letter.

252 See American Bar Association Letter.

253 See SIFMA 2 Letter.

254 See SIFMA 4 Letter.

255 See, e.g., 17 CFR 1.20–1.29.

256 See CME Letter. See also SIPC Letter (expressing "grave concerns" about potential conflict between the proposed amendments and SIPA).

The Commission agrees, in part, with the commenter who stated that the Dodd-Frank Act SIPA amendments make the Commission's proposed amendments to Rules 15c3-3 and 15c3-3a unnecessary.[257] As noted above, the definitions of customer, customer property, and net equity in section 16 of SIPA were amended by the Dodd-Frank Act to take into account futures and options on futures held in a portfolio margin account carried as a securities account pursuant to a Commission-approved portfolio margining program.[258] Consequently, in a proceeding under SIPA, futures and options on futures positions held in a portfolio margin account carried as a securities account would be included in determining a customer's net equity claim.[259] Therefore, the proposed amendment relating to the unrealized value of a futures option is not necessary to achieve the objective of providing SIPA protection for such positions. As a result, the Commission is modifying the final rule to delete the proposed language in paragraph (a)(8) of Rule 15c3-3 that would have treated the unrealized value of a futures option in a portfolio margin account on the filing date of a SIPA proceeding as a free credit balance for purposes of Rule 15c3-3.[260]

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257 See SIFMA 4 Letter.

258 See Pub. L. No. 111–203 § 983.

259 Under the Dodd-Frank Act SIPA amendments, a customer's net equity now includes all positions in futures contracts and options on futures contracts held in a portfolio margining account carried as a securities account pursuant to a portfolio margining program approved by the Commission, including all property collateralizing such positions, to the extent that such property is not otherwise included herein. See 15 U.S.C. 78lll(11)(A)(ii). Further, the amendment provided that a claim for a commodity futures contract received, acquired, or held in a portfolio margining account pursuant to a portfolio margining program approved by the Commission or a claim for a security futures contract, shall be deemed to be a claim with respect to such contract as of the filing date, and such claim shall be treated as a claim for cash. See 15 U.S.C. 78lll(11).

260 Specifically, the final rule does not include the proposed language: ", and, in the event the broker-dealer is the subject of a proceeding under SIPA, the market value as of the "filing date" as that term is defined in SIPA (15 U.S.C. 78lll(7)) of any long options on futures contracts."

As stated above, however, the remaining rule amendments to Rules 15c3-3 and 15c3-3a complement the amendments to SIPA and provide additional protections to customers. Consequently, the Commission is adopting them with some technical modifications in response to suggestions offered by commenters.

One commenter suggested a change to paragraph (a)(8) of Rule 15c3-3 that would expand the definition of free credit balances to include cash balances related to futures positions and the value of futures options positions on the SIPA filing date.[261] First, the commenter noted that paragraph (a)(8) of Rule 15c3-3 concerns free credit balances, which are funds subject to immediate payment (among other limitations).[262] The commenter expressed concern that the Commission's proposal could have been construed as excluding cash balances in a portfolio margin account that are not subject to immediate payment. The Commission agrees that the proposal could have been interpreted as requiring that futures-related cash balances be treated differently depending on whether or not they are subject to immediate payment.

The amendments to Rule 15c3-3 are designed to provide the same treatment to futures-related cash balances in a portfolio margin account as applies to securities-related cash balances. As discussed above, under Item 1 of Rule 15c3-3a, cash balances that do not meet the definition of free credit balances (e.g., because they are not subject to immediate payment) are included in the customer reserve formula if they meet the definition of other credit balances under paragraph (a)(9) of Rule 15c3-3.[263]

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261 See SIFMA 2 Letter.

262 Id.

263 Item 1 of Rule 15c3-3a requires a broker-dealer to include in the customer reserve formula free credit balances and other credit balances in customers' securities accounts. Paragraph (a)(9) of Rule 15c3-3 defines other credit balances as "cash liabilities of a broker or dealer to customers other than free credit balances and funds in commodities accounts segregated as aforesaid." 17 CFR 240.15c3-3(a)(9).

Consequently, to remove any ambiguity as to the effect of the rule changes in response to the comments noted above, the Commission is amending paragraph (a)(9) of Rule 15c3-3 – which defines other credit balances – to include futures-related cash balances other than free credit balances. In addition, the Commission has deleted the phrase "shall include such liabilities," in the amendment to proposed paragraph (a)(8) and replaced it with "includes, if subject to immediate cash payment to customers on demand, funds..." to clarify that this paragraph relates to cash balances in a portfolio margin account that are subject to immediate payment and, hence, that paragraph (a)(9) relates to other cash balances in a portfolio margin account.

One commenter suggested changes with respect to the marks to market language in the rule, stating that the phrase relating to daily marks to market be modified to read "variation margin or initial margin marks to market" and the phrase in the proposal that read "proceeds resulting from closing out futures contracts and options thereon" be modified to read "proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon."[264] The Commission agrees with these technical suggestions because they clarify the rule by incorporating appropriate futures terminology.

Consequently, as adopted, the text in paragraphs (a)(8) and (a)(9) of Rule 15c3-3 expands the terms free credit balance and other credit balances to include "funds carried in a securities account pursuant to a self-regulatory organization portfolio margin rule approved by the Commission . . . including variation margin or initial margin, marks to market, and proceeds resulting from margin paid or released in connection with closing

[264] See SIFMA 2 Letter.

out, settling or exercising futures contracts and options thereon."[265] The amendments, as adopted, more precisely capture the Commission's intent in terms of identifying the types of futures-related cash balances that may be held in a portfolio margin account than the language in the proposed rule.

On the debit side of the customer reserve formula, the Commission is adopting, substantially as proposed, an amendment to Rule 15c3-3a Item 14 that permits a broker-dealer to include as a debit item the amount of customer margin required and on deposit at a derivatives clearing organization related to futures positions carried in a portfolio margin account.[266] Under SIPA, the term customer property includes, "resources provided through the use or realization of customers' debit cash balances and other customer-related debit items as defined by the Commission by rule," as well as, "in the case of a portfolio margining account of a customer that is carried as a securities account pursuant to a portfolio margining program approved by the Commission, a futures contract or an option on a futures contract received, acquired, or held by or for the account of a debtor from or for such portfolio margining account, and the proceeds thereof."[267] Under this provision of SIPA, this amendment to Rule 15c3-3 makes the

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265 See also section II.A.6. of this release.

266 The Commission also is amending Item 14 of Rule 15c3-3a to replace the phrase "Security futures products" with the phrase "security futures products." In addition, the Commission adopting some non-substantive amendments to Note G to Item 14, including: (1) in paragraph (a) replacing the word "shall" with the word "must"; (2) in paragraph (b) replacing the word "shall" with the word "will"; in the second line in paragraph (b)(2) inserting the phrase "futures in a" before the phrase "portfolio margin account" and deleting the word "margin"; (3) in paragraph (b)(2) replacing the word "shall" with the word "will" in three places; (4) in the sixth and seventh lines of paragraph (b)(2), inserting the phrase "futures in a" before the phrase "portfolio margin account" and deleting the phrase "futures margin"; in paragraph (b)(3)(iv) replacing the word "securities" with the word "security", inserting the phrase "futures in a" before the phrase "portfolio margin account" and deleting the word "futures"; and (4) in paragraph (c), replacing the word "shall" with the word "will", inserting the phrase "futures in a" before the phrase "portfolio margin account" and deleting the word "futures."

267 15 U.S.C. 78lll(4)(B) and (D); see also Dodd-Frank Act Section 983.

margin required and on deposit at a derivatives clearing organization part of the "customer property" in the event the broker-dealer is placed in a SIPA liquidation. Thus, it would be available for distribution to the failed firm's customers.

Finally, one commenter suggested changes to Commission rules beyond those in the proposing release. This commenter urged the Commission to consider amending Rules 8c-1, 15c2-1, and 15c3-3 to provide that their provisions could be waived by customers that are entitled to engage in derivative transactions in a portfolio margin account, provided the customer agrees in writing to waive SIPA protection.[268] According to the commenter, a customer executing such a waiver would not be entitled to the protections under SIPA for customers and would be deemed a general creditor of the broker-dealer with respect to claims arising from their portfolio margin accounts. At this time, the Commission does not believe it would be appropriate to amend the rules as recommended by the commenter because such changes are beyond the scope of this rulemaking.

C. Amendments With Respect to Securities Lending and Borrowing and Repurchase/Reverse Repurchase Transactions

In the proposing release, the Commission noted two concerns about stock lending that arose from the failure of the registered broker-dealer MJK Clearing, Inc. ("MJK");[269] namely: (1) that broker-dealers with principal liability in a stock loan transaction may purport to be acting in an agency capacity and, consequently, not taking appropriate capital charges; and (2) that broker-dealers that historically have not been active in stock

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[268] See American Bar Association Letter.

[269] See Amendments to Financial Responsibility Rules, 72 FR at 12869. The failure of MJK raised several concerns regarding securities lending transactions. As explained in more detail in the proposing release, at the time of its failure, MJK owed cash collateral to several borrowing broker-dealers. Id. at 12862, 12869–12870. These broker-dealers suffered losses caused by MJK's failures and, in later proceedings related to these losses, questions arose as to whether these broker-dealers were acting as principal or agent.

loan activities may rapidly expand their balance sheets with such transactions and, thereby, increase leverage to a level that poses significant financial risk to the firm and its counterparties. In response, the Commission proposed, and is now adopting, amendments to Rules 15c3-1 and 17a-11.

With respect to the Rule 15c3-1 proposal, the Commission is adopting the amendment, as proposed. This amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1 clarifies that broker-dealers providing securities lending and borrowing settlement services are deemed, for purposes of the rule, to be acting as principal and are subject to applicable capital deductions.[270] Under the amendment, these deductions can be avoided if a broker-dealer takes certain steps to disclaim principal liability. In particular, the final rule provides that "a broker or dealer that participates in a loan of securities by one party to another party will be deemed a principal for the purpose of the deductions required under this section, [i.e., deductions from net worth] unless the broker or dealer has fully disclosed the identity of each party to the other and each party has expressly agreed in writing that the obligations of the broker or dealer do not include a guarantee of performance by the other party and that such party's remedies in the event of a default by the other party do not include a right of setoff against obligations, if any, of the broker or dealer."[271]

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[270] A broker-dealer is required to deduct from net worth most unsecured receivables, including the amount that the market value of a securities loan exceeds the value of collateral obtained for the loan. See 17 CFR 240.15c3-1(c)(2)(iv)(B). Similarly, with respect to repo transactions, a broker-dealer obligated to resell securities must, in computing net capital, deduct the amount that the market value of the securities is less than the resale price. See 17 CFR 240.15c3-1(c)(2)(iv)(F). A broker-dealer obligated to repurchase securities must, in computing net capital, deduct the amount that the market value of the securities is greater than the repurchase price to the extent the excess is greater than certain percentages. See 17 CFR 240.15c3-1(c)(2)(iv)(F).

[271] See paragraph (c)(2)(iv)(B) of Rule 15c3-1, as adopted. Standard master securities loan agreements (including the annexes thereto) commonly used by the parties to a securities lending transaction contain provisions for establishing agent (as opposed to principal)

The Commission received five comments on the proposed amendment.[272] Two commenters objected to this amendment, stating that they believed the standard legal documents used in securities lending transactions provide sufficient legal certainty on the status of the parties.[273] The Commission, in recognition of standard stock loan agreement templates, designed the amendment to accommodate the continued use of these industry model agreements by incorporating their use into the rule's requirements. For the purposes of establishing a broker-dealer's status as agent or lender, these agreements may be sufficiently detailed to satisfy the new requirements. However, it would be the broker-dealer's responsibility to ensure that any "standard" agreement contains the necessary provisions to comply with this amendment, and that such provisions are not weakened by any other language in the agreement or any subsequent amendment. The goal is to avoid ambiguity about a broker-dealer's status as agent or principal regarding the applicability of the stock loan charges in the net capital rule. As the failure of MJK illustrated, disputes can arise over whether a broker-dealer is acting as a principal or agent in a stock loan transaction.[274] Under the formulation of the rule, a broker-dealer is presumed to be acting in a principal capacity unless it can demonstrate through its agreements with the other participants in the transaction that it is acting as agent. In this regard, a broker-dealer will be responsible for determining that its agreements are fully consistent with the standards of the rule.

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status in a securities lending and borrowing transaction that are consistent with the requirements in paragraph (c)(2)(iv)(B) of Rule 15c3-1, as amended. See, e.g., 2000 Master Securities Loan Agreement, Annex I, published by SIFMA, available at www.sifma.org.

272 See Abbey National Letter; Dresdner Kleinwort Letter; SIFMA 2 Letter; Citigroup Letter; Cornell Letter.

273 See SIFMA 2 Letter; Citigroup Letter.

274 See, e.g., Nomura v. E*Trade, 280 F.Supp.2d 184 (S.D.N.Y. 2003).

One commenter asked for clarification on the timing of when the agent lender must disclose the principal parties to one another in order to disclaim principal liability under the rule.[275] This commenter stated that the amendment should be modified so as not to require pre-trade disclosure of the identity of the principal, since under the agency annex to standardized master lending agreements such disclosure can be made on the next business day.[276] The amendment is intended to accommodate the continued use of these industry model agreements by incorporating their use into the rule's requirements. Consequently, disclosure of principals in conformance with the requirements of the "standard" stock loan agreement templates would be consistent with the requirements of the rule (as long as the identity of the borrower and the lender is disclosed within one business day after the trade date), which is designed to ensure that firms are taking the required net capital charges related to the securities lending activity to the extent they have principal liability.

The Commission also is adding new paragraph (c)(5) to Rule 17a-11 to help identify broker-dealers with highly leveraged non-government securities lending and borrowing and repurchase operations.[277] This new provision requires a broker-dealer to notify the Commission whenever the total amount of money payable against all securities loaned or subject to a repurchase agreement, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement, exceeds 2,500 percent of tentative net capital; provided that, for purposes of this leverage threshold, transactions involving government securities as defined in section 3(a)(42) of the Exchange Act, are excluded

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275 See SIFMA 2 Letter.

276 See, e.g., www.sifma.org for sample Master Securities Loan Agreements (and annex).

277 See paragraph (c)(5) of Rule 17a-11, as adopted.

from the calculation.[278] The amendment is designed to alert regulators to a sudden increase in a broker-dealer's stock loan and repo positions, which could indicate that the broker-dealer is taking on new risk that it may have limited experience in managing.

One commenter supported the proposed amendment and believes the notification could serve as "an early warning" that a firm is approaching insolvency and generally supports the Commission's efforts to protect customers from broker-dealers who recklessly rely on excessively leveraged transactions.[279]

In the proposing release, the Commission estimated that a leverage threshold of 25 times tentative net capital would be triggered by 21 broker-dealers on a regular basis.[280] The Commission stated that this establishes a threshold high enough to only capture on a regular basis those few firms highly active in securities lending and repo transactions. The Commission did not receive any comments regarding the 2,500% tentative net capital threshold in the proposing release. Based on FOCUS Report data, as of December 31, 2011, there were six broker-dealers whose securities loaned and securities borrowed transactions exceeded 25 times their tentative net capital. The Commission continues to believe that the 2,500% threshold is an appropriate notice trigger for a firm that historically has not been as active in these transactions but rapidly leverages up its securities lending and repo positions. Given the updated estimates of how many broker-dealers would trigger this threshold, the Commission believes the proposed threshold is high enough to capture on a regular basis only those few firms

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278 15 U.S.C. 78c(a)(42). "Government securities" generally present less market risk than other types of securities used in securities lending and repo transactions. Consequently, they are excluded from the scope of the rule.

279 See Cornell Letter.

280 See Amendments to Financial Responsibility Rules, 72 FR at 12870 (providing rationale for 2,500% threshold).

highly active in securities lending and repo transactions. Therefore, the Commission is retaining this 2,500% threshold in the final rule without revision.

As proposed, the amendment to Rule 17a-11 also would have provided that a broker-dealer that submitted a monthly report of its stock loan and repo activity to its DEA need not file the notices. This provision was designed to accommodate large broker-dealers that are active in this business and regularly maintain stock loan and repo balances that exceed the threshold. The Commission expects that these broker-dealers have experience in managing the risks specific to these types of transactions and have established controls to address those risks. Consequently, a notice under paragraph (c)(5) from these broker-dealers might not be as useful in providing risk assessment information to regulators. Instead, the monthly reports will provide the Commission and other financial regulators with information with which to develop trend analysis, when deemed appropriate. They could use this analysis to identify leverage levels that are outside the normal trend range, and which may be indicative of a material change in the firm's business model that could indicate it was taking on higher levels of leverage, branching into new products, or experiencing operational or financial difficulties (e.g., the firm could be reducing leverage rapidly because creditors were not willing to enter into new transactions).

Three commenters addressed the proposed monthly notification requirement.[281] They stated that the monthly report in lieu of the notification should be provided as part of the monthly FOCUS report many broker-dealers file with their DEA.[282] The Commission agrees that the FOCUS report may be an appropriate mechanism for reporting stock loan and repo positions in lieu of the proposed monthly notification

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281 See Abbey National Letter; Citigroup Letter; SIFMA 2 Letter; SIFMA 4 Letter.

282 See Abbey National Letter; Citigroup Letter; SIFMA 2 Letter.

requirement.[283] Consequently, the Commission has modified the final rule to delete the phrase "submits a monthly report of" and replace it with "reports monthly."[284] In addition, as adopted, in order to provide that the monthly report be sent to a broker-dealer's DEA, the Commission added the phrase "to its designated examining authority in a form acceptable" before "to its designated examining authority."[285] This language, as adopted, will provide each DEA with the flexibility to prescribe how the monthly reports are to be made and will accommodate a DEA that opts to use the FOCUS report as the reporting mechanism.[286] In summary, as adopted, the notice exemption in paragraph (c)(5) will state "provided further, however, that a broker or dealer will not be required to send the notice required by this paragraph (c)(5) if it reports monthly its securities lending and borrowing and repurchase and reverse repurchase activity (including the total amount of money payable against securities loaned or subject to a repurchase agreement and the total contract value of securities borrowed or subject to a reverse repurchase agreement) to its designated examining authority in a form acceptable to its designated examining authority."[287]

A commenter asked the Commission to clarify that the new reporting provision of paragraph (c)(5) of Rule 17a-11 is triggered only by principal activity meeting or exceeding stated thresholds.[288] The notification provision applies when a broker-dealer is acting as principal and exceeds the stated thresholds, and a broker-dealer will not need to

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283 Carrying broker-dealers generally are required to submit FOCUS reports on a monthly basis.

284 See paragraph (c)(5) of Rule 17a-11, as adopted.

285 Id.

286 See also SIFMA 4 Letter.

287 See paragraph (c)(5) of Rule 17a-11, as adopted. The Commission also inserted the text "(c)(5)" in the final rule before the phrase "if it reports monthly" to make the paragraph reference more explicit.

288 See Dresdner Kleinwort Letter.

include transactions for which it does not have principal liability in determining whether the notification threshold has been triggered.

D. Documentation of Risk Management Procedures

It is important for broker-dealers to document the controls they establish for managing the material risk exposures that arise from their business activities. For example, a broker-dealer active in securities lending is exposed to a variety of risks, including market risk,[289] credit risk,[290] and liquidity risk.[291] Other broker-dealer activities give rise to these risks as well, including managing a repo book, dealing in OTC derivatives, trading proprietary positions, and lending on margin. A well-documented system of internal controls designed to manage material risk exposures reflects the determination of a firm's management as to how its business activities should be conducted in light of such exposures. It also enables management to better identify, analyze, and manage the risks inherent in the firm's business activities with a view to preventing material losses and to review whether the firm's activities are being conducted in a manner that is consistent with such procedures and controls as well as in accordance with the Federal securities laws. Risk management controls are particularly important for the largest broker-dealers, which generally engage in a wide range of highly complex activities across many different markets and geographical locations.

While most broker-dealers already have well-documented procedures and controls for managing risks as a matter of business practice, it is important to reinforce the

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289 Generally, market risk is the risk that prices, values, or rates will adversely change.

290 Generally, credit risk is the risk of loss resulting from a counterparty or other type of obligor failing to meet an obligation, including an obligation with respect to a loan, security, swap, option, or settlement.

291 Generally, funding liquidity risk is the risk that a firm will not be able to meet cash demands as they become due and asset liquidity risk is the risk that an asset will not be able to be sold quickly at its market value.

practice and make it easier for regulators to understand a broker-dealer's procedures and controls so that they can review whether the broker-dealer is adhering to them. Consequently, the Commission proposed an amendment to Rule 17a-3 that would have required a broker-dealer to create a record documenting its "internal risk management controls."[292]

Commenters raised concerns that the proposed amendment would be "overly broad and ambiguous"[293] and "so broad as to create uncertainty."[294] Three commenters argued that the requirement, if adopted, should be limited to market, credit, and liquidity risk management.[295] Another commenter recommended that the Commission propose the minimum elements required to be documented, such as market risk, credit risk, liquidity risk, and operational risk.[296] While market, credit, and liquidity risk were among the specific examples of risk identified in the proposed rule,[297] the Commission agrees that the phrase "risk controls" could be interpreted very broadly. To address this concern, the Commission has modified the final rule to clarify its application. The final rule requires the documentation of controls established specifically to manage market, credit, and liquidity risk, "which have more commonly understood meanings within the industry."[298] This also focuses the rule on the key risks inherent in conducting a securities business.

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292 See Amendments to Financial Responsibility Rules, 72 FR at 12899.

293 See E*Trade Letter.

294 See Citigroup Letter.

295 See E*Trade Letter; SIFMA 2 Letter; Citigroup Letter.

296 See Barnard Letter.

297 See Amendments to Financial Responsibility Rules, 72 FR at 12870.

298 E*Trade Letter. The final rule also deletes the term "internal" because it would be redundant.

Commenters also requested that the Commission clarify that, when a broker-dealer is part of a corporate family, risk management controls could be applicable to multiple entities within the corporate family, including the broker-dealer.[299] In response, the final rule does not specify the type of controls a broker-dealer must establish to manage these risks. It simply requires the documentation of the procedures the broker-dealer has established. Broker-dealers that are part of holding companies may be subject to procedures that are used globally throughout the organization. As long as the broker-dealer maintains documented procedures of controls pertaining to the designated entity, the requirements of the rule would be met.

Other commenters requested that the Commission clarify that the risk management controls do not have to include any minimum elements[300] and that the rule does not impose any qualitative requirements.[301] Two commenters suggested that because there were no stated content requirements for the risk management controls, it would be difficult for a firm to prove that their risk management procedures were adequate, which could lead to a "subjective process"[302] or to examiners applying a "one size fits all" best practices standard.[303] One commenter suggested that to address this issue, the Commission should articulate the process that examiners will follow when examining risk management controls.[304] Finally, one commenter encouraged the

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299 See E*Trade Letter; SIFMA 2 Letter; Citigroup Letter.

300 See SIFMA 2 Letter.

301 See Citigroup Letter.

302 See Coastal Securities Letter.

303 See American Bar Association Letter.

304 Id.

Commission to consider strengthening this requirement in terms of both its scope and applicability.[305]

The Commission is not mandating any specific controls, procedures, or policies that must be established by a broker-dealer to manage market, credit, or liquidity risk, nor is it requiring any minimum elements or specifying any procedures that would be required to be included in a firm's market, credit, and liquidity risk management policies. Rather, the Commission is requiring that a control, procedure, or policy be documented if it is in place. Based on staff experience monitoring large broker-dealers, the Commission anticipates that most brokers-dealers that will be subject to this rule already have documented controls, procedures, and policies as part of their overall risk management processes. The purpose of this amendment is not to change the controls, procedures, and policies that are in place, but to require that they be adequately documented.

For the foregoing reasons, paragraph (a)(23) to Rule 17a-3, as adopted, requires certain broker-dealers to make and keep current a record documenting the credit, market, and liquidity risk management controls established and maintained by the broker-dealer to assist it in analyzing and managing the risks associated with its business activities.[306] This documentation requirement applies only to broker-dealers that have more than (1) $1,000,000 in aggregate credit items as computed under the customer reserve formula of Rule 15c3-3, or (2) $20,000,000 in capital, including debt subordinated in accordance with Appendix D to Rule 15c3-1.[307]

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305 See Cornell Letter.

306 See paragraph (a)(23) of Rule 17a-3, as adopted.

307 The Commission also has modified paragraph (a)(23) of Rule 17a-3 from the proposed rule to delete the reference to the term "member" in two places in the final rule because the reference to "member" is unnecessary. Id.

The Commission also proposed adding paragraph (e)(9) to Rule 17a-4 to require a broker-dealer to retain the documented risk management controls or procedures until three years after the broker-dealer terminates the use of the system of controls or procedures documented therein. One commenter stated that given the minimal cost of electronic storage, the commenter believes that the retention period could be extended beyond three years.[308] Conversely, two commenters suggested that Rule 17a-4 be revised so that a broker-dealer would not be required to maintain outdated versions of its risk management controls.[309]

The Commission is adding paragraph (e)(9) to Rule 17a-4, with a minor modification from the proposed amendment. Specifically, the final rule is modified to require retention of the records until three years after termination of the use of the risk management controls documented therein by replacing the phrase "systems of controls or procedures" with the phrase "risk management controls."[310] This modification maintains consistency with the terminology in paragraph (a)(23) of Rule 17a-3, as adopted, which requires broker-dealers to make and keep current a "record documenting the credit, market, and liquidity risk management controls established and maintained by the broker or dealer."[311] Finally, the three year retention period is designed to establish an audit trail between the risk management controls that have most recently been made inoperative and the risk management controls currently in effect to provide sufficient opportunity to review the former during the broker-dealer's exam cycle. Three years also is consistent

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308 Id.

309 See E*Trade Letter; SIFMA 2 Letter.

310 See paragraph (e)(9) of Rule 17a-4, as adopted. The Commission also modified the final rule to delete the phrase "paragraph (a)(23) of" and insert "(a)(23)" immediately following "17a-3" to make the referenced citation consistent with other parts of the rule.

311 See paragraph (a)(23) of Rule 17a-3, as adopted.

with the retention period for many of the records required to be preserved under Rule 17a-4.[312]

Finally, one commenter noted that the proposed amendment does not impose any requirements beyond those applicable under Rule 15c3-4.[313] Accordingly, the commenter urged the Commission to create an exception from the proposed amendment to Rule 17a-3 for a broker-dealer that is effectively subject to Rule 15c3-4. With the modifications to the final rule to include only market, credit, and liquidity risk, a broker-dealer subject to the conditions of Rule 15c3-4 would already comply with this amendment given that these risks are included in the risks a broker-dealer would be required to address under Rule 15c3-4. Therefore, an exception from the rule is unnecessary.

E. Amendments to the Net Capital Rule

Under Rule 15c3-1, broker-dealers are required to maintain, at all times, a minimum amount of net capital.[314] The capital standard in Rule 15c3-1 is a net liquid assets test. This standard is designed to allow a broker-dealer the flexibility to engage in activities that are part of conducting a securities business (e.g., taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties, and creditors).[315] For example, Rule 15c3-1

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312 See 17 CFR 240.17a-4(b).

313 See SIFMA 2 Letter. See also 17 CFR 240.15c3-4.

314 See 17 CFR 240.15c3-1.

315 See, e.g., Interpretation Guide to Net Capital Computation for Brokers and Dealers, Exchange Act Release No. 8024 (Jan. 18, 1967), 32 FR 856 (Jan. 25, 1967) ("Rule 15c3-1 (17 CFR 240.15c3-1) was adopted to provide safeguards for public investors by setting standards of financial responsibility to be met by brokers and dealers. The basic concept of the rule is liquidity; its object being to require a broker-dealer to have at all times sufficient liquid assets to cover his current indebtedness.") (Footnotes omitted); Net

allows securities positions to count as allowable net capital, subject to standardized or model-based deductions ("haircuts").[316] The rule, however, does not permit most unsecured receivables to count as allowable net capital.[317] This aspect of the rule severely limits the ability of broker-dealers to engage in activities that generate unsecured receivables (e.g., lending money without obtaining collateral). The rule also does not permit fixed assets or other illiquid assets to count as allowable net capital, which creates disincentives for broker-dealers to own real estate and other fixed assets that cannot be readily converted into cash.[318] For these reasons, Rule 15c3-1 incentivizes broker-dealers to confine their business activities and devote capital to activities such as underwriting, market making, and advising on and facilitating customer securities transactions.[319]

Capital Treatment of Securities Positions, Obligations and Transactions in Suspended Securities, Exchange Act Release No. 10209 (June 8, 1973), 38 FR 16774 (June 26, 1973) (Commission release of a letter from the Division of Market Regulation) ("The purpose of the net capital rule is to require a broker or dealer to have at all times sufficient liquid assets to cover its current indebtedness. The need for liquidity has long been recognized as vital to the public interest and for the protection of investors and is predicated on the belief that accounts are not opened and maintained with broker-dealers in anticipation of relying upon suit, judgment and execution to collect claims but rather on a reasonable demand one can liquidate his cash or securities positions."); Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 15426 (Dec. 21, 1978), 44 FR 1754 (Jan. 8, 1979) ("The rule requires brokers or dealers to have sufficient cash or liquid assets to protect the cash or securities positions carried in their customers' accounts. The thrust of the rule is to insure that a broker or dealer has sufficient liquid assets to cover current indebtedness."); Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 26402 (Dec. 28, 1989), 54 FR 315 (Jan. 5, 1989) ("The rule's design is that broker-dealers maintain liquid assets in sufficient amounts to enable them to satisfy promptly their liabilities. The rule accomplishes this by requiring broker-dealers to maintain liquid assets in excess of their liabilities to protect against potential market and credit risks.") (Footnote omitted).

316 See 17 CFR 240.15c3-1(c)(2)(vi); 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f .

317 See 17 CFR 240.15c3-1(c)(2)(iv).

318 See, e.g., 17 CFR 240.15c3-1(c)(2)(iv)(A).

319 See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70214, 70219 (Nov. 23, 2012).

Rule 15c3-1 requires broker-dealers to maintain a minimum level of net capital (meaning highly liquid capital) at all times.[320] The rule requires that a broker-dealer perform two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain;[321] and (2) a computation of the amount of net capital the broker-dealer is maintaining.[322] The minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio or the 2% of aggregate debit items ratio.[323]

In computing net capital, the broker-dealer must, among other things, make certain adjustments to net worth such as deducting illiquid assets, taking other capital charges, and adding qualifying subordinated loans.[324] The amount remaining after these adjustments is defined as tentative net capital.[325] The final step in computing net capital is to take prescribed percentage deductions ("standardized haircuts") from the mark-to-market value of the proprietary positions (e.g., securities, money market instruments, and commodities) that are included in its tentative net capital.[326] The standardized haircuts are designed to account for the market risk inherent in these positions and to create a buffer of liquidity to protect against other risks associated with the securities business.[327]

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320 See 17 CFR 240.15c3-1.

321 See 17 CFR 240.15c3-1(a).

322 See 17 CFR 240.15c3-1(c)(2). The computation of net capital is based on the definition of net capital in paragraph (c)(2) of Rule 15c3-1. Id.

323 See 17 CFR 240.15c3-1(a).

324 See 17 CFR 240.15c3-1(c)(2)(i)–(xiii).

325 See 17 CFR 240.15c3-1(c)(15).

326 See 17 CFR 240.15c3-1(c)(2)(vi).

327 See, e.g., Uniform Net Capital Rule, Exchange Act Release No. 13635 (June 16, 1977), 42 FR 31778 (June 23, 1977) ("[Haircuts] are intended to enable net capital computations to reflect the market risk inherent in the positioning of the particular types of securities enumerated in [the rule]"); Net Capital Rule, Exchange Act Release No. 22532 (Oct. 15,

Alternative Net Capital or "ANC" broker-dealers and a type of limited purpose broker-dealer that deals solely in OTC derivatives ("OTC derivative dealers") are permitted, with Commission approval, to, among other things, use internal models as the basis for taking market risk charges as an alternative approach in lieu of the standardized haircuts for classes of positions for which they have been approved to use models.[328] Rule 15c3-1 imposes substantially higher minimum capital requirements for ANC broker-dealers and OTC derivatives dealers, as compared to other types of broker-dealers, because, among other reasons, the use of internal models to compute net capital can substantially reduce the deductions for securities and money market positions as compared with the standardized haircuts.[329]

1. Requirement to Deduct From Net Worth Certain Liabilities or Expenses Assumed By Third Parties

In the proposing release, the Commission expressed concern that some broker-dealers may be excluding from their calculations of net worth certain liabilities that relate directly to expenses or debts incurred by the broker-dealer.[330] The accounting

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1985), 50 FR 42961 (Oct. 23, 1985) ("These percentage deductions, or 'haircuts', take into account elements of market and credit risk that the broker-dealer is exposed to when holding a particular position."); Net Capital Rule, Exchange Act Release No. 39455 (Dec. 17, 1997), 62 FR 67996 (Dec. 30, 1997) ("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.") (Footnote omitted).

328 See 17 CFR 240.15c3-1(a)(5) and (a)(7); 17 CFR 240.15c3-1e; 17 CFR 240.15c3-1f.

329 See 17 CFR 240.15c3-1(a)(5) and (a)(7). See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071, 77 FR at 70219 ("[T]he use of internal models to compute net capital can substantially reduce the deductions for securities and money market positions as compared with the standardized haircuts."); Alternative Net Capital Requirements for Broker-Dealers that are Part of Consolidated Supervised Entities, Exchange Act Release No. 49830 (June 8, 2004), 69 FR 34428, 34431 (June 21, 2004) ("We expect that use of the alternative net capital computation will reduce deductions for market and credit risk substantially for broker-dealers that use that method.").

330 See Amendments to Financial Responsibility Rules, 72 FR at 12871.

justification for the exclusion is that a third party (usually a parent or affiliate) has assumed responsibility for these expenses and debts through an expense sharing agreement.[331] In some cases, however, the third party does not have the resources – independent of the broker-dealer's revenues and assets – to assume these liabilities. Thus, the third party is dependent on the resources of the broker-dealer to pay the expenses and debts. Excluding liabilities from the broker-dealer's net worth calculation in these situations may misrepresent the firm's actual financial condition, deceive the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition.[332]

To address this issue, the Commission proposed – and is now adopting substantially as proposed – an amendment to Rule 15c3-1 to add a new paragraph (c)(2)(i)(F) that will require a broker-dealer, in calculating net capital, to take into account any liabilities that are assumed by a third party if the broker-dealer cannot demonstrate that the third party has the resources – independent of the broker-dealer's income and assets – to pay the liabilities.[333]

The Commission received five comments regarding this proposal.[334] Two commenters stated that the amendment was overly burdensome and that it would not result in a more accurate picture of a broker-dealer's financial condition than obtained

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331 See, e.g., Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Elaine Michitsch, Member Firm Operations, NYSE, and Susan DeMando, Director, Financial Operations, NASD Regulation, Inc. (July 11, 2003) ("Third Party Expense Letter"); see also FINRA Notice to Members 03-63, Expense-Sharing Agreements (Oct. 2003) (discussing the issuance of the Third Party Expense Letter).

332 See Amendments to Financial Responsibility Rules, 72 FR at 12871.

333 As adopted, the final rule does not include the "-" in the phrase "third-party." In addition, the final rule uses the phrase "broker or dealer" in the place of the phrase "broker-dealer" (which appeared in two places) to maintain consistency throughout Rule 15c3-1, which uses the phrase "broker or dealer."

334 See Beer Letter; Levene Letter; Lowenstein Letter; SIFMA 2 Letter; NIBA 2 Letter.

through current requirements.[335] One of these commenters added that any implementation and enforcement of the amendments "should not be made retroactive."[336] This commenter stated that it is unclear how, and unlikely that, this amendment would achieve any of the desired results and argued that it could conversely impair a firm's ability to continue as a going concern.[337] Finally, this commenter also argued that this amendment would affect capital transactions that originate at the holding company level.[338] Two commenters agreed in principle with the amendments but urged the Commission to carefully consider the potential consequences of implementation and to provide clarification on the standard for demonstrating that the third party has adequate financial resources, including factors beyond those referred to in the proposing release that they believed would be potentially relevant.[339] One commenter supported the Commission's goal of clarifying disclosures relating to expense sharing or obligations.[340]

As with the proposal, the amendment, as adopted, is designed to prohibit a practice that could misrepresent a broker-dealer's actual financial condition, deceive the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition. Moreover, the amendment, as adopted, should not impose undue burdens or present serious implementation difficulties because the requirement is consistent with prior staff guidance regarding the treatment of broker-dealer expenses assumed by a third party.[341] Finally, as compared to staff guidance, a federal regulation offers broker-

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335 See Beer Letter; Levene Letter.

336 See Levene Letter.

337 Id.

338 Id.

339 See Lowenstein Letter; SIFMA 2 Letter.

340 See NIBA 2 Letter.

341 See, e.g., Third Party Expense Letter.

dealers greater certainty as to how to treat expense sharing agreements under Rule 15c3-1.

In response to the comments discussed above, and as the Commission explained in the proposing release, a broker-dealer can demonstrate the adequacy of the third party's financial resources by maintaining records such as the third party's most recent (i.e., as of a date within the previous twelve months) audited financial statements, tax returns, or regulatory filings containing financial reports.[342] Given that the entity to which the broker-dealer is seeking to shift one or more liabilities typically is an affiliate, the staff's experience is that such records should be available to the broker-dealer. Further, because the proposed rule change is consistent with prior staff guidance regarding the need to be able to demonstrate the third party's financial adequacy,[343] a broker-dealer seeking to shift a liability to a third party already would be expected to provide such evidence of the third party's financial resources. For these reasons, the change from staff guidance to Commission rule should not result in implementation and burden concerns of the magnitude raised by the two commenters.[344]

Finally, one commenter noted it would be helpful if the Commission would clarify whether this amendment supersedes the Commission staff guidance in the Third Party Expense Letter.[345] Unlike the PAIB Letter discussed above, the Commission is not directing the staff to withdraw the Third Party Expense Letter on the effective date of these amendments. The Third Party Expense Letter will still be relevant as staff

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342 See Amendments to Financial Responsibility Rules, 72 FR at 12872. The Commission specifically requested comment regarding the records by which a broker-dealer could demonstrate financial resources. It received no comments in response to this request.

343 See, e.g., Third Party Expense Letter.

344 See Lowenstein Letter; SIFMA 2 Letter.

345 See SIFMA 2 Letter.

guidance, notwithstanding that it contains a condition that has been codified into Rule 15c3-1 (i.e., that an expense of the broker-dealer assumed by a third party will be considered a liability for net capital purposes unless the broker-dealer can demonstrate that the third party has adequate resources independent of the broker-dealer to pay the liability or expense).[346] In particular, the letter contains additional staff guidance not incorporated into the rule that will be relevant as staff guidance with respect to complying with the amendment to Rule 15c3-1 being adopted today. For example, the letter contains staff guidance with respect to the records a broker-dealer would be expected to make, keep current, and preserve under Rules 17a-3 and 17a-4 with respect to broker-dealer liabilities and expenses assumed by a third party, as well as requirements regarding written expense sharing agreements.[347] Broker-dealers can continue to rely on the guidance in the Third Party Expense Letter with respect to these matters in complying with today's amendment.

2. Requirement to Subtract From Net Worth Certain Non-Permanent Capital Contributions

In the proposing release, the Commission noted its concern that broker-dealers may be receiving capital contributions from investors that are subsequently withdrawn after a short period of time (often less than a year).[348] In some cases, the capital may be contributed under an agreement giving the investor the option to withdraw it at the investor's discretion. In the past, the Commission has emphasized that capital contributions to broker-dealers should not be temporary,[349] and the Commission staff has

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346 See Third Party Expense Letter, at 2–3.

347 Id.

348 See Amendments to Financial Responsibility Rules, 72 FR at 12873.

349 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991). See also Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc.

explained that a capital contribution should be treated as a liability if it is made with the understanding that the contribution can be withdrawn at the option of the investor.[350]

Consistent with these Commission and staff positions that capital is not temporary,[351] and given the importance of this issue and the Commission's concern that broker-dealers may not be properly treating short-term capital contributions as liabilities, the Commission proposed amending Rule 15c3-1 to add paragraph (c)(2)(i)(G) to further incorporate these positions into the rule.[352] The proposed change would require a broker-dealer to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it or that is contributed with the intent to withdraw the capital within one year. The Commission further proposed that capital withdrawn within one year would be presumptively subject to treatment as a liability (i.e., it would be presumed to have been contributed with the intent to withdraw within one year).[353]

The Commission is adopting the final rule amendment with certain modifications. As adopted, the rule requires that a broker-dealer treat as a liability any capital that is

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No. 92–231 (1971), at 17, 42 (recommending improvement of adequacy and permanency of capital) ("During the 1967-1970 period under review, many broker-dealers, some of them large retail houses, were found to have inadequate and impermanent capital in relation to their business.").

350 Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Raymond J. Hennessy, Vice President, NYSE, and Susan DeMando, Vice President, NASD Regulation, Inc. (Feb. 23, 2000) ("Temporary Capital Letter") ("It is the view of the Division that, for net capital purposes, if an individual investor contributes capital to a broker-dealer with an understanding that the contribution can be withdrawn at the option of the individual investor, the contribution may not be included in the firm's net capital computation and must be re-characterized as a liability. Any withdrawal of capital as to that investor within a period of one year, other than a withdrawal described in paragraph (e)(4)(iii) of Rule 15c3-1, shall be presumed to have been contemplated at the time of the contribution.") (footnote omitted); see also Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991).

351 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991).

352 See Amendments to Financial Responsibility Rules, 74 FR at 12871–12872.

353 Id.

contributed under an agreement giving the investor the option to withdraw it. The rule, as adopted, also requires that a broker-dealer treat as a liability any capital contribution that is intended to be withdrawn within one year of its contribution. In addition, the final rule provides that capital withdrawn within one year of contribution is deemed to have been intended to be withdrawn within one year unless the broker-dealer receives permission in writing for the withdrawal from its DEA.[354] The ability of a broker-dealer to seek permission in writing from its DEA to withdraw capital contributed within one year will provide a means for firms to seek to withdraw capital in limited circumstances after review by its DEA without having to reclassify the withdrawn capital as a liability for net capital purposes.[355]

In the final rule, the Commission has modified the proposed language by moving the qualifier that the DEA can approve a withdrawal so that it modifies this presumption. Specifically, as proposed, the rule provided that a contribution of capital had to be subtracted from net worth if it "is intended to be withdrawn within a period of one year unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer." As adopted, the rule provides that "[a]ny withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the

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354 These requirements will not apply to withdrawals covered by paragraph (e)(4)(iii) of Rule 15c3-1, namely, withdrawals used to make tax payments or to pay reasonable compensation to partners. See 17 CFR 240.15c3-1(e)(4)(iii). These types of payments are ordinary business expenditures and do not raise the types of concerns the proposed rule is designed to address. One commenter suggested that the rule be amended to explicitly exclude any withdrawals that would fall under paragraph (e)(4)(iii) of Rule 15c3-1.

355 See FINRA Rule 4110(c)(1) (providing, in part, that no equity capital of a member may be withdrawn for a period of one year from the date such equity capital is contributed, unless otherwise permitted by FINRA in writing).

Examining Authority for the broker or dealer."[356] The change is intended to eliminate a potential ambiguity in the proposal as to whether a withdrawal of capital within one year could ever be approved by the firm's DEA and, therefore, afford the intended relief from the deduction.[357]

The Commission received five comments regarding the amendment to paragraph (c)(2)(i)(G)(2) of Rule 15c3-1.[358] In addition to the general request for comment included in the proposing release, the Commission also requested specific comment on whether the time period within which withdrawn and intended-to-be-withdrawn contributions must be treated as liabilities should be longer than one year.[359] While the commenters agreed in principle that contributions of capital to broker-dealers should not be subject to withdrawal at will, they expressed concerns regarding the negative effect that overly restrictive limitations on withdrawals of capital could have on obtaining capital contributions and, therefore, on the financial health of broker-dealers. One commenter, a registered broker-dealer, stated that it believed that the amendment would raise its cost of capital to the point where it would be impossible to obtain capital from unrelated third parties at all.[360] Two commenters also expressed concerns about the potential burden posed by the amendment to broker-dealers in need of capital.[361] One suggested the addition of exceptions to the rule for de minimis withdrawals and dividends

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356 See paragraph (c)(2)(i)(G)(2) of Rule 15c3-1, as adopted.

357 The phrase "to the broker or dealer" following "one year of its contribution" is not included in the final rule because it would be redundant, as the contributions covered in the amendment all involve contributions to the broker-dealer.

358 See Chicago Capital Management Letter; SIFMA 2 Letter; American Bar Association Letter; SIG Letter; NIBA 2 Letter.

359 See Amendments to Financial Responsibility Rules, 72 FR at 12871–12872.

360 See Chicago Capital Management Letter.

361 See American Bar Association Letter; SIFMA 2 Letter.

or distributions.[362] Another commenter suggested that the proposal should be amended to exclude a redemption right – a form of option - provided to the investor in connection with the investor's capital contribution to the broker-dealer, where (i) the redemption right may only be exercised by the investor commencing more than one year following the date of the capital contribution to the broker-dealer and (ii) the redemption right would not be mandatorily redeemable.[363]

Another commenter opposed the rule, stating that it contravenes pertinent legal and accounting standards and is unnecessary in view of existing capital withdrawal limitations and notification requirements.[364] This commenter stated that neither GAAP nor Rule 15c3-1 contain a requirement that capital must be permanent, and the word "capital" has no intrinsic meaning that requires it to be permanent.[365] This commenter stated that if any further limitations on capital withdrawals are adopted beyond the current provisions of the net capital rule, they should be designed to allow for the ability of broker-dealer holding companies to withdraw excess net capital at their option for legitimate purposes.[366]

The fifth commenter agreed that there should be no circumstance in which a broker-dealer accepted a capital contribution for net capital purposes that could be withdrawn at the option of the investor.[367] This commenter, however, also stated that the standard for withdrawals should be shortened from one year to nine or six months to increase the availability of funds from investors and owners, allowing more broker-

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362 See SIFMA 2 Letter.

363 See American Bar Association Letter.

364 See SIG Letter.

365 Id.

366 Id.

367 See NIBA 2 Letter.

dealers to raise capital and strengthen their financial stability.[368] The commenter requested that the Commission consider the needs of small firms that it said likely will require additional net capital over the next decade.[369]

In response to the commenters' concerns about firms' ability to obtain capital and that the amendment contravenes pertinent legal and accounting standards, the amended rule merely clarifies what constitutes a broker-dealer's permanent capital under Rule 15c3-1 and further emphasizes the requirement that capital contributions cannot be temporary.[370] Rule 15c3-1 imposes a capital standard that is distinct from the use of the term "capital" in other legal and accounting contexts, and the rule amendments under

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368 Id.

369 Id. The commenter also stated that rules that "restrict small broker-dealers from raising capital as a result of uncertainty of investors or owner-operators related to the return of their capital in a reasonable time frame will create a disproportionate and impossible hurdle for small broker-dealers to overcome." Id.

370 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991) ("The Commission wishes to emphasize that the net capital maintained in a broker-dealer should be permanent capital and not merely a temporary infusion of funds from an affiliate or other sources. For example, there are instances where a broker-dealer receives funds from an affiliate in an amount that would enable the broker-dealer to engage in a transaction that it would otherwise be prohibited from doing because of minimum net capital requirements. If the funds are transferred back to the affiliate within a relatively short period of time after the transaction, the Commission questions whether the funds transferred into the broker-dealer entity could properly be characterized as capital of the firm. Instead, the transaction could be viewed as a loan by the affiliate to the broker-dealer, with the result that the broker-dealer would have to treat the transaction as a liability."). See also Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 18417 (Jan. 13, 1982), 47 FR 3512 (Jan. 25, 1982) (describing subordination agreement requirements under Appendix D to Rule 15c3-1, including that, among other things, no prepayment may be made (except under the strictly defined limitations of paragraph (c)(5) of Appendix D) before the expiration of one year from the effective date of the subordination agreement, and noting this provision was designed to insure the adequacy as well as the permanence of capital in the industry.); Temporary Capital Letter; Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 92–231 (1971) (recommending improvement of adequacy and permanency of capital); and Letter from Nelson Kibler, Assistant Director, Division of Market Regulation to John Pinto, National Association of Securities Dealers, Inc. (Sept. 8, 1980).

paragraph (c)(2)(i)(G) of Rule 15c3-1 are consistent with the Commission's and staff's views that capital under Rule 15c3-1 should not be temporary.[371]

The Commission also considered the commenter's suggestion that there be exceptions for de minimis withdrawals, dividends, or distributions. As previously stated, however, the Commission has emphasized that capital contributions should not be temporary.[372] Moreover, paragraph (e) of Rule 15c3-1 already contains mechanisms to permit a broker-dealer to make capital withdrawals for specified purposes.[373] Finally, if a broker-dealer believes it has a basis to appropriately withdraw capital within one year of contribution because, for example, the withdrawal would be de minimis, the final rule

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371 See Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 92–231 (1971), at p. 15 ("The unfortunate use of the term "net capital" in the financial responsibility rules of the Commission and the various exchanges resulted in a semantic confusion which too frequently has led to the mistaken belief that a broker-dealer's net capital is the equivalent of or has some relationship to the concept of "capital", as that term is commonly understood. "Net Capital" applies only to a hard core residue of net liquid assets designed to enable a broker-dealer to meet all rightful current demands of customers for their funds and securities."). See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR at 70230 ("The net liquid assets test is imposed through the mechanics of how a broker-dealer is required to compute net capital pursuant to Rule 15c3-1. These requirements are set forth in paragraph (c)(2) of Rule 15c3-1, which defines the term net capital. The first step is to compute the broker-dealer's net worth under GAAP. Next, the broker-dealer must make certain adjustments to its net worth to calculate net capital. These adjustments are designed to leave the firm in a position where each dollar of unsubordinated liabilities is matched by more than a dollar of highly liquid assets. There are thirteen categories of net worth adjustments required by the rule.") (footnotes omitted).

372 See Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 92–231 (1971), at p. 15; Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR at 70230.

373 See 17 CFR 240.15c3-1(e)(1)(iii)(B) and (e)(4)(iii). See also Amendments to Financial Responsibility Rules, 72 FR at 12872, n.79 ("These requirements would not apply to withdrawals covered by paragraph (e)(4)(iii) of Rule 15c3-1, namely, withdrawals used to make tax payments or pay reasonable compensation to partners. These types of payments are ordinary business expenditures and do not raise the types of concerns the proposed rule is designed to address.").

provides a mechanism for the broker-dealer to seek permission in writing from its DEA to make such a withdrawal.[374]

With respect to a commenter's view that the standard for withdrawal should be less than one year (e.g., six or nine months), the Commission continues to believe that one year is an appropriate amount of time that a broker-dealer must retain a contribution in order to classify it as capital and not a liability. This is the standard that the Commission staff and FINRA have applied for a number of years and there is no compelling reason to change it.[375] Because the final rule change is an incorporation of, among other things, existing Commission staff guidance into Rule 15c3-1, the requirement should not significantly alter current practice.

Moreover, with respect to commenters' concerns about the ability to obtain capital, the rule does not prohibit an investor from withdrawing capital at any time. It prohibits a broker-dealer from treating temporary cash infusions as capital for purposes of Rule 15c3-1. Finally, as stated above, the final rule provides a mechanism for a broker-dealer to apply to its DEA to make a withdrawal without triggering the deduction.[376] This provides a process for firms to affect withdrawals within one year where appropriate.

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374 See paragraph (c)(2)(i)(G)(2) of Rule 15c3-1, as adopted.

375 See Temporary Capital Letter; FINRA Rule 4110(c)(1) ("No equity capital of a member may be withdrawn for a period of one year from the date such equity capital is contributed, unless otherwise permitted by FINRA in writing."). See also Exchange Act Release No. 60933 (Nov. 4, 2009), 74 FR 58334 (Nov. 12, 2009) (SR-FINRA-2008-067); Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991) (emphasizing "that the net capital maintained in a broker-dealer should be permanent capital and not merely a temporary infusion of funds from an affiliate or other sources").

376 The final rule does not distinguish between complete and partial withdrawals of capital and, consequently, the deduction could be triggered in either event. Moreover, a partial withdrawal would require a deduction of the full amount of the original contribution as it would indicate that the contribution was merely temporary in nature.

In summary, the Commission is adding paragraph (c)(2)(i)(G) to Rule 15c3-1 to require a broker-dealer to subtract from net worth any contribution of capital to the broker or dealer: "(1) [u]nder an agreement that provides the investor with the option to withdraw the capital; or (2) [t]hat is intended to be withdrawn within a period of one year of contribution."[377] The final rule further provides that "[a]ny withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer."[378]

3. Requirement to Deduct the Amount by which a Fidelity Bond Deductible Exceeds SRO Limits

Under SRO rules, certain broker-dealers that do business with the public or that are required to become members of SIPC must comply with mandatory fidelity bonding requirements.[379] SRO rules typically permit a broker-dealer to have a deductible provision included in the bond; however, such rules provide that the deductible may not exceed certain amounts. With regard to firms that maintain deductible amounts over the maximum amount specified, several SRO rules provide that the broker-dealer must deduct this excess amount from its net worth when calculating net capital under Rule

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377 See paragraph (c)(2)(i)(G) of Rule 15c3-1, as adopted.

378 Id.

379 See, e.g., FINRA Rule 4360, CBOE Rule 9.22, and NASDAQ OMX PHLX Rule 705. SRO fidelity bonding requirements typically contain agreements covering areas such as: a "Fidelity" insuring clause to indemnify against loss of property through dishonest or fraudulent acts of employees; an "On Premises" agreement insuring against losses resulting from crimes such as burglary and theft and from misplacement of property of the insured; an "In Transit" clause indemnifying against losses occurring while property is in transit; a "Forgery and Alteration" agreement insuring against loss due to forgery or alteration of various kinds of negotiable instruments; and a "Securities Loss" clause protecting against losses incurred through forgery and alteration of securities. Id.

15c3-1.[380] Other SROs require that any deductible amount elected by a broker-dealer that is greater than 10% of the coverage purchased by the broker-dealer must be deducted from the broker-dealer's net worth when calculating net capital under Rule 15c3-1.[381]

Rule 15c3-1, however, does not specifically reference the SRO deductible requirements as a charge to net worth. Therefore, a broker-dealer would not be required to account for the deduction required by an SRO rule in computing net capital under Rule 15c3-1 or in the net capital computation reflected on the broker-dealer's FOCUS report. To address this inconsistency, the Commission proposed to amend Rule 15c3-1 to add paragraph (c)(2)(xiv) to require a broker-dealer to deduct, with regard to fidelity bonding requirements, the amount required by the rules of the broker-dealer's DEA, i.e., the amount in excess of the deductible prescribed in the applicable DEA's fidelity bond rule.[382] The Commission received one comment supporting the proposal and one opposing it.[383] The commenter opposing the amendment noted that amending Rule 15c3-1 to conform to FINRA Rule 4360 would create an increase in minimum net capital requirements for some broker-dealers.[384]

SRO rules prescribing fidelity bond deductibles, and capital charges for deductibles in excess of a certain amount, are designed to incentivize broker-dealers to carry fidelity bonds with a deductible low enough to help ensure customer protection. Moreover, in response to the comment that this amendment would increase minimum net capital requirements, the Commission notes that broker-dealers that are members of an

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380 See, e.g., CBOE Rule 9.22.

381 See, e.g., FINRA Rule 4360.

382 See 17 CFR 240.15c3-1(c)(12) (defining examining authority for purposes of Exchange Act Rule 15c3-1).

383 See SIFMA 2 Letter; NIBA 2 Letter.

384 See NIBA 2 Letter.

SRO with such a fidelity bonding rule already must account for the deduction in complying with the net capital requirements of the SROs and nothing in the Commission's amendment to paragraph (c)(2)(xiv) of Rule 15c3-1 would alter this status quo. Rather, the proposed rule change would conform the capital calculation under paragraph (c)(2)(xiv) of Rule 15c3-1 to that required by the broker-dealer's SRO.

For these reasons, the Commission is adopting paragraph (c)(2)(xiv) to Rule 15c3-1 with technical revisions to the proposed rule text to make the text of the final rule, as adopted, a more generic cross reference to SRO fidelity bond requirements. The technical changes are designed to increase the flexibility of the final rule so that revisions to SRO fidelity bond requirements pursuant to section 19(b) of the Exchange Act[385] will not require conforming amendments to paragraph (c)(2)(xiv) of Rule 15c3-1.[386] More specifically, the proposed rule text, as set forth in the proposing release, would have required the broker-dealer to deduct "with respect to fidelity bond coverage, the excess of any deductible amount over the maximum deductible amount permitted by the Examining Authority for the broker or dealer."[387] The final rule, as adopted, provides that the broker-dealer must deduct "the amount specified by rule of the Examining Authority for the broker or dealer with respect to a requirement to maintain fidelity bond coverage."[388] Thus, the final rule does not include the phrase "maximum permissible deductible amounts." This phrase was borrowed from SRO fidelity bond rules. Because

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385 15 U.S.C. 78s(b).

386 See, e.g., FINRA Rule 4360.

387 See, e.g., Amendments to Financial Responsibility Rules, 72 FR at 12872.

388 See paragraph (c)(2)(xiv) of Rule 15c3-1, as adopted.

the construction of the SRO rules may change over time, the Commission is making the cross-reference to the SRO rules more general.[389]

4. Broker-Dealer Solvency Requirement

The Commission is adopting an amendment to paragraph (a) of Rule 15c3-1 to require a broker-dealer to cease conducting a securities business if certain insolvency events were to occur. Specifically, as adopted, amended paragraph (a) of Rule 15c3-1 provides that a broker-dealer must not be insolvent as that term is defined in new paragraph (c)(16) of the rule.[390] By making solvency a requirement of Rule 15c3-1, this amendment will require an insolvent[391] broker-dealer to cease conducting a securities business pursuant to section 15(c)(3) of the Exchange Act, which generally prohibits a broker-dealer from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any security in contravention of the Commission's financial responsibility rules (which include Rule 15c3-1).[392]

As proposed, paragraph (c)(16) of Rule 15c3-1 would have defined the term insolvent as, among other things, a broker-dealer's placement in a voluntary or involuntary bankruptcy or similar proceeding; the appointment of a trustee, receiver, or similar official; a general assignment by the broker-dealer for the benefit of its creditors; an admission of insolvency; or the inability to make computations necessary to establish

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389 See, e.g., FINRA Rule 4360. See also Exchange Act Release No. 63961 (Feb. 24, 2011), 76 FR 11542 (Mar. 2, 2011).

390 The final rule also has been modified by replacing the word "shall" with the word "must."

391 The definition of insolvent is intended to be broad enough to encompass any type of insolvency proceeding or condition of insolvency; for example, the proposed definition incorporates concepts of insolvency in the U.S. Bankruptcy Code and SIPA. See 11 U.S.C. 101; 15 U.S.C. 78eee(b)(1).

392 15 U.S.C. 78o.

compliance with Rule 15c3-1.[393] As discussed more specifically below, the Commission modified paragraph (c)(16) of Rule 15c3-1 in the final rule in response to concerns raised by commenters.

In the proposing release, the Commission solicited comment on whether there are other insolvency events that should be captured in the proposed definition.[394] One commenter noted that involuntary insolvency proceedings do not necessarily indicate that the broker-dealer is insolvent, as such proceedings can be frivolous, malicious, or otherwise lacking in merit.[395] The commenter also noted that industry standard contract forms generally provide a grace period for a party to such a proceeding to obtain a stay or dismissal before an event of default is deemed to occur.[396] In response to this comment, the Commission notes that the number of broker-dealer bankruptcy filings (voluntary or involuntary) is small, and therefore, the institution of a frivolous involuntary proceeding involving a broker-dealer likely is a very rare event. Thus, the Commission must consider the potential need for an automatic grace period to address the potential for a frivolous involuntary bankruptcy as well as the harm that could result from allowing a broker-dealer to continue to effect securities transactions for a period of time even though it is properly the subject of a bankruptcy proceeding. The Commission believes the more appropriate approach is to address potentially frivolous proceedings on a case-by-case basis. In the event that a case arises where there would be a need to fashion relief for a

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393 See Amendments to Financial Responsibility Rules, 72 FR at 12872–12873. A broker-dealer's inability to make computations necessary to establish compliance with Rule 15c3-1 may also impact the broker-dealer's ability to make the computations necessary to establish compliance with Rule 15c3-3 and vice versa. See, e.g., Rule 15c3-1(a)(1)(ii) (incorporating computations under Rule 15c3-3 into the minimum net capital requirement).

394 See Amendments to Financial Responsibility Rules, 72 FR at 12873.

395 See SIFMA 2 Letter.

396 Id.

broker-dealer that was the subject of a frivolous or meritless involuntary petition, the Commission's existing authority permits it sufficient flexibility to fashion exemptions under appropriate circumstances.[397]

In addition to the comment discussed above, the Commission received four other comment letters that addressed these amendments.[398] One commenter objected to the amendments as unnecessary, citing the Rule 15c3-1 prohibition on broker-dealers effecting securities transactions if their net capital is below certain minimums and noting that a broker-dealer that was insolvent would "by definition" be below those minimums.[399] In response to this comment, the Commission notes that the purpose of the amendment is to address cases where a broker-dealer is subject to an insolvency event but takes the position that it is in compliance with the net capital rule. While such instances may be rare, an insolvent broker-dealer could seek the protection of the bankruptcy laws but continue to effect transactions with the public, potentially jeopardizing customers and other creditors of the broker-dealer, including counterparties.

Another commenter requested that the Commission modify the definition of insolvent to carve out market-wide disruptions that prevent the computation of net capital but are unrelated to the solvency of the broker-dealer.[400] In response to this suggestion, the Commission notes that if appropriate and necessary, such an event can be addressed through the Commission's exemptive authority, rather than by a specific exception in the rule.

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397 See 15 U.S.C. 78mm(a). See also 17 CFR 240.15c3-1(b)(3).

398 See SIPC Letter; St. Bernard Financial Services Letter; American Bar Association Letter; Cornell Letter.

399 See St. Bernard Financial Services Letter.

400 See American Bar Association Letter.

One commenter, while supporting the amendment, objected to the incorporation of the definition of insolvent from section 101 of the Bankruptcy Code.[401] This commenter argued a bankruptcy-based standard for insolvency was appropriate for a notice requirement but that the proper standard for determining whether a broker-dealer should be prohibited from continuing to conduct a securities business is its amount of net capital. As noted above, allowing an insolvent broker-dealer to continue conducting a securities business during the period of its insolvency, notwithstanding its net capital position, could jeopardize customers and other market participants because a broker-dealer that has made an admission of insolvency, or is otherwise deemed insolvent or entitled to protection from creditors, does not possess the financial resources necessary to operate a securities business.[402] Continuing to operate in such circumstances poses a significant credit risk to counterparties and to the clearance and settlement system, and, in the event the firm subsequently is placed in a liquidation proceeding under SIPA, may impair the ability of the SIPA trustee to make customers of the broker-dealer whole and satisfy claims of other creditors out of the assets of the general estate.[403]

In addition, this commenter also was concerned that under the proposed amendment a firm would be prevented from effecting hedging or liquidating transactions intended to reduce the risk the firm poses to the financial markets and its customers. The commenter noted that such limitations also would be at odds with section 5(a)(2) of SIPA, which contemplates that a broker-dealer that is in, or approaching, financial difficulty may undertake to liquidate or reduce its business either voluntarily or pursuant

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401 See SIFMA 2 Letter.

402 See Amendments to Financial Responsibility Rules, 72 FR at 12872.

403 Id.

to the direction of an SRO.[404] The final rule amendment is not intended to affect in any a broker-dealer's ability to act under section 5(a)(2) of SIPA.[405]

In addition, the Commission is amending the final rule to incorporate within the term insolvency the circumstance in which a broker-dealer is unable to make such computations as may be necessary to establish compliance with Rule 15c3-3.[406] In the proposing release, the Commission stated that the "proposed definition of 'insolvent' is intended to be broad enough to encompass any type of insolvency proceeding or condition of insolvency,"[407] and noted that the proposed definition incorporates concepts of insolvency from the U.S. Bankruptcy Code and SIPA.[408] Consequently, consistent with the discussion in the proposing release, the modification in the final rule will more closely align the definition of insolvent under paragraph (c)(16) of Rule 15c3-1 with the grounds for the commencement of a proceeding under SIPA,[409] which includes the circumstance that a broker-dealer is unable to make computations necessary to establish compliance with the financial responsibility or hypothecation rules.[410] Rule 3a40-1 defines the term financial responsibility rules to include, among others, any rule adopted

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404 See SIFMA 2 Letter; SIPC Letter. See also 15 U.S.C. 78eee(a)(5).

405 See15 U.S.C. 78eee(a)(5). Further, the amendment is not intended to affect in any way a SIPA trustee's ability to liquidate a broker-dealer. Effectively, a SIPA trustee steps into the shoes of the debtor broker-dealer in order to liquidate the broker-dealer and protect its customers' interests.

406 The final rule adds the phrase "or with § 240.15c3-3" to follow the phrase "[i]s unable to make such computations as may be necessary to establish compliance with this section." See paragraph (c)(16)(iv) of Rule 15c3-1. See also generally, SIPC Letter (favoring an amendment requiring broker-dealers to cease doing business if insolvent as defined under proposed Rule 15c3-l(c)(16) and noting that the circumstances under which the broker would be required to cease doing business are consistent with the circumstances under which SIPC may seek to place a firm in liquidation).

407 See Amendments to Financial Responsibility Rules, 72 FR at 12872.

408 Id. at n.85.

409 See 15 U.S.C. 78eee(b).

410 See 15 U.S.C. §78eee(b)(l)(D). See also 17 CFR 240.3a40-1 (defining the term financial responsibility rules for purposes of SIPA to include Rule 15c3-3).

by the Commission pursuant to section 15(c)(3) of the Exchange Act – Rules 15c3-1 and 15c3-3 were adopted under section 15(c)(3). As a financial responsibility rule, the inability of a broker-dealer to make a computation necessary to establish compliance with Rule 15c3-3 constitutes a basis for commencing a SIPA proceeding. Consequently, this modification to the proposed definition of insolvency under paragraph (c)(16) of Rule 15c3-1 will more closely align the definition with SIPA.[411]

The Commission also is adopting an amendment to the first sentence of paragraph (b)(1) of Rule 17a-11 to require that a broker-dealer meeting the definition of insolvent must provide immediate notice to the Commission, the firm's DEA and, if applicable, the CFTC. One commenter specifically favored this amendment.[412] This notice will assist regulators in taking steps to protect the insolvent firm's customers, including, if appropriate, notifying SIPC of the need to commence a SIPA proceeding. The Commission is adopting the amendment to paragraph (b)(1) of Rule 17a-11, with one technical modification.[413]

5. Amendment to Rule Governing Orders Restricting Withdrawal of Capital from a Broker-Dealer

Paragraph (e) of Rule 15c3-1, which places certain conditions on a broker-dealer when withdrawing capital,[414] also allows the Commission to issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to

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411 The Commission also has made three technical modifications to the text of the insolvency definition. In response to a comment, the phrase "broker-dealer" was replaced with the phrase "broker or dealer" to be consistent with the use of the phrase in Rule 15c3-1. In addition, the phrase "for purposes of this section" was moved to the beginning of paragraph (c)(16) in order to clarify that the term insolvency is defined for purposes of Rule 15c3-1 in its entirety. Finally, the final rule does not include the phrase "whether commenced voluntarily or involuntarily" because the phrase would be redundant.

412 See SIPC Letter.

413 The Commission is deleting the phrase "paragraph (c)(16) of" and inserting "(c)(16)" immediately following the second "15c3-1".

414 See 17 CFR 240.15c3-1(e).

stockholders, insiders, and affiliates under certain circumstances.[415] The rule, however, limits such orders to withdrawals, advances, or loans that, when aggregated with all other withdrawals, advances, or loans on a net basis during a 30 calendar day period, exceed 30 percent of the firm's excess net capital.[416] When the Commission adopted this paragraph of Rule 15c3-1 more than 20 years ago, the Commission stated that it intended this section to be applied only where the continued viability of a broker-dealer appeared to be at stake.[417] In the ensuing years, the Commission has utilized this provision only one time.[418] The Commission has determined that the requirement is difficult to enforce, as it generally would not be clear when the 30% threshold had been reached, due to the inherent unreliability of a troubled broker-dealer's books and records. Consequently, the Commission proposed, and is adopting, a change to delete this provision and instead to allow the Commission to restrict all withdrawals, advances, and loans so long as the other conditions under the rule (all of which remain unchanged) are met. [419]

The Commission received three comment letters addressing this proposal.[420] One commenter supported the deletion of the 30% threshold, but believed its removal reflected the Commission's desire to regulate large firms with complex capitalization

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415 See 17 CFR 240.15c3-1(e)(3).

416 Id.

417 Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124, 9128 (Mar. 5, 1991).

418 Order Regarding Withdrawals, Unsecured Loans or Advances from Refco Securities, LLC and Refco Clearing, LLC, Exchange Act Release No. 52606 (Oct. 13, 2005).

419 The Commission also proposed revising the second sentence in paragraph (e)(3)(ii) to remove the text "The hearing" and in its place adding the text "A hearing on an order temporarily prohibiting the withdrawal of capital."

420 See NIBA 2 Letter; SIFMA 2 Letter; Raymond James 2 Letter.

without considering the needs of smaller firms.[421] This commenter recommended the Commission set forth all conditions required for a firm to withdraw, repay, or redeem any amount that affects its overall capitalization.[422] Specifically, the commenter suggested the following non-exclusive list of conditions for consideration: (1) "[r]egulatory minimum capital requirement related to all lines of business"; (2) "[e]xcess mandated by that firms' accruals for that period"; (3) "[e]xcess mandated by the firms' upcoming one-time non-recurring costs within that quarter"; (4) "[e]xcess mandated by operating costs expected[,] but not related to accruals for that period"; (5) [c]osts related to increased personnel coverage or recruitment within that quarter"; and (6) "[d]etermination of the Board of the firm that there is no reasonable expectation at the time of its approval of the capital withdrawal, repayment or redemption, that the firm would be required to, or advisable to, increase its net capital excess."

The second commenter recommended several modifications to the amendment, including: (1) clarifying that in addition to ordering complete restrictions on withdrawals, advances, and loans, the Commission may also issue orders imposing partial or conditional restrictions; (2) explicitly permitting certain types of withdrawals, advances, or loans, such as those in paragraphs (e)(4)(ii) and (iii) of Rule 15c3-1 (e.g., required tax payments or payments to partners for reasonable compensation) even after the issuance of a temporary restrictive order; and (3) clarifying that the provision in paragraph (e)(3)(ii) of the rule allowing a broker-dealer to request and receive a hearing on an order

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421 See NIBA 2 Letter. As noted above, the 30% threshold provision only applied in emergency situations and has only been used once before. As such, its deletion should only affect a limited number of broker-dealers.

422 Id.

temporarily restricting withdrawals also applies to orders temporarily restricting advances and loans (in addition to withdrawals).[423]

Finally, the third commenter noted that the proposed amendment would eliminate the 30% requirement limit and allow the Commission to restrict all withdrawals, advances, and loans under specific circumstances.[424] The commenter believes this action will impose an additional compliance burden on broker-dealers and will significantly limit the flexibility of broker-dealers in the event of a liquidity crisis.[425]

In response to these comments, the Commission notes that the 30% threshold pertains only to paragraph (e)(3)(i) of Rule 15c3-1, which relates to the Commission's authority to temporarily restrict withdrawals of net capital. The Commission cannot impose these restrictions without concluding under subparagraph (e)(3)(i) that "such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970."[426] While paragraph (e)(3)(i) of Rule 15c3-1 would apply to all broker-dealers, the conditions under which the Commission may exercise its authority under the rule apply only to circumstances where

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423 See SIFMA 2 Letter.

424 See Raymond James 2 Letter.

425 Id.

426 See paragraph (e)(3)(i) of Rule 15c3-1, as adopted.

the continued viability of the broker-dealer appears to be at stake.[427] As noted above, the Commission has only utilized this provision once.[428]

The Commission, however, agrees with the importance of maintaining flexibility in the context of ordering restrictions on withdrawals, advances, and loans. Therefore, the Commission is modifying the amendment, as adopted, to add language to paragraph (e)(3)(i) to state (following the phrase "employee or affiliate") that such orders will be issued, "under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors . . . ." [429] With respect to the suggestion that the Commission explicitly permit certain types of withdrawals, advances, or loans even after the issuance of a temporary order, the Commission does not believe that it would be appropriate to permit – by codifying in the rule – a broker-dealer to take the actions described if the Commission has issued an order placing temporary restrictions on a broker-dealer's ability to withdraw net capital under paragraph (e)(3) of the rule. The order would be intended to protect the customers and creditors of the broker-dealer, and permitting the actions by rule could undermine those protections. Moreover, there is no need to explicitly permit certain types of withdrawals, advances or loans because if there were circumstances that merited the broker-dealer making such payments, the Commission order could be fashioned as appropriate to permit those payments.

With respect to the suggestion that the Commission clarify in paragraph (e)(3)(ii) of Rule 15c3-1 that a broker-dealer may request and receive a hearing on orders

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427 Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124, 9128 (Mar. 5, 1991).

428 Order Regarding Withdrawals, Unsecured Loans or Advances from Refco Securities, LLC and Refco Clearing, LLC, Exchange Act Release No. 52606 (Oct. 13, 2005).

429 See paragraph (e)(3)(i) of Rule 15c3-1, as adopted. See also 17 CFR 15c3-1(e). See generally, 15 U.S.C. 78mm(a)(1).

temporarily restricting advances and loans (in addition to withdrawals), under the existing rule, a broker-dealer may request a hearing if the Commission has issued an order temporarily restricting advances and loans by a broker-dealer, in addition to withdrawals, and the Commission is therefore adopting the amendment to paragraph (e)(3)(ii), as proposed.[430]

6. Adjusted Net Capital Requirements

i. Amendment to Appendix A of Rule 15c3-1

The Commission is adopting an amendment to Appendix A of Rule 15c3-1, which permits broker-dealers to employ theoretical option pricing models to calculate haircuts for listed options and related positions that hedge those options.[431] The amendment makes permanent a temporary amendment the Commission originally adopted in 1997.[432] The temporary amendment expired on September 1, 1997, unless it was otherwise extended by the Commission.[433] The Commission staff subsequently issued a no-action letter on January 13, 2000, which stated that the staff would not recommend enforcement action if broker-dealers continued to rely on the temporary amendment.[434]

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430 17 CFR 240.15c3-1(e)(3)(ii). The Commission also is adopting revisions to the second sentence of paragraph (e)(3)(ii), replacing the phrase "The hearing" with the phrase "A hearing on an order temporarily prohibiting the withdrawal of capital."

431 17 CFR 240.15c3-1a.

432 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

433 See 17 CFR 15c3-1a(b)(1)(iv)(B).

434 Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Richard Lewandowski, Vice President, Regulatory Division, The Chicago Board Options Exchange, Inc. (Jan. 13, 2000) (stating that the Division of Market Regulation "will not recommend . . . enforcement action if non-clearing option specialists and market-makers continue to rely on subparagraph (b)(1)(iv) of Appendix A to Rule 15c3-1 under the Exchange Act until such time as the Commission has determined whether it should be extended"). The letter did not grant any other relief.

The temporary amendment decreased the range of pricing inputs to the approved option pricing models, which effectively reduced the haircuts applied by the carrying firm with respect to non-clearing option specialist and market maker accounts.[435] The temporary amendment, which applied only to these types of accounts, was limited to major market foreign currencies and diversified indexes. Even during periods of substantial volatility, there have been no significant increases in the number of deficits in non-clearing option specialist and market-maker accounts, nor did the lower capital charges under paragraph (b)(1)(iv) result in excessive leverage. Consequently, this amendment appropriately aligns the net capital requirements of affected firms with the risks Rule 15c3-1 seeks to mitigate. The Commission received one comment letter regarding this aspect of the proposing release. The commenter concurred with the Commission's conclusions as to the effect of the temporary amendment and supported the proposal to make it permanent.[436] Accordingly, the Commission is amending paragraph (b)(1)(iv) of Appendix A to Rule 15c3-1, as proposed, to make the temporary amendment permanent.[437]

ii. Money Market Funds

a. Clarification

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435 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997). Under Appendix A to Rule 15c3-1, a broker-dealer calculating net capital charges for its options portfolios shocks the products in each portfolio (grouped by underlying instrument) at ten equidistant points along a potential market move range. The market move ranges for major market foreign currencies, high-capitalization diversified indexes, and non-high-capitalization diversified indexes are, respectively: +(-) 6%, +(-) 10% and +(-) 15%. The temporary rule lowered these market move ranges to respectively: +(-) 4½%, + 6% (-) 8% and +(-) 10% in terms of calculating haircuts for positions of non-clearing options specialists and market makers. Id.

436 See SIFMA 2 Letter.

437 As a result, the Commission also is redesignating paragraphs (b)(1)(iv)(A), (b)(1)(iv)(A)(1), (b)(1)(iv)(A)(2), and (b)(1)(iv)(A)(3) as paragraphs (b)(1)(iv), (b)(1)(iv)(A), (b)(1)(iv)(B), and (b)(1)(iv)(C), respectively.

The Commission is adopting an amendment to paragraph (c)(2)(vi)(D)(1) of Rule 15c3-1 to clarify that a money market fund, for the purposes of paragraph (c)(2)(vi)(D)(1), is a fund described in Rule 2a-7 under the Investment Company Act of 1940 ("Rule 2a-7").[438] The Commission did not receive any comments on this proposal and is adopting it, as proposed.

b. Proposed Haircut Reduction from 2% to 1%

The Commission proposed an amendment to reduce the "haircut" that broker-dealers apply under Rule 15c3-1 for money market funds.[439] In 1982, the Commission adopted a 2% haircut requirement for redeemable securities of money market funds.[440] In 1991, the Commission adopted certain amendments to Rule 2a-7 that strengthened the risk-limiting investment restrictions for money market funds.[441] Based on the enhancements to Rule 2a-7, the Commission proposed to amend paragraph (c)(2)(vi)(D)(1) of Rule 15c3-1 to reduce the haircut on such funds from 2% to 1% in order to better align the net capital charge with the risk associated with holding shares of a money market fund.[442] In addition to the general request for comments in the proposing release, the Commission also specifically requested comments regarding whether the haircut for certain types of money market funds should be reduced to 0% as suggested in a petition for rulemaking submitted to the Commission.[443]

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438 See 17 CFR 270.2a-7.

439 See Amendments to Financial Responsibility Rules, 72 FR at 12874.

440 Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 18737 (May 13, 1982), 47 FR 21759 (May 20, 1982). See 17 CFR 240.15c3-1(c)(2)(vi)(D)(1).

441 Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991), 56 FR 8113 (Feb. 27, 1991).

442 See Amendments to Financial Responsibility Rules, 72 FR at 12874.

443 See Public Petitions for Rulemaking No. 4-478 (Apr. 3, 2003) (available at http://www.sec.gov/rules/petitions/petn4-478.htm), as amended (Apr. 4, 2005) (available

The Commission received a total of 14 responses from 12 different commenters regarding this proposed amendment. All of the commenters supported a reduction in the haircut for money market funds and urged that the haircut be reduced below the proposed 1%, with the majority proposing a haircut of 0% for "top-rated" money market funds (i.e., those with the highest ratings).[444] Commenters cited the safety record of money market funds, in particular AAA-rated money market funds, in support of imposing lower haircuts.[445] Several commenters argued that top-rated money market funds were more liquid and posed less credit and interest rate risk than other instruments and suggested haircuts of 1/8 of 1% or even 0%.[446] One commenter argued that since broker-dealers (like investors) view money market funds as cash equivalents, they would view a 1% haircut as a significant cost and would therefore avoid using money market funds.[447] Two commenters suggested that if the Commission determined it necessary to impose a haircut on some Rule 2a-7 money market funds, it should implement a bifurcated scheme under which money market funds that qualify for deposit into a broker-dealer's reserve account under Rule 15c3-3 would be subject to a 0% haircut,[448] with one arguing that such qualifying money market funds should in any case receive a haircut no greater than 1/8 of 1%.[449] Another commenter suggested that the proposed amendments to reduce the

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at http://www.sec.gov/rules/petitions/petn4-478a.pdf), and No. 4-577 (Feb. 3, 2009) (available at http://www.sec.gov/rules/petitions/2009/petn4-577.pdf).

444 See Federated Letter; Federated 3 Letter; Curion Clearing Letter; FAF Advisors Letter; Brown Brothers Harriman Letter; SIFMA 2 Letter; ICI Letter; Barclays Letter; National Chamber Foundation Letter; Blackrock Letter; Deutsche Bank Securities Letter; UBS Letter; SIFMA 4 Letter; NIBA 2 Letter.

445 See, e.g., Barclays Letter.

446 See, e.g., FAF Advisors Letter.

447 See Federated Letter.

448 See Blackrock Letter; ICI Letter.

449 See Blackrock Letter.

haircut for money market funds should be deferred until the results of the Commission's money market reforms are known.[450] Another commenter suggested a haircut of 5/8 of 1%, based on a combination of the 1/8 of 1% haircut applied to highly rated shorter-term (at least 30 but less than 91 days to maturity) commercial paper and municipal securities and an additional charge of 1/2 of 1% to account for any minimal risk associated with the nature or operation of mutual funds.[451] Finally, one commenter supported a 0% haircut for applied to money market funds that: (1) do not hold investments in their affiliates or holding companies; and (2) are not affiliated with the bank in which the broker-dealer holds its cash reserves and operating funds.[452]

As discussed above in section II.E.6.ii. of this release, the Commission recently proposed substantial amendments to its money market fund rules.[453] In light of these proposed amendments,[454] the Commission is deferring consideration of a reduction of the haircut for money market funds in Rule 15c3-1 at this time. Therefore, the haircut that broker-dealers apply for money market funds will remain at 2% under paragraph (c)(2)(vi)(D)(1) of Rule 15c3-1. Deferring action will allow the Commission to assess the potential impact of any money market fund reforms it may adopt and whether any such impact would have consequences for the net liquid asset standard of Rule 15c3-1.

c. Aggregate Debit Items Charge

The Commission proposed amendments to Rule 15c3-1 that would have eliminated a reduction to aggregate debit items that certain broker-dealers must take

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450 See SIFMA 4 Letter.

451 See SIFMA 2 Letter.

452 See NIBA 2 Letter.

453 See Money Market Fund Reform; Amendments to Form PF, Release No. IC-30551 (June 5, 2013), 78 FR 36834 (June 19, 2013)

454 Id.

when computing their reserve requirements under Rule 15c3-3.[455] Under paragraph (a)(1)(ii)(A) of Rule 15c3-1, a broker-dealer using the "alternative standard"[456] to compute its minimum net capital requirement must reduce aggregate debit items by 3% when computing its customer reserve requirement under Rule 15c3-3. Conversely, Note E(3) to the customer reserve formula (Rule 15c3-3a) requires a broker-dealer using the "basic method" of computing net capital under Rule 15c3-1 to reduce by 1% the total debits in Item 10 of the formula (i.e., debit balances in customer cash and margin accounts).[457] Both of these provisions serve to increase the amount of funds a broker-dealer must deposit into its customer reserve account; however, the deduction applicable to alternative standard firms can result in an even larger reserve deposit requirement.

The Commission received four comment letters regarding these amendments and all were supportive.[458] However, recent market turmoil has highlighted the importance of maintaining adequate amounts of funds and qualified securities in the customer reserve account under Rule 15c3-3 to protect customers. Consequently, it would be imprudent to lower the debit reduction requirement for broker-dealers using the alternative standard at this time (especially given the fact that this standard is primarily used by firms with a substantial customer business). Therefore, the Commission has determined to defer consideration of action on this amendment at this time.

F. Technical Amendments

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455 See Amendments to Financial Responsibility Rules, 72 FR at 12867.

456 Under the "alternative standard," a broker-dealer's minimum net capital requirement is equal to 2% of the firm's aggregate debit items. 17 CFR 240.15c3-1(a)(1)(ii).

457 Under the "basic method," a broker-dealer cannot permit its aggregate indebtedness (generally total money liabilities) to exceed 1500% of its net capital. 17 CFR 15c3-1(a)(1)(i).

458 See Curian Clearing Letter; SIFMA 2 Letter; Deutsche Bank Securities Letter; Citigroup Letter.

The Commission proposed a number of technical amendments to these rules, including changes to the definitions of fully paid securities, margin securities, and bank in Rule 15c3-3.[459] These proposed technical amendments were not designed to substantively change the meanings of these defined terms but, rather, to amend out-of-date citations and remove text that the Commission believed to be superfluous or redundant.

Two commenters[460] opposed the proposed technical amendments to the Rule 15c3-3 definition of fully paid securities. As proposed, the definition of fully paid securities would have included "all securities carried for the account of a customer unless such securities are purchased in a transaction for which the customer has not made full payment."[461] The commenters contend that the amendments to the definition of fully paid securities would significantly expand the universe of fully paid securities because these securities generally are carried in a cash account, and under the proposed definition any security, in any account, including a margin account, could be considered a fully paid security (and subject to possession and control requirements) if it has been paid for in full. As such, the commenter noted that the term fully paid securities, as proposed, would require broker-dealers to determine whether securities in a margin account are fully paid (in which case they could not be hypothecated even if they are not excess margin securities). As a result, the commenter suggested that this definition should be limited to include only securities in a cash account that have been paid for in full. After careful consideration, and in response to the comment, the Commission has modified the text of paragraph (a)(3) to Rule 15c3-3 to more closely follow the original definition, while still

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459 17 CFR 240.15c3-3(a)(3), (4), and (7), respectively.

460 See SIFMA 2 Letter; Angel Letter.

461 See Amendments to Financial Responsibility Rules, 72 FR at 12894.

adopting the updated references and terminology to reflect changes made to Regulation T since 1972. As adopted, the term fully paid securities includes "all securities carried for the account of a customer in a cash account as defined in Regulation T (12 CFR 220.1 et seq.), as well as securities carried for the account of a customer in a margin account or any special account under Regulation T that have no loan value for margin purposes, and all margin equity securities in such account if they are fully paid . . . ."[462] The definition also states that, "the term "fully paid securities" does not apply to any securities purchased in transactions for which the customer has not made full payment."

The Commission did not receive any comments on the proposed amendments to the definition of margin securities under paragraph (a)(4) of Rule 15c3-3. The Commission is adopting this definition as proposed. In addition, the Commission did not receive any comments to the proposed amendments to the definition of bank under paragraph (a)(7) of Rule 15c3-3. The Commission, however, has modified the language in this paragraph to make the paragraph gender neutral by replacing the phrase "who maintains his principal place of business" with the phrase "that maintains its principal place of business."

The Commission also has amended other provisions of Rule 15c3-3 to make the rule gender neutral. Finally, the Commission has replaced the word "shall" throughout the rule, as amended, with clearer words, such as "will" or "must." This change will not change either the nature or substance of the affected rule provisions.

III. RESPONSES TO SPECIFIC REQUESTS FOR COMMENT

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[462] See paragraph (a)(3) of Rule 15c3-3, as adopted.

In the proposing release, the Commission requested comment on certain specific matters, in addition to the proposed rule amendments.[463] These matters included: (1) a proposal to reduce the Rule 17a-11 notice requirement for broker-dealers that carry over $10 billion in debits; (2) whether to harmonize the net capital deductions required under paragraph (c)(2)(iv)(B) of Rule 15c3-1 for securities lending and borrowing transactions with the deductions required under paragraph (c)(2)(iv)(F) for securities repo transactions; and (3) solicitation of 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.

The Commission received seven comment letters that addressed the solicitation of comments for these matters.[464] With respect to the early warning level proposal, one commenter proposed modifying the Commission's early warning levels for very large "alternative standard" firms with more than $10 billion in debits.[465] The commenter recommended this approach because of the increase in debit items at large broker-dealers and the increased focus on effective risk management practices.[466] Another comment supported the amendment, suggesting that the notification could serve as an early warning if a firm is approaching insolvency.[467]

In addition, the Commission received three comments with respect to harmonizing the net capital deductions required under paragraph (c)(2)(iv)(B) of Rule 15c3-1 for securities lending and borrowing transactions with the deductions required

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463 Id. at 12874.

464 See SIFMA 2 Letter; SIFMA 4 Letter; First Clearing Letter; Citigroup Letter; American Bar Association Letter; Cornell Letter; Raymond James 2 Letter.

465 See SIFMA 2 Letter.

466 Id.

467 See Cornell Letter.

under paragraph (c)(2)(iv)(F) for securities repo transactions.[468] These commenters stated that the Commission should consider the potential disruption to the marketplace that may arise in connection with any effort to harmonize capital charges.[469]

The Commission also received seven comments in response to the solicitation of 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.[470] Two commenters stated that the Commission should not require that a broker-dealer include third party liens as a credit in the reserve formula and stated that this is an area in which it would be productive to have a detailed discussion between Commission staff and the industry before any amendments are proposed.[471] Another commenter stated that each of the suggested approaches in the proposing release imposes burdens and requirements on broker-dealers that do not serve to address the concerns noted by the Commission.[472] Two commenters stated that the most effective way to avoid confusion regarding third party liens in a SIPC liquidation would be to segregate securities subject to a lien to a separate pledge account in the name of the pledgee.[473] Finally, one commenter argued that requiring broker-dealers to include the amount of liens as a credit item in the reserve formula was not necessary to achieve customer protection and would impose significant costs and burdens on the broker-dealers.[474]

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468 See SIFMA 2 Letter; Citigroup Letter; Raymond James 2 Letter.

469 Id.

470 See SIFMA 2 Letter; SIFMA 4 Letter; First Clearing Letter; Citigroup Letter; American Bar Association Letter; NIBA 2 Letter; Raymond James 2 Letter.

471 See SIFMA 2 Letter; SIFMA 4 Letter; Citigroup Letter.

472 See First Clearing Letter.

473 See American Bar Association Letter; NIBA 2 Letter.

474 See Raymond James 2 Letter.

The Commission will consider the comments received in developing any proposals should the Commission decide to take further action in any of these areas.

IV. PAPERWORK REDUCTION ACT

Certain provisions of the amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[475] The Commission published a notice requesting comment on the collection of information requirements in the proposing release[476] and submitted the amendments to the Office of Management and Budget ("OMB") for review in accordance with the PRA.[477] An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The amended rules – Rule 15c3-1, Rule 15c3-3, Rule 17a-3, Rule 17a-4 and Rule 17a-11 – contain currently approved collections of information under, respectively, OMB control numbers 3235-0200, 3235-0078, 3235-0033, 3235-0279 and 3235-0085.

In response to comments received regarding the proposed amendments in the proposing release, the Commission has modified the language in the final rules being adopted, as discussed above. These comments and their impact on PRA estimates are discussed below. In addition, the initial burden estimates in the proposing release have been adjusted,[478] as discussed below, to reflect updated information used to make the current estimates, including updated FOCUS Report data.[479]

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475 44 U.S.C. 3501, et seq.

476 See Amendments to Financial Responsibility Rules, 72 FR at 12875.

477 44 U.S.C. 3507(d); 5 CFR 1320.11.

478 See Amendments to Financial Responsibility Rules, 72 FR at 12875.

479 The PRA estimates derived from FOCUS Reports filed by broker-dealers pursuant to Section 17 of the Exchange Act and Rule 17a-5 have been updated in this final release to reflect more recently available information, including FOCUS Report data as of December 31, 2011. The PRA estimates in the proposing release derived from FOCUS

Finally, one commenter specifically stated that the estimates the Commission provided utilized only that number of broker-dealers in its estimates that the Commission "justifiably considers to be affected by the proposals."[480] The commenter, however, believes that most, if not all, broker-dealers will spend over 90 hours each analyzing the effects of the rules as implemented, will spend many more than 90 hours each in implementing procedures and modifying their written supervisory procedures to comply with the new rules, will spend in excess of 240 hours each in the monitoring of such rules, and will spend in excess of $15,000 each for outside counsel and auditor opinions or work product.[481] This commenter did not provide additional detail about the basis for its view that the Commission's estimates were too low. The Commission agrees with the commenter that broker-dealers directly affected by the rule amendments may be required to implement procedures or modify their written supervisory procedures in order to comply with the rule amendments. In cases where the rule amendments are requiring a broker-dealer to implement or document certain policies and procedures, these hour burdens are already included in the final hour estimates discussed below.[482] In addition, the Commission acknowledges that a broker-dealer may need to review its operations to determine whether or not it has any obligations under the rule amendments. Even if a broker-dealer is not directly affected by the rule amendments, such a review may result in an indirect effect on its operations. These indirect effects or costs, however, are more appropriately addressed in the Economic Analysis in section V. of this release because

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reports were from 2004 year end data. See Amendments to Financial Responsibility Rules, 72 FR at 12875.

480 See NIBA 2 Letter.

481 Id.

482 See, e.g., paragraph (j)(1) of Rule 15c3-3 and paragraph (a)(23) of Rule 17a-3, as adopted.

they relate to the overall impact of the amendments, rather than to the specific collections of information discussed below. Consequently, the Commission addresses the commenter's concerns that directly relate to the collections of information below, and the indirect burdens and costs in the Economic Analysis in section V. of this release.

A. Summary of the Collection of Information Requirements

The rule amendments contain recordkeeping and disclosure requirements that are subject to the PRA. In summary, the amendments may require a broker-dealer, under certain circumstances, to: (1) disclose the principals and obtain certain agreements from the principals in a securities lending transaction where it performs settlement services if it is to be considered an agent (as opposed to a principal) for the purposes of the net capital rule;[483] (2) obtain permission in writing from its DEA to withdraw capital within one year of contribution;[484] (3) enter into a subordination agreement with an account holder in order to exclude such account holder from the definition of PAB account;[485] (4) provide written notice to PAB account holders that their securities may be used in the ordinary course of its securities business;[486] (5) perform a PAB reserve computation;[487] (6) obtain written notification from each bank with which it maintains a PAB reserve account that the bank was informed that all cash and/or qualified securities being held by the bank are being held for the exclusive benefit of brokers and dealers;[488] (7) enter into a written contract with a bank with which it maintains its PAB reserve accounts providing that the cash and/or qualified securities shall at no time be used directly or indirectly as security

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483 See paragraph (c)(2)(iv)(B) of Rule 15c3-1, as adopted.

484 See paragraph (c)(2)(i)(G) to Rule 15c3-1, as adopted.

485 See paragraph (a)(16) to Rule 15c3-3, as adopted.

486 See paragraph (b)(5) to Rule 15c3-3, as adopted.

487 See paragraph (e)(1) and (e)(3) of Rule 15c3-3, as adopted.

488 See paragraph (f) of Rule 15c3-3, as adopted.

for a loan to the broker-dealer by the bank, and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank;[489] (8) develop adequate procedures to ensure a customer for whom a free credit balance is carried is sent a written statement regarding the customer's free credit balances, including information regarding the amount due to the customer and that the funds are payable on demand, prior to using funds arising from free credit balances in the broker-dealer's operations;[490] (9) obtain the written affirmative consent of a new customer before including the customer's free credit balances in a Sweep Program, as well as provide certain disclosures and notices to all customers with regard to the broker-dealer's Sweep Program;[491] (10) make and maintain records documenting its credit, market, and liquidity risk management controls to assist the broker-dealer in analyzing the risks associated with its business activities;[492] (11) provide notice to the Commission and other regulatory authorities if the broker-dealer becomes insolvent;[493] and (12) provide notice to the Commission and other regulatory authorities if the broker-dealer's securities borrowed and loaned or securities repurchase/reverse repurchase activity reaches a certain threshold or, alternatively, report monthly its securities borrowed and loan or securities repurchase/reverse repurchase activity to its DEA in a form acceptable to its DEA.[494]

B. Use of Information

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489 Id.

490 See paragraph (j)(1) to Rule 15c3-3, as adopted.

491 See paragraph (j)(2) to Rule 15c3-3, as adopted.

492 See paragraph (a)(23) to Rule 17a-3 and paragraph (e)(9) of Rule 17a-4, as adopted.

493 See paragraph (b)(1) of Rule 17a-11, as adopted.

494 See paragraph (c)(5) to Rule 17a-11, as adopted.

The Commission, its staff, and SROs will use the information collected under the amendments to Rule 15c3-1 and Rule 15c3-3 to determine whether the broker-dealer is in compliance with each rule and to help fulfill their oversight responsibilities. The collections of information would also help to ensure that broker-dealers are meeting their obligations under the rule amendments and have any required policies and procedures in place.

In particular, the record with respect to acting as agent in a securities loan transaction will assist examiners in verifying that the broker-dealer is properly accounting for securities loan deficits under Rule 15c3-1. The records with respect to obtaining DEA approval prior to withdrawing capital within one year of contribution under Rule 15c3-1 will assist examiners in determining if a broker-dealer is computing its net capital accurately with regard to the proper classification of its capital contributions, and will help to ensure the DEA only approves capital withdrawals which are appropriate in light of the firm's current financial condition at the time of the requested withdrawal. The amendments to Rule 15c3-1 also will facilitate the monitoring of the financial condition of broker-dealers by the Commission and its staff, as well as by SROs.

The records with respect to the PAB accounts will assist examiners in verifying that: (1) a carrying broker-dealer has properly excluded certain accounts from being treated as PAB accounts by entering into subordination agreements with particular account holders; (2) a carrying broker-dealer sent written notices to PAB accountholders to use their PAB securities; (3) the broker-dealer performed the PAB reserve computation; and (4) the bank holding the PAB reserve account agreed to do so free of lien by entering into a written contract with the broker-dealer.

The records with respect to customer's free credit balances will assist examiners in verifying that: (1) a carrying broker-dealer has obtained the written affirmative consent

of a new customer before including a customer's free credit balances in a Sweep Program; (2) a carrying broker-dealer has provided the required disclosures and notices to all customers with regard to the broker-dealer's Sweep Program; and (3) the broker-dealer has maintained adequate procedures with regard to the use of a customer's free credit balances prior to using such customer's free credit balances in its operations. The amendments to Rule 15c3-3 will facilitate the process by which the Commission, its staff, and SROs monitor how broker-dealers are fulfilling the customer protection requirements of the rule. The written affirmative consent, disclosures and notices required to be provided to customers also will alert customers to the alternatives available to them with respect to their free credit balances.

The Commission, its staff, and SROs will use the information collected under the amendments to Rules 17a-3 and 17a-4 to determine whether the broker-dealer is adhering to its documented credit, market, and liquidity risk management controls, as well as to evaluate the effectiveness of these controls.

The Commission, its staff, and SROs will use the information collected under the amendments to Rule 17a-11 to identify a broker-dealer experiencing financial difficulty. This information will assist the Commission and other regulators in promptly taking appropriate steps to protect customers, creditors, and counterparties. In particular, a notice of insolvency will assist regulators in responding more quickly to protect customers of a failing institution. The notices and reports with respect to securities lending and repos will assist regulators in identifying broker-dealers that are active in these transactions or suddenly take on large positions and thereby assist in monitoring systemic risk.

C. Respondents

The final estimates of respondents below have been updated to reflect more recent information.[495] The amendment to Rule 15c3-1 requiring a broker-dealer to make disclosures to, and obtain certain agreements from, securities lending principals will apply only to those firms that participate in the settlement of securities lending transactions as agents. The Commission estimates that approximately 122 broker-dealers will be affected by this requirement.[496] This estimate has been updated from the estimate of 170 broker-dealers in the proposing release.[497] No comments were received on this estimate.

The amendment to Rule 15c3-1 with respect to a broker-dealer obtaining permission in writing from its DEA prior to withdrawing capital within one year of contribution under Rule 15c3-1 will apply to any broker-dealer who wishes to withdraw such capital. Because most broker-dealers already comply with existing interpretations regarding the treatment of temporary capital contributions and similar SRO requirements, or are familiar with such interpretations and requirements, this part of the amendment to Rule 15c3-1 regarding temporary capital contributions likely will impact only a small number of the approximately 4,709 broker-dealers registered with the Commission, as of December 31, 2011 (based on FOCUS Report data).[498] Therefore, the Commission

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495 The final estimates of respondents derived from FOCUS Reports filed by broker-dealers pursuant to Section 17 of the Exchange Act and Rule 17a-5 have been updated in this final release to reflect more recently available information, including FOCUS Report data as of December 31, 2011. The estimates of respondents in the proposing release derived from FOCUS reports were from 2004 year end data. See Amendments to Financial Responsibility Rules, 72 FR at 12876.

496 This estimate is derived from FOCUS Reports.

497 See Amendments to Financial Responsibility Rules, 72 FR at 12876.

498 Temporary Capital Letter; see also Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991); and FINRA Rule 4110(c).

estimates that approximately 90 broker-dealers will seek permission from their DEA in writing to withdraw capital within one year of its contribution under the amendment.[499]

The amendments to Rule 15c3-3 requiring a broker-dealer to perform a PAB reserve computation and to obtain certain agreements and notices related to its PAB accounts will affect only those firms that carry such accounts. Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately 61 broker-dealers will carry such accounts.[500] The amendment to Rule 15c3-3 requiring a broker-dealer to obtain the affirmative consent of a new customer before changing the terms under which the customer's free credit balances are maintained will apply only to firms that carry free credit balances for customers. Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately 189 broker-dealers carry free credit balances.[501]

The Commission estimates that the amendment to Rule 15c3-3 permitting a broker-dealer to exclude certain accounts from being treated as PAB accounts under Rule 15c3-3 by entering into subordination agreements with certain account holders will apply to all 61 broker-dealers that will carry such accounts. The Commission estimates that

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499 The Commission received 900 broker-dealer capital withdrawal notices under paragraph (e) of Rule 15c3-1 in 2012. Because this amendment is consistent with prior Commission and staff positions that capital is not temporary, as well as current SRO requirements, it is likely that only a small number of these notices are capital withdrawals made within one year of contribution, and therefore, based on staff experience with the application of Rule 15c3-1, the Commission estimates that approximately 90 broker-dealers (10% of 900) will seek permission from their DEA in writing to withdraw capital under the amendment. See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991); Temporary Capital Letter; and FINRA Rule 4110.

500 This estimate has been updated from our estimate of 75 broker-dealers in the proposing release. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate.

501 In the proposing release, the Commission estimated approximately 256 broker-dealers carried free credit balances. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate.

these 61 broker-dealers each will enter into an average of 11 subordination agreements.[502]

The amendments to Rules 17a-3 and 17a-4 requiring a broker-dealer to make and maintain records documenting the credit, market and liquidity risk management control for analyzing and managing risks will apply only to firms that have more than $1,000,000 in aggregate credit items, or $20,000,000 in capital. Thus, its impact will be limited to larger broker-dealers. Accordingly, the number of respondents will equal the number of broker-dealers meeting the thresholds set forth in the amendment. The Commission estimates that approximately 490 broker-dealers will meet at least one of these thresholds.[503]

One amendment to Rule 17a-11 will require a broker-dealer to provide the Commission with notice if it becomes subject to certain insolvency events. The Commission estimates that approximately two broker-dealers will become subject to one of these events in a given year.[504] Another amendment to Rule 17a-11 will require a

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502 See Order Granting Conditional Exemption Under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps, Exchange Act Release No. 68433 (Dec. 14, 2012), 77 FR 75211, 75222 n.69 (Dec. 19, 2012). ("FINRA CRD data indicate that the 17 largest broker-dealers (i.e., those with total assets of $50 billion or more) reported a total of 188 affiliates that are themselves registered with the SEC (i.e., they have their own CRD numbers), representing approximately 11 affiliates per broker-dealer."). Carrying firms likely will enter into subordination agreements with affiliates, including foreign banks or foreign broker-dealers affiliated with the carrying broker-dealer to exclude such accounts from the rule. See SIFMA 2 Letter.

503 This estimate has been updated from the proposing release estimate of 517 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate.

504 This estimate is based on the 2012 SIPC Annual Report, which indicates that over the last ten-year-period, the annual average of new customer protection proceedings was two. A copy of the 2012 Annual Report is available at http://www.sipc.org/. This estimate has been updated from our proposing release estimate of 6, which was based on the SIPC 2005 Annual Report. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate.

broker-dealer to provide notice to the Commission if its securities borrowed or loaned, or its securities repurchase or reverse repurchase activity reaches a certain threshold or, alternatively, provide monthly reports to its DEA about such activities. This amendment will only affect a limited number of firms per year. The Commission estimates that approximately one broker-dealer[505] will provide notice and six broker-dealers[506] will opt to send the monthly reports in a given year.

D. Total Annual Reporting and Recordkeeping Burden

1. Securities Lending Agreements and Disclosures

The amendments to paragraph (c)(2)(iv)(B) of Rule 15c3-1 will require a broker-dealer to make disclosures to, and obtain certain agreements from, securities lending principals in situations where the firm participates in the settlement of a securities lending transaction but wants to be deemed an agent for purposes of Rule 15c3-1.[507] The Commission has adopted the final rule substantially as proposed, and consequently, there were no changes to the final rule amendments that would affect the Commission's PRA

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505 This estimate is derived from information filed by broker-dealers in their FOCUS Reports. This estimate has been updated from the proposing release estimate of 11. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate. Based on FOCUS Report data, as of December 31, 2011, there were seven broker-dealers whose securities borrowed or securities loaned exceeded 80% of 25 times their tentative net capital, and there were six broker-dealers whose securities borrowed or securities loaned exceeded 25 times their tentative net capital. Therefore, the Commission assumes for purposes of the PRA that six broker-dealers would chose to file monthly reports in lieu of the notice requirements, and that one would file a notice.

506 This estimate is derived from information filed by broker-dealers in their FOCUS Reports. Based on FOCUS Report data, as of December 31, 2011, there were six broker-dealers whose securities borrowed or securities loaned exceeded 25 times their tentative net capital. These firms likely will opt to file the monthly report under the proposed amendments to Rule 17a-11. This estimate has been updated from our proposing release estimate of 21 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12876. No comments were received on this estimate. The estimated number of firms filing notices and monthly reports has decreased largely due to an overall decrease in the number of broker-dealers. See also id. at 12870 (discussing rationale for 2,500% threshold).

507 17 CFR 240.15c3-1(c)(2)(iv)(B).

estimates. In addition, the Commission did not receive any comments on the estimates in the proposing release,[508] and is therefore is retaining the amendment's PRA hour burden estimates without revision. The Commission, however, is updating the number of respondents to reflect more recently-available data from broker-dealer FOCUS Reports.

As discussed above in section II.C. of this release, the Commission, in recognition of standard stock loan agreements, designed the amendment to accommodate the continued use of these industry model agreements by incorporating their use into the rule's requirements. For the purpose of establishing a broker-dealer's status as agent or lender, these agreements may be sufficiently detailed to satisfy the new requirements. Thus, the standard agreement used by the vast majority of broker-dealers may contain the representations and disclosures required by the amendment. Nevertheless, based on staff experience with securities lending agreements and disclosure and the application of Rule 15c3-1, the Commission continues to believe that a small percentage of broker-dealers may need to modify their standard agreements. In the proposing release, the Commission estimated that 5%[509] of broker-dealers may need to modify their standard agreements. No comments were received on this estimate and the Commission believes 5% continues to be an appropriate estimate for the final rule amendments. Thus, the Commission estimates that 5% of the approximately 122 firms engaged in this business, or approximately 6 firms, will not have used the standard agreements.[510] The Commission estimates each of these firms will spend approximately 20 hours of employee resources

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508 See Amendments to Financial Responsibility Rules, 72 FR at 12876.

509 Id.

510 This estimate is updated from the estimate of 9 firms (5% of 170 firms) in the proposing release. Id.

updating their standard agreement template.[511] Therefore, the Commission estimates that the total one-time burden to broker-dealers as a result of this requirement will be approximately 120 hours.[512]

2. DEA Permission to Withdraw Capital within One Year of Contribution

The amendment to paragraph (c)(2)(i)(G)(2) of Rule 15c3-1 will require that a broker-dealer treat as a liability any capital contribution that is intended to be withdrawn within one year of its contribution.[513] The rule amendment also includes the presumption that capital withdrawn within one year of contribution is presumed to have been intended to be withdrawn within one year, unless the broker-dealer receives permission in writing for the withdrawal from its DEA. This amendment likely will impose annual recordkeeping burdens on broker-dealers making the request.

The Commission estimates that 90 broker-dealers will seek to obtain permission from their DEA in writing to withdraw capital within one year of its contribution, and that it will take a broker-dealer approximately one hour to prepare and submit the request to its DEA to withdraw capital.[514] Therefore, the Commission estimates that the total annual hour burden with respect to the rule amendment will be approximately 90 hours.[515]

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511 Because these firms are already engaging in stock loan and repo activities, these functions likely will be performed by in-house employees, rather than outside counsel.

512 6 broker-dealers x 20 hours per firm = 120 hours. This is an update from the proposing release estimate of 9 broker-dealers x 20 hours = 180 hours. Id.

513 17 CFR 240.15c3-1(c)(2)(i)(G)(2).

514 See section IV.C. of this release.

515 90 broker-dealers x 1 hour = 90 hours.

3. Written Subordination Agreements under Rule 15c3-3

As discussed above in section II.A.2. of this release, in response to comments, the final rule amendment adopted by the Commission excludes from the definition of PAB account in paragraph (a)(16) of Rule 15c3-3, an account that "has been subordinated to the claims of creditors of the carrying broker or dealer."[516] This modification to the final rule will result in one-time burdens under the collection of information for Rule 15c3-3.[517]

In light of comments received[518] and based on staff experience, the Commission understands most PAB account holders that enter into a subordinated loan agreement with a carrying broker-dealer in order to not be treated as PAB accounts under paragraph (a)(16) likely will be affiliates of the broker-dealer.[519] The Commission estimates that the 61 broker-dealers that carry PAB accounts will enter into an average of 11 subordination agreements as a result of the rule amendment.[520] The Commission estimates that it will take a carrying broker-dealer approximately 20 hours to develop a subordination agreement, based on the Commission's prior experience with the

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516 17 CFR 240.15c3-3(a)(16).

517 The proposing release did not contain any proposals with regard to subordination agreements.

518 See SIFMA 2 Letter; SIFMA 4 Letter; Deutsche Bank Securities Letter.

519 See Deutsche Bank Letter; SIFMA 2 Letter.

520 See section IV.C. of this release.

development of subordination agreements.[521] Therefore, the Commission estimates that the total one-time hour burden resulting from this requirement will be 13,420 hours.[522]

4. PAB Reserve Bank Account Recordkeeping Requirements

The amendments to Rules 15c3-3 and 15c3-3a require carrying broker-dealers to: (1) perform a separate reserve computation for PAB accounts (in addition to the reserve computation currently required for Rule 15c3-3 customer accounts); (2) establish and fund a separate PAB reserve account; and (3) obtain and maintain physical possession or control of non-margin securities carried in PAB accounts unless the carrying broker-dealer has provided written notice to the PAB account holders that it will use those securities in the ordinary course of its securities business, and has provided opportunity for the PAB account holder to object to such use.

In the proposing release, the Commission proposed to require that the carrying broker-dealer obtain written permission from a PAB account holder before it could use the securities of the PAB account holder in the ordinary course of its securities business. The Commission estimated that, based on FOCUS Report data, there were approximately 2,533 existing PAB customers, and therefore, broker-dealers would have to amend approximately 2,533 existing PAB agreements.[523] The Commission further estimated that, on average, a firm would spend approximately 10 hours of employee resources amending each agreement and that 75 firms would spend 20 hours amending their

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521 See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071, 77 FR at 70299. See also Order Granting Conditional Exemption Under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps, Exchange Act Release No. 68433 (Dec. 14, 2012), 77 FR 75211 (Dec. 19, 2012).

522 61 broker-dealers x 11 accounts x 20 hours = 13,420 hours.

523 See Amendments to Financial Responsibility Rules, 72 FR at 12877.

standard PAB agreement template, for a total of 26,830 hours.[524] The Commission did not receive any comments regarding these estimates in the proposing release.

In response to comments, as discussed above, the Commission determined not to adopt the requirement, as proposed. Instead, paragraph (b)(5) of Rule 15c3-3 requires the carrying broker-dealer to provide PAB account holders with written notice that the account holder's non-margin securities may be used in the ordinary course of its business.[525] Therefore, the Commission is revising the final one-time hour burden in light of the change in the rule to a notice requirement, which is expected to be less burdensome than the proposed customer consent provision while still providing customers with necessary information. The Commission estimates, based on FOCUS Report data, that approximately 61 broker-dealers carry PAB accounts.[526] The Commission further estimates, based on similar collections of information and the fact that these firms already carry PAB accounts, and on average, a firm will spend approximately 10 hours of employee resources drafting a standard notice template, for a total one-time burden of 610 hours.[527] In addition, based on FOCUS Report data, the Commission estimates that there are approximately 1,551 existing PAB customers and,

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524 (2,533 PAB customers x 10 hours per customer) + (75 firms x 20 hours per firm) = 26,830. Id.

525 17 CFR 240.15c3-3(b)(5).

526 This estimate is based on the number of broker-dealers carrying PAB accounts as of December 31, 2011. This is an update from the proposing release estimate of approximately 75 broker-dealers that carry PAB accounts. See Amendments to Financial Responsibility Rules, 72 FR at 12877.

527 61 firms x 10 hours = 610 hours. See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071, 77 FR at 70298 (estimating that the notice required to be sent by a security based swap dealer to a counterparty pursuant to section 3E(f) of the Exchange Act would take an outside counsel 10 hours to draft).

therefore, broker-dealers will have to send approximately 1,551 written notices.[528] The Commission estimates, based on staff experience, that a firm will spend approximately 10 minutes per account sending out the required written notice, for a total one-time burden of 259 hours.[529]

The Commission estimates that a broker-dealer will incur postage costs sending out the required written notice to customers. These carrying broker-dealers likely will use the least cost method to comply with this requirement and may include this notification with other mailings sent to PAB account holders. The Commission, however, conservatively estimates that the postage cost of for each notification, using the current price of first class postage, will be approximately $.46 per document sent. Therefore, the staff estimates that the cost of sending the required written notification to PAB account holders will be approximately $713.[530]

Based on FOCUS Report data, the Commission also estimates that approximately 61 broker-dealers carry PAB accounts, and based upon differences between the PAIB Letter and the final rule, these 61 firms would have to amend their standard PAB agreement template. The Commission estimates a firm will spend, on average, approximately 20 hours of employee resources on this task, for a total of 1,220 hours.[531]

In light of the changes to the final rule amendments which require a broker-dealer to send a written notice, rather than obtain a customer's consent regarding the use of a

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528 The number of customers also is updated from the proposing release estimate of 2,533 customers. See Amendments to Financial Responsibility Rules, 72 FR at 12877.

529 1,551 PAB account holders x 10 minutes = 15,510 minutes/60 minutes = 258.5 hours (rounded to 259 hours). See generally, Exchange Act Release No. 68071, 77 FR at 70298 (estimating that the notice required to be sent by a security based swap dealer to a counterparty pursuant to section 3E(f) of the Exchange Act would take 10 minutes to send).

530 1,551 notices x $0.46 = $713.46.

531 61 firms x 20 hours = 1,220.

PAB account holder's securities, the 61 broker-dealers carrying PAB accounts likely will engage outside counsel[532] to review the required notice,[533] as well as the standard PAB template agreement under the final rule amendments to Rule 15c3-3. As a result, the Commission estimates that these 61 broker-dealers will likely incur $2,000 in legal costs,[534] or $122,000[535] in aggregate initial burden to review and comment on these materials.

The requirements to perform a PAB reserve computation and obtain agreements and notices from banks holding PAB accounts will result in annual burdens based on the number of broker-dealers that hold PAB accounts and the number of times per year these broker-dealers open new PAB reserve accounts. Currently, to obtain the relief provided in the PAIB Letter, broker-dealers are required to obtain the agreements and notices from the banks.[536] The Commission understands that broker-dealers generally already obtain these agreements and notices. Therefore, the Commission estimates there will be no

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532 See NIBA 2 Letter.

533 17 CFR 240.15c3-1(b)(5).

534 5 hours x $400 per hour = $2,000. The Commission estimates the review of the notice and standard PAB template would require 5 hours of outside counsel time, which is the same estimate used for outside counsel review in another recent release. Based on staff experience with the PAIB Letter and the application of Rule 15c3-3, the Commission estimates the outside counsel review related to the PAB amendments will take a comparable amount of time. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release 68071, 77 FR at 70297, n.904. The Commission estimates that the outside counsel would cost $400 per hour, which is the same estimate used by the Commission in other recent releases. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release 68071, 77 FR at 70297; Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Exchange Act Release No. 67453 (July 18, 2012), 77 FR 48208 (Aug. 13, 2012).

535 61 firms x $2,000 legal cost = $122,000.

536 See PAIB Letter.

additional burden imposed by this requirement.[537] The Commission did not receive any comments on this estimate from the proposing release.

The amendment requiring a PAB reserve computation will produce a one-time burden. Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately 61 broker-dealers will perform a PAB reserve computation.[538] These firms already perform a reserve computation for domestic broker-dealer customers under the PAIB Letter. Nonetheless, the Commission estimates these firms will spend, on average, approximately 30 hours of employee resources per firm updating their systems to implement changes that will be necessitated by the amendment. Therefore, consistent with the hour estimates in the proposing release, the Commission estimates that the total one-time burden to broker-dealers arising from updating their systems to comply with this requirement will be approximately 1,830 hours.[539]

The amendment requiring a PAB reserve computation also will produce an annual burden. Based on FOCUS Report data, the Commission estimates that of the 61 broker-dealers estimated to perform a PAB reserve computation, approximately 56 of the current PAB filers will perform the PAB reserve computation on a weekly basis, two broker-dealers will perform it on a monthly basis, and three broker-dealers will perform the PAB reserve computation on a daily basis.[540] The Commission further estimates that a broker-

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537 In addition, the hour burdens for broker-dealers to open new customer reserve bank account under Rule 15c3-3 are already included within the currently approved collection of information for Rule 15c3-3.

538 This estimate is based on the number of broker-dealers which currently perform a PAB computation as of December 31, 2011. This is an update from the estimate in the proposing release of 75 broker-dealers.

539 61 broker-dealers x 30 hours per firm = 1,830 hours. This is an update from the proposing release estimate of 75 firms x 30 hours per firm = 2,250 hours. See Amendments to Financial Responsibility Rules, 72 FR at 12877.

540 These estimates are based on the number of broker-dealers performing a PAB reserve computation monthly, weekly, and daily, as of December 31, 2011. This is an update

dealer will spend, on average, approximately 2.5 hours to complete the PAB reserve computation in order to make a record of such computation under Rule 15c3-3 as a result of the amendment.[541] Therefore, consistent with the hour burden estimates in the proposing release, the Commission estimates that the total annual burden to broker-dealers from this requirement will be approximately 9,215 hours.[542]

5. Adequate Procedures Required under Paragraph (j)(1) of Rule 15c3-3

The Commission proposed importing requirements in Rule 15c3-2 into Rule 15c3-3 and eliminating Rule 15c3-2 as a stand-alone rule in the Code of Federal Regulations, and adopting new paragraph (j)(1) to Rule 15c3-3, which includes a condition that a broker-dealer must establish adequate procedures that will impose a paperwork burden if a broker-dealer wishes to accept or use any free credit balance for the account of any customer of the broker-dealer. The Commission is adopting this amendment substantially as proposed, which provides, "[a] broker or dealer must not accept or use any free credit balance carried for the account of any customer of the broker or dealer unless such broker or dealer has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent,

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from the estimate in the proposing release, which provided that of the 75 broker-dealers estimated to perform a PAB computation, 71 broker-dealers would prefer PAB computations on a weekly basis and four broker-dealers would perform it on a monthly basis. See Amendments to Financial Responsibility Rules, 72 FR at 12877. No broker-dealers performed daily PAB computations as of the date of the proposing release. No comments were received on this estimate.

541 This estimate is based on staff experience with the current estimate of 2.5 hours under the current collection of information for Rule 15c3-3 to make a record of each reserve computation. See 17 CFR 240.15c3-3(e)(3).

542 (56 weekly filers x 52 weeks x 2.5 hours per computation) + (2 monthly filers x 12 months x 2.5 hours per computation) + (3 daily filers x 250 business days per year x 2.5 hours per computation) = 9,215 total hours. This is an update from the proposing release estimate of 9,350 hours. See Amendments to Financial Responsibility Rules, 72 FR at 12877, n.137.

together with or as part of the customer's statement of account, whenever sent but not less frequently than once every three months, a written statement informing the customer of the amount due to the customer by the broker or dealer on the date of the statement, and that the funds are payable on demand of the customer."[543]

The requirement that broker-dealers establish adequate procedures with regard to free credit balances will result in one-time and annual hours burdens for broker-dealers subject to the requirements of new paragraph (j)(1) to Rule 15c3-3. Based on FOCUS Report data, the Commission estimates that 189 broker-dealers carry free credit balances. Most firms may already have such procedures in place with regard to the requirements of the rule, because these provisions are being imported from current Rule 15c3-2, which is being eliminated as a result of these amendments. Therefore, the Commission estimates that a broker-dealer will spend approximately 25 additional hours reviewing and updating its procedures to ensure it is in compliance with new paragraph (j)(1) to Rule 15c3-3 and approximately 10 additional hours per year reviewing and updating its procedures, for a total one-time and annual hour burden of 4,725 hours[544] and 1,890 hours,[545] respectively.[546]

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543 17 CFR 240.15c3-3(j)(1).

544 189 broker-dealers x 25 hours = 4,725 hours. The 25 and 10 hour estimates are based on similar collections of information and the Commission's belief that many of these broker-dealers already have procedures in place and, therefore, most broker-dealers will only be revising and updating their current policies and procedures to ensure compliance with the rule. See Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, Exchange Act Release No. 64532 (Apr. 27, 2011), 76 FR 26550, 26568 (May 6, 2011).

545 189 broker-dealers x 10 hours = 1,890 hours.

546 See NIBA 2 Letter.

6. Treatment of Free Credit Balances

New paragraph (j)(2) to Rule 15c3-3 will require a broker-dealer to obtain the written affirmative consent of a new customer before including a customer's free credit balances in a Sweep Program, as well as to provide certain disclosures and notices to all customers with regard to the broker-dealer's Sweep Program.

These requirements will result in one-time and annual burdens to broker-dealers subject to its provisions. However, these requirements will apply only to a firm that carries customer free credit balances and opts to have the ability to change how its customers' free credit balances are treated. The Commission did not receive comments regarding the hour burden estimates relating to the treatment of free credit balances in the proposing release.

In the proposing release, the Commission estimated that approximately 50 broker-dealers[547] would choose to provide new customers with the disclosures and notices required under the amendment in order to have the ability to change how their customers' free credit balances were treated. The Commission did not receive any comments on this estimate. The Commission, however, is revising this estimate for the final rule to include all 189 broker-dealers that carry free credit balances to reflect the fact that these firms may have to update their systems to comply with these new requirements. The Commission further estimates these firms will spend, on average, approximately 200 hours of employee resources per firm updating their current systems (including processes for generating customer account statements) to incorporate changes that will be necessitated by the amendment. Therefore, the Commission estimates that the total one-

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[547] See Amendments to Financial Responsibility Rules, 72 FR at 12877.

time burden to broker-dealers arising from this requirement will be approximately 37,800 hours.[548]

The Commission also estimates that these firms will consult with outside counsel in making these systems changes, particularly with respect to the language in the disclosures and notices under new paragraph (j)(2) to Rule 15c3-3. The Commission estimates that an outside counsel will spend, on average, approximately 50 hours assisting a broker-dealer in updating its systems[549] for a one-time aggregate burden to broker-dealers of 9,450 hours.[550] The Commission estimates that the average hourly cost for an outside counsel will be approximately $400 per hour.[551] For these reasons, consistent with its estimate in the proposing release, the Commission estimates that the average one-time cost to a broker-dealer will be approximately $20,000[552] and the one-time cost to broker-dealers will be approximately $3,780,000.[553]

As for the annual hour burden, the Commission estimates, consistent with its estimate in the proposing release, these requirements will impact 5%[554] of the total

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548 189 broker-dealers x 200 hours per firm = 37,800.

549 Because broker-dealers affected by these amendments are likely to already have existing sweep programs in place, a broker-dealer likely will need to update its existing systems, rather than be required to purchase additional hardware to comply with these rule amendments.

550 189 broker-dealers x 50 hours per firm = 9,450 hours.

551 Based on staff experience, the Commission used the estimate of $400 per hour for legal services provided by outside counsel, which is the same estimate used by the Commission in other recent releases. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release 68071, 77 FR at 70297; Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule, Exchange Act Release No. 67453 (July 18, 2012), 77 FR 48208 (Aug. 13, 2012).

552 $400 per hour x 50 hours = $20,000.

553 189 broker-dealers x $20,000 = $3,780,000.

554 See Amendments to Financial Responsibility Rules, 72 FR at 12877.

broker-dealer customer accounts per year. Based on FOCUS Report data, the Commission estimates there are approximately 110,493,215 customer accounts and, consequently, 5% of the accounts (5,524,661 accounts per year) will be impacted.[555] Based on staff experience with similar requirements under the existing PRA collection for Rule 17a-3, the Commission further estimates that a broker-dealer will spend, on average, four minutes[556] of employee resources to process a written affirmative consent for new customers, as well as disclosures required under paragraph (j) to Rule 15c3-3. Therefore, the Commission estimates that the annual burden to broker-dealers arising from the requirement will be approximately 368,311 hours.[557]

7. Documentation of Risk Management Procedures

The amendments to Rules 17a-3 and 17a-4 will require certain large broker-dealers to make and keep current a record documenting credit, market, and liquidity risk management controls established and maintained by the broker-dealer to assist it in analyzing and managing the risks associated with its business activities. The amendment only will apply to broker-dealers that have more than (1) $1,000,000 in aggregate credit items as computed under the customer reserve formula of Rule 15c3-3, or (2) $20,000,000 in capital, including debt subordinated in accordance with Appendix D to Rule 15c3-1.

As proposed, the amendment would have required a broker-dealer to create a record documenting its "internal risk management controls."[558] To address commenters'

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555 These estimates have been updated from the proposing release estimates of 109,300,000 customer accounts and 5% of the customer account or 5,465,000 accounts. Id.

556 Id.

557 [5,524,661 accounts x 4 minutes/account]/60 minutes = 368,311 hours. This is an update from our proposing release estimate of 5,465,000 accounts x 4 minutes/account = 364,333 hours. Id. at 12878.

558 Id. at 12899.

concerns that the proposed rule language was ambiguous and that the Commission should narrow the application of the rule, the Commission modified new paragraph (a)(23) to Rule 17a-3, as stated above, so that the final rule requires certain broker-dealers to document risk management controls established to manage market, credit, and liquidity risk, rather than all of its "internal risk management controls."

In the proposing release, the Commission estimated that based on FOCUS Report data, that there would be approximately 517 broker-dealers that would meet the applicability threshold of this amendment ($1,000,000 in credits or $20,000,000 in capital), and therefore would be subject to the proposed rule.[559] The Commission also estimated that this requirement would result in a one-time burden to broker-dealers of approximately 62,040 hours, based on the estimate that a broker-dealer would spend approximately 120 hours of employee resources augmenting its procedures to comply with the proposed rule.[560] The Commission did not receive any comments on this estimate in the proposing release.

In light of the change in the final rule text to require the documentation of controls established to manage market, credit, and liquidity risk, rather than all of its "internal risk management controls," the Commission is reducing the final PRA estimate for Rule 17a-3 because the final rule narrows the scope of internal risk management controls the broker-dealer is required to document. Consequently, the change to the final rule should result in a reduction in the one-time hour burden estimate. The rule does not specify the type of controls a broker-dealer must establish to manage these risks. It simply requires the documentation of the procedures the broker-dealer has established. Broker-dealers that are part of holding companies may be subject to procedures that are

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559 Id. at 12878.

560 517 broker-dealers x 120 hours = 62,040 hours.

used globally throughout the organization. As long as the broker-dealer maintains documented procedures of controls pertaining to the designated entity, the requirements of the rule would be met. The one-time hour burden to comply with the rule will vary depending on the size and complexity of a firm. In addition, some larger broker-dealers required to comply with Rule 15c3-4 (Internal Risk Management Control Systems for OTC Derivatives Dealers) already would be required to document their internal risk management control systems related to market, credit, and liquidity risk.[561]

Taking this into account, as well as based on staff experience monitoring compliance of risk management controls of broker-dealers, the Commission estimates that a broker-dealer will spend, on average, approximately 100 hours of employee resources to comply with this amendment to ensure its market, credit, and liquidity risk controls are documented. For the reasons discussed above, including narrowing the scope of the final rule, the estimate of 100 hours reflects a 20% reduction from the estimate in the proposing release of 120 hours. Based on FOCUS Report data, as of December 31, 2011, the Commission estimates there are approximately 490 broker-dealers that would be subject to the final rule amendment (because the firm has $1,000,000 in credits or $20,000,000 in capital). Therefore, the Commission estimates the total one-time burden to broker-dealers will be approximately 49,000 hours.[562]

In addition to the one-time hour burden discussed in the proposing release,[563] based on similar collections of information requiring the documentation of risk management controls,[564] large broker-dealers required to comply with the amendment as

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561 See 17 CFR 240.15c3-4(a).

562 490 broker-dealers x 100 hours = 49,000 hours.

563 See Amendments to Financial Responsibility Rules, 72 FR at 12878.

564 See Risk Management Controls for Brokers or Dealers with Market Access; Final Rule, Exchange Act Release No. 63241 (Nov. 3, 2010), 75 FR 69792, 69815 (Nov. 15, 2013).

adopted likely will incur annual hour burdens.[565] Consequently, the Commission is incorporating annual hour burdens for this collection of information in the final rule amendments.[566] Therefore, the Commission estimates that a broker-dealer would spend approximately 45 hours per year to ensure its compliance with the amendment to Rule 17a-3, for a total annual hour burden to the industry of 22,050 hours.[567]

Additionally, the proposing release did not specifically allocate the estimated hour burdens with respect to the amendments to Rule 17a-3 and 17a-4 between these two rules.[568] As discussed above, and based on staff experience with the application of Rule 17a-4, the Commission estimates that broker-dealers meeting the threshold requirements of paragraph (a)(23) of Rule 17a-3 will already have documented their established procedures and controls to manage the risks arising from their business. Consequently, the amendment to Rule 17a-4 to require a broker-dealer to preserve the records required pursuant to paragraph (a)(23) of Rule 17a-3 until three years after the termination of the use of the risk management controls documented therein should have a minimal impact on the current annual hour burden for Rule 17a-4 because the paperwork burden associated with this amendment derives from the substance of the amendments to paragraph (a)(23) of Rule 17a-3. Therefore, the Commission is retaining the current annual hour burden for Rule 17a-4 without change.

See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release 68071, 77 FR at 70295 and 70297.

565 See NIBA 2 Letter.

566 The proposing release did not contain annual hour burden estimates for this collection of information.

567 490 broker-dealers x 45 hours = 22,050 hours. The 45 per hour annual estimate is based on a similar collection of information. See Risk Management Controls for Brokers or Dealers with Market Access; Final Rule, Exchange Act Release No. 63241 (Nov. 3, 2010), 75 FR 69792, 69815 (Nov. 15, 2010).

568 See Amendments to Financial Responsibility Rules, 72 FR at 12878.

Because the final rule amendment requires a broker-dealer to document its liquidity, credit, and market risk management controls, if it has established such controls, these broker-dealers may incur one-time startup costs to hire outside counsel to review the documented controls to ensure the broker-dealer is meeting the requirements of the rule. Based on staff experience with similar reviews, the Commission estimates that these broker-dealers would incur $2,000 in legal costs,[569] or $980,000,[570] in the aggregate, initial one-time burden to review and comment on the documented risk management controls.[571]

8. Notice Requirements

The amendment to Rule 17a-11 requiring notice when a broker-dealer becomes subject to certain insolvency events will result in irregular filings from a small number of broker-dealers. As noted above, SIPC's 2012 annual report indicates that the average annual number of broker-dealers which have become subject to a liquidation proceeding under SIPA over the last ten years is two. Accordingly, the Commission estimates that approximately two insolvency notices will be sent per year and that a broker-dealer will spend, on average, approximately ten minutes of employee resources to prepare and send the notice.[572] The Commission did not receive any comments on its estimates from the

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569 The Commission staff estimates that the review of the documented controls would require 5 hours of outside counsel time at a cost of $400 per hour. See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release 68071, 77 FR at 70297, n.904.

570 490 broker-dealers x $2,000 = $980,000.

571 See NIBA 2 Letter.

572 This is an update from the proposing release estimate of an average of six broker-dealers per year have become subject to a liquidation proceeding under SIPA, based on SIPC's 2005 annual report. The proposing release also contained a 10 minute estimate per broker-dealer (6 notices x 10 minutes per notice = 1 hour). See Amendments to Financial Responsibility Rules, 72 FR at 12878.

proposing release. Therefore, the Commission estimates that the total annual burden to broker-dealers arising from this amendment will be approximately 20 minutes.[573]

The amendment to Rule 17a-11 requires broker-dealers engaged in securities lending or repurchase activities to either: (1) file a notice with the Commission and their DEA whenever the total money payable against all securities loaned, subject to a reverse repurchase agreement or the contract value of all securities borrowed or subject to a repurchase agreement, exceeds 2,500% of tentative net capital; or, alternatively, (2) report monthly their securities lending and repurchase activities to their DEA in a form acceptable to their DEA. The Commission did not receive any comments on these specific estimates in the proposing release and continues to believe they are appropriate. As such, the Commission is adopting this amendment with a minor modification that does not impact the collection of information.

In addition, based on FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately one stock loan/borrow notice will be sent per year.[574] The Commission further estimates that a broker-dealer will spend, on average, approximately ten minutes of employee resources to prepare and send the notice. Therefore, the Commission estimates that the total annual burden to broker-dealers arising from this amendment will be approximately ten minutes.[575]

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573 2 notices x 10 minutes per notice = 20 minutes.

574 This estimate is an update of the proposing release estimate that twelve notices will be sent per year based on FOCUS data. See Amendments to Financial Responsibility Rules, 72 FR at 12878. As of December 31, 2011, there were seven broker-dealers whose securities borrowed or securities loaned exceeded 80% of 25 times their tentative net capital, and there were six broker-dealers whose securities borrowed or securities loaned exceeded 25 times their tentative net capital. The Commission assumes for purposes of the PRA that six broker-dealers would chose to file monthly reports in lieu of the notice requirements, and that one would file a notice.

575 1 notice x 10 minutes per notice = 10 minutes. This is an update of the proposing release estimate of 2 hours (12 notices x 10 minutes per notice). See Amendments to Financial Responsibility Rules, 72 FR at 12878. The Commission does not expect broker-dealers

Based on FOCUS Report data, as of December 31, 2011, and staff experience, the Commission estimates that, annually, six broker-dealers will submit the monthly stock loan/borrow report.[576] Based on staff experience, the Commission estimates each firm will spend, on average, approximately 100 hours of employee resources updating its systems to generate the information required in the monthly report. Therefore, the Commission estimates that the total one-time burden to broker-dealers arising from this requirement will be approximately 600 hours.[577] With respect to the annual hour burden, the Commission estimates each firm will spend, on average, approximately one hour per month (or twelve hours per year) of employee resources to prepare and send the report or to prepare the information for the FOCUS report (as required by the firm's DEA, if applicable). Therefore, the Commission estimates the total annual burden arising from this amendment will be approximately 72 hours.[578]

E. Collection of Information Is Mandatory

These recordkeeping and notice requirements are mandatory with the exception of: (1) the option for a broker-dealer to report monthly its securities lending activities to its DEA in lieu of filing the notice required under paragraph (c)(5) of Rule 17a-11; (2) the option for a broker-dealer to request written approval from its DEA in order to withdraw capital that has been contributed within one year under paragraph (c)(2)(i)(G)(2) of Rule

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to incur postage costs as a result of this amendment because most broker-dealers file these notices via facsimile or email. Therefore, any incremental postages costs will likely be minimal.

576 This is an update from the proposing release estimate that 21 broker-would submit a monthly report. See Amendments to Financial Responsibility Rules, 72 FR at 12878.

577 6 broker-dealers x 100 hours per firm = 600 hours. This is an update from our proposing release estimate of 2,100 hours (21 broker-dealers x 100 hours per firm). See Amendments to Financial Responsibility Rules, 72 FR at 12878.

578 6 broker-dealers x 12 hours per year = 72 hours. This is an update from the proposing release estimate of 252 hours (21 broker-dealers x 12 hours per year). See Amendments to Financial Responsibility Rules, 72 FR at 12878.

15c3-1; and (3) the option of a carrying broker-dealer to enter into a subordination agreement with an account holder in order to exclude such account holder's account from being treated as a PAB account under paragraph (a)(16) of Rule 15c3-3.

F. Confidentiality

Some of the information the Commission expects to receive may be confidential information. The information collected under the amendments to Rules 15c3-1, 15c3-3, 17a-3, and 17a-4 would be stored by the broker-dealers and made available to the Commission, Commission staff, and SROs, as required in connection with examinations, investigations, and enforcement proceedings. The information collected under the amendments to Rule 17a-11 would be generated from the internal records of the broker-dealers. It would be provided to the Commission, its staff, and SROs but not on a regular basis (except for the optional monthly reports).

To the extent that the Commission receives confidential information pursuant to these collections of information, the Commission is committed to protecting the confidentiality of such information to the extent permitted by law.[579]

Broker-dealers will send required written notices regarding use of a PAB account holder's securities to its customers, as required by Rule 15c3-3.[580] In addition, broker-dealers will send certain notices and disclosures to customers regarding the treatment of

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579 See, e.g., Exchange Act Section 24, 15 U.S.C. 78x (governing the public availability of information obtained by the Commission) and 5 U.S.C. 552 et seq. (Freedom of Information Act – "FOIA"). FOIA provides at least two pertinent exemptions under which the Commission has authority to withhold certain information. FOIA Exemption 4 provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). FOIA Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8).

580 See 17 CFR 15c3-3(b)(5).

their free credit balances under new paragraph (j)(2) to Rule 15c3-3. To the extent these standard notices and disclosures are made available to the Commission, they may not be kept confidential.

G. Record Retention Period

One amendment to Rule 15c3-1 will require broker-dealers to make disclosures to principals and obtain agreements from principals with respect to securities lending transactions where the broker-dealer acts as agent. In addition, the amendment to Rule 15c3-3 to define the term PAB account will require carrying broker-dealers to enter into subordination agreements with certain account holders if they wish their account to be excluded from the definition. These records will have to be maintained for not less than three years under paragraph (b)(7) of Rule 17a-4.[581]

The amendments to Rule 15c3-3 require broker-dealers to provide PAB account holders with written notice that the securities may be used in the ordinary course of its business, obtain the written affirmative consent of a new customer before including a customer's free credit balances in a Sweep Program, and provide certain disclosures and notices to all customers with regard to the broker-dealer's Sweep Program. These agreements relate to the terms and conditions of the maintenance of the customer's account and, accordingly, fall within the record retention requirements of paragraph (c) of Rule 17a-4.[582] Under this paragraph, the records must be retained until six years after the closing of the customer's account. The amendments to Rule 15c3-3 also require broker-dealers to obtain notices and contracts from the banks holding their PAB reserve accounts. In order to comply with Rule 15c3-3, broker-dealers must have these notices

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[581] 17 CFR 240.17a-4(b)(7).

[582] 17 CFR 240.17a-4(c).

and contracts in place and documented. These records will have to be maintained for not less than three years under the requirements of Rule 17a-4.[583]

The amendments to Rules 17a-3 and 17a-4 require broker-dealers to document credit, market, and liquidity risk management controls. The amendments to Rule 17a-4 include the establishment of a retention period for these records, which will be until three years after the termination of the use of the risk management controls documented therein under new paragraph (e)(9) of Rule 17a-4. The three-year retention period is designed to document former and current procedures and to provide sufficient opportunity to review the records during the broker-dealer's normal exam cycle.

The amendments to Rule 17a-11 will require broker-dealers to provide notice or report monthly to the Commission and other regulatory authorities under certain circumstances. These notices and reports will constitute communications relating to a broker-dealer's "business as such" and, therefore, will need to be retained for three years.[584]

V. ECONOMIC ANALYSIS

A. Introduction

The Commission is sensitive to the costs and benefits of its rules. When engaging in rulemaking that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, section 3(f) of the Exchange Act requires that the Commission consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[585] In addition, section 23(a)(2) of the Exchange Act requires the Commission to consider the effects on

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583 17 CFR 240.17a-4.

584 17 CFR 240.17a-4(b)(4).

585 15 U.S.C. 78c(f).

competition of any rules the Commission adopts under the Exchange Act, and prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[586]

In the proposing release,[587] the Commission solicited comment on the costs and benefits of the proposed amendments including whether these costs and benefits were accurate.[588] The Commission also requested that commenters identify and assess any costs and benefits not discussed in the proposing release. The Commission further encouraged commenters to provide specific data and analysis in support of their views.[589] The Commission also requested comment on whether the proposed amendments would place a burden on competition, and promote efficiency, competition, and capital formation.[590] In May 2012, the Commission re-opened the comment period to permit commenters additional opportunity to address these, and any other, issues raised by the

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586 15 U.S.C. 78w(a)(2).

587 See Amendments to Financial Responsibility Rules, 72 FR at 12879; see also Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 66910 (May 3, 2012), 77 FR 27150 (May 9, 2012) (re-opening of comment period).

588 For the purposes of this final economic analysis, the Commission is using salary data from the SIFMA Management & Professional Earnings in the Securities Industry 2012, which provides base salary and bonus information for middle-management and professional positions within the securities industry. The salary costs derived from the report and referenced in this cost/benefit section, are modified to account for an 1800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. Hereinafter, references to data derived from the report as modified in the manner described above will be cited as "SIFMA 2012 Report as Modified." The proposing release used salary information for New York based employees derived from the SIA Report on Management and Professional Earnings in the Securities Industry 2005. See Amendments to Financial Responsibility Rules, 72 FR at 12879, n.151.

589 Id. at 12879.

590 Id.

proposed rule amendments.[591] The general comments received, as well as comments received relating to specific rule amendments, are discussed below.

In adopting the rule amendments, the Commission has been mindful of the associated costs and benefits. The discussion focuses on the Commission's reasons for adopting these amendments, the affected parties, the costs and benefits of the amendments compared to a baseline, and alternative courses of action. The discussion of the costs of the rule amendments includes a discussion of certain implementation burdens and related costs,[592] which may include assessment costs, personnel costs, and other costs (e.g., technology costs).[593] The cost estimates and related data derived from FOCUS Reports discussed in the proposing release have also been updated in this final release to reflect more recently available data.[594]

Many of the benefits and costs discussed below are difficult to quantify, in particular when discussing enhancements in investor protection. For example, it is unknown how much the amendments to the financial responsibility rules will result in enhanced compliance with those rules. Therefore, much of the discussion is qualitative in nature but, where possible, the Commission has attempted to quantify the costs. However, the inability to quantify these costs and benefits does not mean that the costs and benefits of these rule amendments are any less significant.

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591 Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 66910 (May 3, 2012), 77 FR 27150 (May 9, 2012).

592 In the proposing release, the Commission estimated that the one-time and annual costs to broker-dealers would be $32,814,454 and $39,651,716, respectively. See Amendments to Financial Responsibility Rules, 72 FR at 12887.

593 As discussed in section IV. of this release, the Commission has estimated certain indirect burdens and related costs of these implementation requirements.

594 See Amendments to Financial Responsibility Rules, 72 FR at 12887. The FOCUS Report data from the proposing release was derived from 2004 year end numbers.

As discussed throughout this release, in part in response to comments, the Commission has modified the proposed rules to reduce compliance burdens where consistent with investor protection. In addition, where commenters identified additional costs, the Commission has revised its economic analysis of the final rules to take these costs into account. Finally, the Commission has considered all comment letters received related to the impact of the proposed amendments on efficiency, competition, and capital formation, and responds to these comments in the sections below discussing individual rule amendments.

B. Economic Baseline

The regulatory changes adopted today amend requirements that apply to broker-dealers registered with the Commission. The discussion below includes the approximate numbers of broker-dealers that will be affected by today's amendments and a description of the economic baseline against which the costs and benefits, as well as the impact on efficiency, competition, and capital formation, of today's amendments are measured.

The broker-dealers registered with the Commission vary significantly in terms of their size, business activities, and the complexities of their operations. For example, carrying broker-dealers hold customer securities and funds.[595] Clearing broker-dealers clear transactions as members of security exchanges, the Depository Trust & Clearing

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[595] Rule 15c3-1 specifies that a broker-dealer shall be deemed to carry customer accounts "if, in connection with its activities as a broker or dealer, it receives checks, drafts, or other evidences of indebtedness made payable to itself or persons other than the requisite registered broker or dealer carrying the account of a customer, escrow agent, issuer, underwriter, sponsor, or other distributor of securities" or "if it does not promptly forward or promptly deliver all of the securities of customers or of other brokers or dealers received by the firm in connection with its activities as a broker or dealer." 17 CFR 240.15c3-1(a)(2)(i). Rule 15c3-3 defines the term securities carried for the account of a customer to mean "securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the account of any customer," as well as securities sold to, or bought for, a customer by a broker-dealer. 17 CFR 240.15c3-3(a)(2).

Corporation and the Options Clearing Corporation.[596] Many clearing broker-dealers are carrying broker-dealers, but some clearing broker-dealers clear only their own transactions and do not hold customer securities and cash.

In addition, a broker-dealer that does not hold customer securities and/or cash is generally referred to as a "non-carrying broker-dealer." Non-carrying broker-dealers include "introducing brokers."[597] These introducing broker-dealers accept customer orders and introduce their customers to carrying broker-dealers that hold the securities and cash of the customers of the introducing broker-dealers along with the securities and cash of their direct customers. A carrying broker-dealer generally receives and executes orders of the introducing broker-dealers' customers.[598] Carrying broker-dealers generally also prepare trade confirmations, settle trades, and organize book entries of the securities purchased and sold.[599] Introducing broker-dealers also may use carrying broker-dealers to clear the introducing firm's proprietary trades and carry the firm's securities. Another group of non-carrying broker-dealers effects transactions in securities like mutual funds on a subscription-way basis, where customers generally purchase the securities by

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596 See Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Exchange Act Release No. 56501 (Sept. 24, 2007), 72 FR 56514 (Oct. 3, 2007), at n.269.

597 Id. at ¶ 1.15; see also Net Capital Rule, Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992) (describing role of introducing broker-dealers).

598 Net Capital Rule, Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992).

599 See, e.g., FINRA Rule 4311 (Carrying Agreements). This FINRA rule governs the requirements applicable to FINRA members when entering into agreements for the carrying of any customer accounts in which securities transactions can be effected. Historically, the purpose of this rule has been to ensure that certain functions and responsibilities are clearly allocated to either the introducing or carrying firm, consistent with the requirements of the SRO's and Commission's financial responsibility and other rules and regulations, as applicable. See also Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Adopting, as Modified by Amendment No. 1, Rules Governing Guarantees, Carrying Agreements, Security Counts and Supervision of General Ledger Accounts in the Consolidated FINRA Rulebook, Exchange Act Release No. 63999 (Mar. 7, 2011), 76 FR 12380 (Mar. 7, 2011).

providing the funds directly to the issuer.[600] Finally, some non-carrying broker-dealers act as finders by referring prospective purchasers of securities to issuers.[601]

While these amendments will impact investors and markets more generally, the broker-dealer industry is the primary industry directly affected by the rule amendments. In some cases, the amendments impose requirements on certain types of broker-dealers that engage in specific activities. For example, only carrying broker-dealers that carry free credit balances would be subject to the requirements regarding the treatment of free credit balances under paragraph (j) of Rule 15c3-3. All broker-dealers would be subject to the requirements to deduct from net worth certain liabilities or expenses assumed by third parties under Rule 15c3-1.

To establish a baseline for competition among broker-dealers, the Commission looked at the status of the broker-dealer industry detailed below. In terms of size, the following table provides the distribution of broker-dealers by total capital levels and the aggregate total capital within each capital bracket.

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600 See Books and Records Requirement for Brokers and Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 44992 (Nov. 2, 2001) ("[T]he Commission recognizes that for some types of transactions, such as purchases of mutual funds or variable annuities, the customer may simply fill out an application or a subscription agreement that the broker-dealer then forwards directly to the issuer.").

601 See American Bar Association, Report and Recommendations of the Task Force on Private Placement Broker-Dealers 23–24 (2005); see also Net Capital Rule, Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992).

Broker-Dealer Capital at Calendar Year End 2011[602]
($ millions)

Capital	Number of Firms	Aggregate Total Capital
Less than $500,000	2,506	$347
Greater than or equal to $500,000 and less than $5 million	1,320	$2,212
Greater than or equal to $5 million and less than $50 million	608	$10,520
Greater than or equal to $50 million and less than $100 million	80	$5,672
Greater than or equal to $100 million and less than $500 million	125	$26,655
Greater than or equal to $500 million and less than $1 billion	28	$19,248
Greater than or equal to $1 billion and less than $5 billion	27	$61,284
Greater than or equal to $5 billion and less than $10 billion	6	$41,175
Greater than or equal to $10 billion	9	$175,585
Total	**4,709**	**$342,698**

According to FOCUS Report data, as of December 31, 2011, there were approximately 4,709 broker-dealers registered with the Commission. Nine broker-dealers hold over half of broker-dealers' total capital. Further, based on FOCUS Report data, as of December 31, 2011, the Commission also estimates that there are approximately 287 broker-dealers that are clearing or carrying firms that do not claim exemptions pursuant to paragraph (k) of Rule 15c3-3. Based on FOCUS Report data, as of December 31, 2011, approximately 189 of these broker-dealers carry free credit balances, while 61 broker-dealers carry PAB accounts.

For the purposes of this economic analysis, the baseline is the current customer protection, net capital, books and records, and notification requirements for broker-dealers promulgated under the Exchange Act and existing interpretations thereunder, and how they affect broker-dealers.

As discussed above in section II.A.1. of this release, Rule 15c3-3 – the customer protection rule – in effect mandates a separation of customer assets from broker-dealer

602 The information in this chart is based on FOCUS Report data filed by broker-dealers in 2011. The information in the "Aggregate Total Capital" column is based on data reported on line 3530 of the FOCUS Report, which includes total capital and allowable subordinated liabilities.

assets through two fundamental requirements: (1) that a carrying broker-dealer must maintain physical possession or control over customers' fully paid and excess margin securities; and (2) that a carrying broker-dealer must maintain a reserve of cash or qualified securities[603] in an account at a bank that is at least equal in value to the net cash owed to customers, including cash obtained from the use of customer securities. These provisions are designed to require the broker-dealer to hold customer securities and cash in a manner that enables the prompt return of these assets in the event that the firm falls into financial difficulty or becomes insolvent. The goal of the rule is to place a broker-dealer in a position where it is able to wind down in an orderly self-liquidation without the need for financial assistance from SIPC through a formal proceeding under SIPA.[604]

As discussed above in section II.E. of this release, Rule 15c3-1 – the net capital rule – requires broker-dealers to maintain a minimum level of net capital (meaning highly liquid capital) at all times.[605] The rule requires that a broker-dealer perform two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain;[606] and (2) a computation of the amount of net capital the broker-dealer is maintaining.[607] The minimum net capital requirement is the greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio or the 2% of aggregate debit

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603 Rule 15c3-3 defines qualified securities as securities issued by the United States or guaranteed by the United States with respect to principal and interest. 17 CFR 240.15c3-3(a)(6).

604 15 U.S.C. 78aaa et seq.

605 See 17 CFR 240.15c3-1.

606 See 17 CFR 240.15c3-1(a).

607 See 17 CFR 240.15c3-1(c)(2). The computation of net capital is based on the definition of net capital in paragraph (c)(2) of Rule 15c3-1. Id.

items ratio.[608] In computing net capital, the broker-dealer must, among other things, make certain adjustments to net worth, such as deducting illiquid assets, taking other capital charges, and adding qualifying subordinated loans.[609] The amount remaining after these adjustments is defined as tentative net capital.[610] The final step in computing net capital is to take prescribed percentage deductions ("standardized haircuts") from the mark-to-market value of the proprietary positions (e.g., securities, money market instruments, and commodities) that are included in its tentative net capital.[611]

As discussed above in section II.D. of this release, Rule 17a-3 and 17a-4 – the books and records rules – require broker-dealers to make and keep current certain records (e.g., trade blotters, asset and liability ledgers, income ledgers, customer account ledgers, etc.), which must be maintained in a specific manner for required retention periods. [612] Finally, Rule 17a-11 – the notification rule – requires a broker-dealer to notify the Commission and its DEA when certain events occur, such as if it fails to maintain certain levels of net capital.[613]

The specific requirements as well as the benefits and costs of each amendment and how broker-dealers will be affected are discussed in more detail in the sections below.

C. Discussion of General Comments Received

As stated above, in the proposing release, the Commission requested comment on estimates and views regarding the costs and benefits for particular types of market

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608 See 17 CFR 240.15c3-1(a).

609 See 17 CFR 240.15c3-1(c)(2)(i)–(xiii).

610 See 17 CFR 240.15c3-1(c)(15).

611 See 17 CFR 240.15c3-1(c)(2)(vi).

612 17 CFR 240.17a-3; 17 CFR 240.17a-4.

613 17 CFR 240.17a-11.

participants, as well as any other costs and benefits that may result from the adoption of the proposed rules.[614] In response to this specific request, the Commission received two comment letters.[615] The first commenter who was explicitly addressing the Commission's Initial Regulatory Flexibility Analysis stated that the Commission should pay "explicit attention to regulatory trends in the rest of the world" because doing so "benefits not only small entities [the focus of the Initial Regulatory Flexibility Analysis] (by reducing their regulatory burden) but all entities, as larger entities can experience more consistent regulatory procedures around the world."[616] The commenter suggested that the Commission consider a "Basel II type approach to net capital requirements."[617] The second commenter requested that the Commission publish an update to all statistics and costs referenced in the proposing release.[618] The commenter further requested that, once published, the Commission reopen the comment period so that comments could be provided based on "current conditions and statistics."[619]

In response to the first commenter's request that the Commission should explicitly examine the alternatives used by regulators in other jurisdictions,[620] in adopting the final rule amendments today, as discussed throughout this section, the Commission considered reasonable alternatives, including alternatives in other jurisdictions, as well as the costs and benefits of the amendments. Moreover, the amendments relate to discrete areas of the broker-dealer financial responsibility rules (i.e., they do not establish new

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614 See Amendments to Financial Responsibility Rules, 72 FR at 12879.

615 See Angel Letter; NIBA 2 Letter.

616 See Angel Letter.

617 Id.

618 See NIBA 2 Letter.

619 Id.

620 See Angel Letter.

financial responsibility standards such as would be the case if the Commission were to adopt a "Basel II type approach to net capital requirements."). Consequently, the commenter's suggestion is beyond the scope of this rulemaking.[621]

In response to the second commenter, the Commission is publishing updated costs and statistics in this release. The Commission, however, believes that it is unnecessary to reopen the comment period to obtain comment on the updated statistics for several reasons. First, in proposing the rule changes, the Commission included then current estimates in the proposing release. Second, as noted above, the Commission reopened the comment period in 2012.[622] The reopening of the comment period afforded commenters an additional opportunity to comment on the proposed rules (including estimated costs and benefits), given the economic events since the rule amendments were proposed, the regulatory developments, the comments received on the proposed amendments, the continuing public interest in the proposed amendments, and the passage of time.[623] The Commission received a total of 97 comment letters on the proposed amendments.[624] As discussed below, in many cases, the revised data included in this release reflects a decrease in overall costs because of the decline in the total number of broker-dealers (including the number of broker-dealers that will be affected by each of these rule amendments). As of the 2004 year end, the number of registered broker-dealers was 6,339. As of the 2011 year end, the number of registered broker-dealers was

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621 The commenter cited the JP Morgan Letter in support of the suggestion to "consider regulatory trends in the rest of the world." Id. The JP Morgan Letter recommends that the Commission adopt a due diligence standard – citing a U.K. regulation – with respect to the amendments regarding customer reserve account cash deposits. See JP Morgan Letter. The Commission addresses this comment below in section V.D.1.i.b.(III) of this release.

622 Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 66910 (May 3, 2012), 77 FR 27150 (May 9, 2012).

623 Id.

624 See supra note 6.

4,709, reflecting a net decrease of 1,630 (or 26%) in the number of registered broker-dealers. Consequently, many of the aggregate costs included in the proposing release have declined due to the decrease in the number of registered broker-dealers.

Further, the costs incurred by a broker-dealer to comply with the rule amendments will generally depend, among other factors, on the size and complexity of its business activities. Because the size and complexity of broker-dealers varies significantly, their costs also could vary significantly. In some cases, the Commission provided in the proposing release, and is providing here, estimates of the average cost per broker-dealer, taking into consideration the variance in size and complexity of the business activities of broker-dealers. In other cases, the cost impact to broker-dealers will depend on whether the broker-dealer is conducting activities that are subject to the rule amendments. For example, the amendments to Rule 15c3-3 will apply, for the most part, only to broker-dealers that carry PAB accounts (e.g., PAB account amendment), have a reserve deposit requirement (e.g., reserve bank account amendments), or carry free credit balances (e.g., free credit balance amendments). These amendments would have no direct cost impact on non-carrying broker-dealers, many of which are small broker-dealers. Moreover, given that some amendments are largely codifications of existing Commission and staff guidance (e.g., amendments related to PAB accounts, third parties assuming broker-dealer liabilities, temporary capital contributions, and fidelity bond deductions), any economic effects, including costs and benefits, should be compared to the baseline of current practice. Broker-dealers that are already complying with these requirements would not be expected to incur substantial costs to comply with these amendments.

The second commenter also stated that broker-dealers are dealing with relatively static commission and fee schedules in comparison to what they might charge customers, and, as such, broker-dealers will be unable to pass on any cost increases resulting from

these rule amendments directly to customers.[625] The commenter stated that these cost increases over a relatively short period of time threaten the viability of all small broker-dealers, irrespective of their business line types or classes.[626] The commenter noted that the estimates provided by the Commission utilized only the number of broker-dealers in its estimate that the Commission justifiably considered to be affected by the proposals.[627] In contrast, the commenter believes that most, if not all broker-dealers will spend over 90 hours each analyzing the effects of these proposals and, if the rules are implemented, will spend much more than 90 hours each in implementing procedures to comply with the new rules. The commenter also believes that implementation will require broker-dealers to modify their written supervisory procedures and supervisory controls, and broker-dealers will spend in excess of 240 hours each in the monitoring of such rules on an ongoing basis. Consequently, the commenter believes that each broker-dealer will spend in excess of $15,000 for outside counsel and auditor opinions or work product.[628] This commenter did not provide additional detail about the basis for its view that the Commission's estimates were too low.

As stated above in section IV. of this release, the Commission agrees with the commenter that the broker-dealers directly affected by the rule amendments may be required to implement procedures or modify their written supervisory procedures to comply with the rule amendments. In cases where the rule amendments require a broker-dealer to directly implement or document certain policies and procedures, these hour burdens and costs already are incorporated into the PRA costs discussed above in section

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625 See NIBA 2 Letter.

626 Id.

627 Id.

628 Id.

IV. of this release, and incorporated into the discussion below.[629] In response to the commenter, the Commission also acknowledges that a broker-dealer may need to review its operations to determine whether it has any obligations under the rule amendments. Even if the broker-dealer is not affected by the rule amendments, such a review may result in an indirect effect on its operations. These indirect costs are discussed in more detail below. In adopting these final rules, as discussed throughout the release, including this economic analysis, the Commission has sought to take into account the costs and benefits associated with each particular rule amendment. The Commission has also considered the indirect costs that a broker-dealer would incur to assess the impact of these final rule amendments.

The Commission estimates that a broker-dealer likely will hire outside counsel to assess the impact of the final rules on the broker-dealer's operations because all broker-dealers may be affected by the final rules, including non-carrying broker-dealers that may be affected by certain amendments, such as the Rule 15c3-1 amendments regarding third party liabilities or temporary capital contributions. Whether a broker-dealer determines to incur such assessment costs will depend on the nature and size of the broker-dealer's business and the range of activities the broker-dealer conducts. Therefore, while the Commission cannot estimate an aggregate assessment cost for all broker-dealers, the Commission estimates that these assessment costs would range approximately from $2,000 to $30,000[630] per broker-dealer.[631]

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629 See, e.g., paragraph (j)(1) of Rule 15c3-3 and paragraph (a)(23) of Rule 17a-3, as adopted.

630 These costs estimates include hour estimates in the range of 5 hours to 75 hours for outside counsel assessment review. A small broker-dealer may hire outside counsel to review only 1 or 2 of the final rule amendments for approximately 5 hours x $400 per hour = $2,000. See Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 64766, 76 FR 42396 (June 29, 2011), 76 FR 42396 (July 18, 2011) (applying the estimated cost of $400 for

D. Economic Analysis of the Amendments and Alternatives

This section discusses costs and benefits of the rule amendments for the affected parties against the economic baseline identified above, both in terms of each of the specific changes from the baseline and in terms of the overall impact. In considering costs, benefits, and overall impact, this discussion addresses comments received, modifications made to the proposed amendments, and reasonable alternatives, where applicable.

This section also discusses the Commission's considerations on the burden on competition, and the promotion of efficiency, competition, and capital formation.[632] In significant part, the effects of the final rules on efficiency and capital formation are linked to the effects of these rules on competition. Competitive markets are generally expected to promote an efficient allocation of capital. Rules that promote, or do not unduly restrict, investor participation and competition in the broker-dealer industry can

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legal services by outside counsel). See also Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", Exchange Act Release No. 66868 (Apr. 27, 2012), 77 FR 30596 (May 23, 2012) (noting that the review of the final rules by outside counsel for a large firm would generally cost more because the review would be more complex).

631 As discussed above, and in section IV. of this release, broker-dealers directly affected by a specific rule amendment may be required to implement procedures or modify their written supervisory procedures in order to comply with the rule amendments. The hours and related costs are discussed in section IV. of this release, and are incorporated into the specific sections below discussing each rule amendment. Therefore, while the range of hours is less than 90 hours (as suggested by the commenter), the Commission has adjusted other specific hour and cost estimates (in sections IV. and V. of this release) in response to the commenter's concerns, and believes these adjusted estimates, in totality, for the reasons discussed above, adequately address the estimated costs as well as the commenter's concerns. See NIBA 2 Letter.

632 In the proposing release, the Commission stated that its preliminary view was that the proposed amendments promote efficiency, competition, and capital formation and would not have any anti-competitive effects. See Amendments to Financial Responsibility Rules, 72 FR at 12887.

be accompanied by regulatory benefits that may reduce the risk of market failure and thus promote market efficiency and capital formation.

1. Amendments to the Customer Protection Rule

i. Economic Analysis

a. Proprietary Accounts of Broker-Dealers

(I). Summary of Amendments

Today's amendments to Rules 15c3-3 and 15c3-3a require carrying broker-dealers to: (1) perform a separate reserve computation for PAB accounts (in addition to the customer reserve computation currently required under Rule 15c3-3);[633] (2) establish and fund a separate reserve account for the benefit of the PAB account holders;[634] and (3) obtain and maintain physical possession or control of securities carried for a PAB account, unless the carrying broker-dealer has provided written notice to the PAB account holder that the securities may be used in the ordinary course of its securities business, and has provided opportunity for the PAB account holder to object.[635] In addition to the amendments to Rules 15c3-3 and 15c3-3a, the Commission is adopting amendments to Rule 15c3-1 that will require a broker-dealer to deduct from net capital cash and securities held in a securities account at a carrying broker-dealer except where the account has been subordinated to the claims of creditors of the carrying broker-dealer.[636]

As discussed above in section II.A.2. of this release, there is a disparity between the customer reserve requirements in Rule 15c3-3 and the treatment of customers in a

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633 17 CFR 250.15c3-3(e)(3).

634 17 CFR 240.15c3-3(e)(1).

635 17 CFR 240.15c3-3(b)(5).

636 17 CFR 240.15c3-1(c)(2)(iv)(E).

liquidation proceeding under SIPA.[637] Broker-dealers are not within the definition of customer for the purposes of Rule 15c3-3.[638] Accordingly, a carrying broker-dealer that carries PAB accounts is not required to treat these accounts as customer accounts for the purposes of Rule 15c3-3. However, the definition of customer in SIPA is broader than the definition in Rule 15c3-3 in that the SIPA definition does not exclude broker-dealers.[639]

SIPA customers are entitled to a number of protections if their broker-dealer fails and is liquidated in a SIPA proceeding, including the right to share pro rata with other SIPA customers in the customer property held by the broker-dealer and, if the fund of customer property is insufficient to make each SIPA customer whole, the entitlement to receive an advance from the SIPC fund of up to $500,000 (of which only $250,000 can be used to cover cash claims).[640] Broker-dealers that are SIPA customers have the right to share pro rata in customer property.[641] Consequently, when a carrying broker-dealer is liquidated in a SIPA proceeding, each customer (including a SIPA customer that is a broker-dealer) has a claim on the customer property. However, because the possession and control and customer reserve account provisions of Rule 15c3-3 do not apply to PAB account holders by virtue of the definition of customer in the rule, the carrying broker-

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637 15 U.S.C. 78aaa et seq.

638 17 CFR 240.15c3-3(a)(1).

639 See 15 U.S.C. 78lll(a).

640 See 15 U.S.C. 78fff-2(c) and 15 U.S.C. 78fff-3(a), respectively. Under SIPA, the term customer property includes "cash and securities … at any time received, acquired, or held by or for the account of the debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." Therefore, customer property includes those securities positions that are held for customers and the cash that is owed to customers. 15 U.S.C. 78lll(4).

641 See 15 U.S.C. 78fff-2(c). Broker-dealers, however, are not entitled to receive an advance from the SIPC fund. 15 U.S.C. 78fff-3(a).

dealer is not restricted from using the securities and cash in these accounts for its business purposes.

The treatment of PAB account holders as customers for the purposes of SIPA but not as customers for the purposes of Rule 15c3-3 increases the risk that, in the event that a carrying broker-dealer is liquidated under SIPA, the claims of all SIPA customers will exceed the amount of customer property available and, thereby, expose the SIPC fund and potentially SIPA customers to losses. In addition, if the customer property is insufficient to satisfy fully all SIPA customer claims, and losses are incurred, the broker-dealer SIPA customers could be potentially placed in financial distress causing adverse effects to the securities markets, in addition to the adverse effects resulting from the failure of the carrying broker-dealer.[642]

The amendments address the disparity between the customer reserve requirements in Rule 15c3-3 and the treatment of customers in a liquidation proceeding under SIPA by requiring broker-dealers to reserve for the amount that credits exceed debits with respect to broker-dealer accounts. The amendments create a process that protects customers and PAB account holders of a failed carrying broker-dealer, and are designed to provide such protection by mitigating the risk that there will be insufficient customer property to fully satisfy all customer claims in a SIPA liquidation. By requiring the protection of PAB account holders (who qualify as customers under SIPA), the amendments to Rule 15c3-3 also reduce the risk that advances from the SIPC fund would be necessary to protect customer claims.

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[642] As noted above, while broker-dealers are customers for the purposes of SIPA, they are not entitled to the advances from the SIPC fund of up to $500,000 (limited to $250,000 for cash claims) allowed under SIPA to make up for potential shortfalls after the pro rata distribution of customer property. 15 U.S.C. 78fff-3(a).

The amendments to Rule 15c3-1 are intended to prevent broker-dealers from including in their net capital amount assets that may not be readily available to be returned to such broker-dealer account holders because the assets would not be subject to the PAB account provisions under Rules 15c3-3 and 15c3-3a. The amendments to Rule 15c3-1 also provide consistency with the exclusions from the definition of PAB account in paragraph (a)(16) of Rule 15c3-3.

Overall, the PAB-related amendments to Rules 15c3-3, 15c3-3a, and 15c3-1 should serve to reduce certain risks to investors and PAB account holders and, thereby, strengthen customer protection. The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. The Commission did not receive any comments in response to this request.

(II). Baseline and Incremental Economic Effects

Under the no-action relief set forth in the PAIB Letter,[643] discussed in section II.A.2 of this release, broker-dealers currently perform a reserve computation for domestic broker-dealer accounts and have obtained the necessary agreements and notices from the banks holding their PAIB reserve deposits. Therefore, as compared to the baseline of current Rule 15c3-1 and existing interpretations and guidance thereunder, including the no-action relief set forth in the PAIB Letter, the amendments will likely result only in small incremental benefits and costs because the final rule codifies many of the provisions of the PAIB Letter.[644]

Incorporation of certain aspects of the PAIB Letter into Rule 15c3-3 is intended to provide broker-dealers with more certainty with respect to the PAB requirements because

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643 See PAIB Letter.

644 See section II.B. of this release. The PAIB Letter is being withdrawn as of the effective date of these rule amendments.

these requirements will be expressly stated in a Commission rule. Moreover, the PAB final rule amendments will not impose a significant additional burden on broker-dealers presently utilizing the interpretive relief provided in the PAIB Letter since the provisions of the final rule amendments are substantially similar. Relative to the baseline, there will be economic differences to the extent that carrying broker-dealers are currently not following the PAIB Letter, as compliance with conditions of the PAIB Letter are voluntary, while the PAB amendments to Rule 15c3-3 will be mandatory for the carrying broker-dealers subject to its requirements. Consequently, to the extent that carrying broker-dealers are not currently complying with the PAIB Letter, and to the extent the amendments as adopted differ from the PAIB Letter, they may incur incremental costs, including possible costs of capital as firms reallocate capital to comply with the rule amendments.

(III). Alternatives

In adopting these amendments, the Commission considered alternatives suggested by commenters on specific provisions of the rule, and incorporated some of these alternative approaches into the final rule amendments.

Two commenters raised concerns about the proposed definition of the term PAB account, because by including proprietary accounts of foreign broker-dealers and foreign banks acting as broker-dealers within the definition, the definition would differ from provisions in the PAIB Letter, which excluded such accounts from a PAIB computation.[645] The first commenter suggested allowing broker-dealers to "opt out" of the rule.[646] The second commenter stated that foreign broker-dealers and foreign banks acting as broker-dealers should be allowed to subordinate their claims to customers and

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[645] See Dresdner Kleinwort Letter; Deutsche Bank Securities Letter.

[646] See Dresdner Kleinwort Letter.

creditors of the broker-dealer to remove their accounts from PAB account treatment because under SIPA foreign broker-dealers and foreign banks acting as broker-dealers, under certain circumstances, will not be deemed customers and, therefore, would not be entitled to a pro rata share of the estate of customer property in a SIPA liquidation.[647] More specifically, the commenter suggested that, to parallel the language in SIPA,[648] the Commission modify the definition of PAB account to exclude "any foreign broker-dealer and foreign bank, to the extent that such entity has a claim for cash or securities that is subordinated to the claims of creditors of the carrying broker-dealer." This commenter also recommended that the subordinating broker-dealer would need to follow the requirements for non-conforming subordinated loans to remove an account from being treated as a PAB account.[649]

In response to commenters' concerns and suggested alternatives, the Commission is excluding from the PAB account definition accounts that have been subordinated to the claims of creditors of the carrying broker-dealer. Consequently, this provision will provide flexibility to carrying broker-dealers and their broker-dealer affiliates to structure their PAB account relationships in a manner that permits operational efficiencies (i.e., the ability to exclude these accounts from the PAB reserve computation) while still promoting the goal of the amendments to have a consistent treatment of these accounts under Rule 15c3-3 and SIPA, and thereby protect accounts holders that are customers under SIPA. As discussed below, however, the requirement to enter into a subordination

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647 See Deutsche Bank Securities Letter.

648 Id. The definition of customer in SIPA excludes any person, to the extent that "such person has a claim for cash or securities which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor, or is subordinated to the claims of any or all creditors of the debtor, notwithstanding that some ground exists for declaring such contract, agreement, or understanding void or voidable in a suit between the claimant and the debtor." 15 U.S.C. 78lll(2)(C)(ii).

649 See Deutsche Bank Securities Letter.

agreement with certain account holders to exclude them from the definition of PAB account may result in a one-time cost to broker-dealers.

In addition, in the proposing release, the Commission proposed to require that a carrying broker-dealer obtain written permission from a PAB account holder before it could use the securities of the PAB account holder in the ordinary course of its securities business. One commenter stated that this provision should be eliminated from the proposed amendments, arguing that it interferes unnecessarily in the contractual arrangements between broker-dealers, which are capable of understanding the terms of standard industry custodial relationships and that the PAIB Letter did not contain any such requirements. The Commission considered this alternative and believes that an appropriate level of protection for PAB account holders will be achieved by requiring the carrying broker-dealer to provide written notice to the PAB account holders that the firm may use their non-margin securities in the ordinary course of its securities business. The written notice requirement in the final rule will increase protection for PAB account holders from the status quo without imposing substantial burdens on existing account relationships. The revised rule will alert PAB account holders to the fact that the carrying broker-dealer may use their securities in its business for its own benefit, thereby reducing possible contractual ambiguity between the PAB account holder and the broker-dealer. The revised rule also will provide a PAB account holder the opportunity to seek to move the account to another broker-dealer or to negotiate different terms with regard to the use of its securities. Finally, this amendment will eliminate the need for, and the costs that would result from, carrying broker-dealers reworking existing contracts.

An alternative considered in adopting the PAB-related amendments to Rule 15c3-1 would have required a broker-dealer, when calculating net capital, to deduct from net worth cash and securities held in a securities account at another broker-dealer, if the other

broker-dealer does not treat the account, and the assets in the account, in compliance with the applicable PAB requirements of the rule.[650] Although the proposing release stated that the Commission did not expect broker-dealers to audit or examine their carrying broker-dealers to determine whether such firms were in compliance with the proposed rule, commenters expressed concern that the proposed rule text suggested that broker-dealers in fact would have such an obligation.[651] There were also concerns expressed that a broker-dealer should not be deemed to have violated the net capital rule because its carrying firm fails to properly perform requirements solely applicable to the carrying firm and that Rule 15c3-1 should be modified to clarify that cash and securities held in a securities account at another broker-dealer are not subject to the deduction specified in paragraph (c)(2)(iv)(E) of Rule 15c3-1.[652] In response to these concerns, the Commission has modified the language in the Rule 15c3-1 to eliminate the proposed capital charge that would have resulted from a failure of a carrying broker-dealer to comply with the PAB requirements. Instead, the Commission has adopted amendments providing that a broker-dealer need not deduct cash and securities held in a securities account at another broker-dealer, with one exception. As discussed in section II.A.2. of this release, the exception generally parallels the exclusions from the definition of PAB account in Rule 15c3-3.

(IV). Compliance Cost Estimates

The Commission is mindful of the compliance costs associated with the final PAB rule amendments. In particular, the Commission recognizes that, though many requirements of the PAB rule amendments being adopted by the Commission today are

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650 See section II.A.2.v. of this release.

651 See SIFMA 2 Letter.

652 Id.

incorporated from the PAIB Letter, there may be incremental imposed costs. For example, as discussed above in section II.A.2. of this release, because the possession and control and customer reserve account provisions of Rule 15c3-3 do not apply to PAB account holders by virtue of the definition of customer in the rule, the carrying broker-dealer is not restricted from using the securities and cash in those accounts for its own business purposes. Broker-dealers carrying PAB accounts will be required to comply with the final PAB rule amendments, in contrast to the provisions of the PAIB Letter, which are voluntary.[653] To the extent that carrying broker-dealers are not currently complying with the PAIB Letter, or to the extent the amendments as adopted differ from the PAIB Letter, they may incur incremental costs, including possible costs of capital as firms reallocate capital to comply with the rule amendments.

The requirement to enter into a subordination agreement with certain account holders to exclude them from the definition of PAB account,[654] the requirement to provide written notice to PAB account holders that their securities may be used in the ordinary course of the carrying broker-dealer's securities business,[655] the requirement to amend the standard PAB agreement templates,[656] and the need to update systems to

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653 See PAIB Letter.

654 The internal hours for this requirement would likely be performed by an in-house Attorney at $379 per hour. Therefore the estimated internal cost would be calculated as follows: $379 per hour x 13,420 hours = $5,086,180. See also section IV.D.3. of this release.

655 The internal hours required to draft the notice would likely be performed by an in-house Attorney at $379 per hour. The estimated internal cost would be calculated as follows: $379 per hour x 610 hours = $231,190. The internal hours required to send out the notices would likely be performed by a Compliance Clerk at $63 per hour, resulting in an internal estimated cost calculated as follows: $63 per hour x 259 hours = $16,317. See also section IV.D.4. of this release.

656 The internal hours would likely be performed by an in-house Attorney at $379 per hour, resulting in an internal estimated cost calculated as follows: $379 per hour x 1,220 hours = $462,380. See also section IV.D.4. of this release.

implement the necessary changes[657] may also impose one-time costs. In addition, a carrying broker-dealer will incur postage costs as a result of the requirement to send written notices to PAB account holders regarding the use of their non-margin securities, as well as outside counsel fees to review the notice and standard PAB agreement template.[658] Finally, the requirements to compute and establish a separate reserve for PAB accounts will result in annual costs to carrying broker-dealers to the extent that these requirements will lengthen the time needed to compute and establish the PAB reserve account under the PAIB Letter. The Commission estimates that these requirements would impose one-time and annual costs in the aggregate of approximately $6,434,840[659] and $2,709,210,[660] respectively.

As noted above, the Commission requested comment on the proposed cost estimates.[661] In particular, the Commission requested comment on whether there would be additional costs to broker-dealers as a consequence of these proposals. The Commission requested comment on whether these requirements would result in such costs and, if so, how to quantify the costs. The Commission also requested comment on whether these proposals would impose costs on other market participants, including

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657 The internal hours would likely be performed by a Senior Programmer at $282 per hour, resulting in the estimated internal cost calculated as follows: $282 per hour x 1,830 hours = $516,060. See also section IV.D.4. of this release.

658 The estimated postage costs are calculated as follows: 1,551 notices x $0.46 = $713.46. To review and comment on the notice and PAB templates, the estimated outside counsel burden is $122,000, in aggregate. See also section IV.D.4. of this release.

659 See section IV.D.3 and 4. of this release ($5,086,180 + $231,190 + $16,317 + $462,380 + $516,060 + $713.46 + $122,000 = $6,434,840.46).

660 The internal hours would likely be performed by a Financial Reporting Manager at $294 per hour, resulting in the estimated internal cost calculated as follows: $294 per hour x 9,215 hours = $2,709,210. See also section IV.D.4. of this release.

661 See Amendments to Financial Responsibility Rules, 72 FR at 12880. In the proposing release, the Commission estimated that the one-time and annual costs to broker-dealers resulting from these proposed amendments would be $603,000 and $2,599,399. Id.

broker-dealer customers. Commenters were also asked to identify the metrics and sources of any empirical data that support their cost estimates. The Commission did not receive any comments in response to these requests.

b. Banks Where Special Reserve Deposits May Be Held

(I). Summary of Amendments

As amended, paragraph (e) of Rule 15c3-3 requires carrying broker-dealers to deposit cash or qualified securities into their customer or PAB reserve account, which must be maintained at a "bank."[662] As adopted, the final rule excludes when determining whether a broker-dealer maintains the minimum deposits required under paragraph (e) of Rule 15c3-3: (1) cash deposited with an affiliated bank; and (2) cash deposited at a "non-affiliated bank to the extent that the amount of the deposit exceeds 15% of the bank's equity capital as reported by the bank in its most recent Call Report or any successor form the bank is required to file by its appropriate Federal banking agency (as defined by Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813))."

Under paragraph (f) of Rule 15c3-3, a broker-dealer is currently required to obtain a written contract from the bank wherein the bank agrees not to re-lend or hypothecate the qualified securities deposited into the reserve account.[663] This means that the bank cannot use the qualified securities in its business, which provides a measure of protection by requiring that the securities will be available to the broker-dealer if the bank falls into

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662 The term qualified securities is defined in paragraph (a)(6) of Rule 15c3-3 to mean securities issued by the United States or guaranteed by the United States with respect to principal and interest. 17 CFR 240.15c3-3(a)(6). The term bank is defined in paragraph (a)(7) of Rule 15c3-3 as a "bank as defined in section 3(a)(6) of the Act and will also mean any building and loan, savings and loan or similar banking institution subject to the supervision by a Federal banking authority." See paragraph (a)(7) to Rule 15c3-3, as adopted.

663 17 CFR 240.15c3-3(f).

financial difficulty. Cash deposits, however, may be freely used in the course of the bank's commercial activities. Therefore, because they do not have that same type of protection, the amendments to Rule 15c3-3 enhance customer protection by prohibiting a carrying broker-dealer from holding customer cash deposits at its affiliated bank and establishing requirements designed to avoid the situation where a carrying broker-dealer's cash deposits constitute a substantial portion of the bank's deposits.

Customer cash deposits may be at risk if a carrying broker-dealer does not exercise due diligence when assessing the financial soundness of an affiliated bank with the same degree of impartiality and care as it would with an unaffiliated bank. The situation where a broker-dealer's cash constitutes a substantial portion of a bank's deposits also poses a risk that some or all of the cash deposits may not be readily available for quick withdrawal by the broker-dealer. Depending on the relative size of the deposit, a lost deposit that is large relative to the broker-dealer's capital could cause the firm to fail.[664] If the broker-dealer fails and the deposit is not recovered, the SIPC fund may not recover advances that it has made for the purpose of returning customer assets. To the extent that customer losses exceed the SIPA advance limits, customers may suffer permanent losses.

The amendment to Rule 15c3-3 should serve to reduce certain risks to investors in the event of a bank's failure and, thereby, enhance customer protection. The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. Commenters were also requested to identify sources of empirical data that could be used for the proposed metrics. The Commission did not receive any comments in response to these requests.

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[664] See Amendment to the Financial Responsibility Rules for Broker-Dealers, 72 FR at 12880.

(II). Baseline and Incremental Economic Effects

The current baseline for the amendment to paragraph (e) of Rule 15c3-3 is the existing customer protection requirements under Rule 15c3-3 and interpretations of the rule. Under paragraph (e) of Rule 15c3-3, broker-dealers are currently required to deposit cash or qualified securities into the customer reserve account, which must be maintained at a "bank." Under current interpretations, broker-dealers are limited in their reserve account cash deposits at parent or affiliated banks to 50% of the broker-dealer's excess net capital or 10% of the bank's equity capital.[665] Current interpretations also place similar restrictions on certain types of products at unaffiliated banks, including restrictions on concentration in money market deposit accounts and time deposits.[666]

As compared to the baseline, the Commission estimates that the incremental costs resulting from this amendment will be limited. Using FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately 224 broker-dealers report reserve deposits.[667] A considerable proportion of these broker-dealers, including some of the largest firms, meet their deposit requirements using mostly qualified securities as opposed to cash and, therefore, will be marginally impacted by this amendment. For example, based on FOCUS Report data, as of December 31, 2011, for the 224 broker-dealers with reserve deposits, 79% of the total customer reserve requirement was met using qualified securities that could still be deposited at affiliated banks to meet customer reserve requirements, under the rule, as adopted. The remaining customer reserve requirement could be met by using qualified securities (as opposed to

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665 FINRA Interpretation 15c3-3(e)(3)/051.

666 See FINRA Interpretation 15c3-3(e)(1)/01 and /011.

667 This estimate is based on FOCUS Report filings the 2011 year end. It is an update from the proposing release estimate of 216 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12881.

cash) and/or opening one or more accounts at unaffiliated banks, which would hold the cash within the limits permitted under the rule.

Relative to the current baseline, broker-dealers may incur two types of costs. The first type of cost relates to the costs of opening a new account at an unaffiliated bank for broker-dealers that currently hold cash in a reserve account at an affiliated bank. It is difficult to estimate the number of broker-dealers that hold cash reserve deposits at an affiliated bank because FOCUS Report data does not include the names of banks at which broker-dealers maintain their reserve accounts. Therefore, this data is not readily available to the Commission and commenters did not provide it. Based on an analysis of FOCUS Report data as of December 31, 2011, as well as available bank data,[668] the Commission, however, estimates that there are approximately 50 broker-dealers[669] that have an affiliated bank and cash in their customer reserve accounts.

The second type of cost relates to the costs of opening and maintaining multiple bank accounts if the cash deposit exceeds the 15% bank equity capital threshold as defined in the final rule, the likelihood of which the Commission expects to decrease because, with the relaxation of the bank equity capital threshold in the final rule, fewer broker-dealers will be required to open multiple accounts, relative to the current baseline. Broker-dealers, however, may replace these types of cost with the costs of converting cash into qualified securities to meet some or all of their reserve deposit requirements under Rule 15c3-3.

Moreover, in an attempt to reduce search costs, the potential exists that broker-dealers will select one or a few large unaffiliated banks or create networks on the basis of

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668 Data regarding a bank's equity capital as of the 2011 year end is publicly available at http://www2.fdic.gov/sdi/.

669 This estimate is based on a review of broker-dealers and affiliated banks based on legal names, as well as customer reserve account data, from FOCUS Report data.

reciprocity between broker-dealers and banks. This could result in a potential concentration of reserve cash deposits at a few banks. If as a result of such concentration, the carrying broker-dealer's deposit constitutes a substantial portion of the bank's total deposits, the risk increases that the bank may not have the liquidity to quickly return the deposit to the broker-dealer. Finally, the affiliated banks that are currently holding and using broker-dealer reserve cash deposits in the course of their business may incur funding costs, resulting from the possible transfer of cash deposits in the reserve account by broker-dealers to unaffiliated banks. These incremental funding costs to the affiliated banks may potentially be offset by the benefit of receiving cash deposits from unaffiliated broker-dealers.

(III). Alternatives

In adopting the final rule, the Commission considered several alternative approaches suggested by commenters. For example, commenters urged the Commission not to adopt the proposed prohibition on broker-dealers maintaining cash in reserve accounts at banks that are affiliates, stating that affiliated banks should be treated the same as unaffiliated banks because both groups are subject to the same financial regulation. One commenter noted that if a broker-dealer must move their reserve accounts to an unaffiliated bank this may require the broker-dealer to enter into new or additional banking relationships to comply with the amendment, which would increase the costs and administrative burdens of those reserve account funds.[670]

Several commenters suggested that the Commission allow cash reserve deposits without percentage restrictions at unaffiliated banks that are well-capitalized or for which

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[670] See Raymond James 2 Letter.

a broker-dealer has performed due diligence.[671] One of these commenters cited a U.K. regulation that requires a firm selecting a bank to hold customer deposits to undertake due diligence on the bank taking into consideration a number of factors including: (1) the capital of the bank; (2) the amount of client money placed, as a proportion of the bank's capital and deposits; (3) the credit rating of the bank (if available); and (4) to the extent the information is available, the level of risk in the investment and loan activities undertaken by the bank and its affiliated companies.[672]

One commenter suggested that the Commission consider higher percentages for cash deposits at large money-center banks.[673] This commenter also stated that the percentage thresholds would negatively impact small broker-dealers because they would cross the 50% of excess net capital threshold at lower deposit levels.[674] Another commenter suggested that the Commission reconsider the proposed limitation on the amount of reserve account cash deposits that may be held at any one bank because the limitation would result in significant costs for broker-dealers and could potentially adversely impact the customers of broker-dealers.[675]

In the final rule, the language excluding customer and PAB reserve cash deposits at affiliated banks from counting towards a broker-dealer's reserve requirement is being adopted as proposed. As discussed further below, relative to the proposed rule, in the final rule, the Commission eliminated the proposed language that would have excluded the amount of the deposit at an unaffiliated bank that exceeded 50% of a broker-dealer's

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671 See Raymond James Letter; JP Morgan Letter; The Clearing House Letter; ABASA Letter; PNC Letter; Deutsche Bank Securities Letter; E*Trade Letter; JP Morgan 2 Letter.

672 See JP Morgan Letter.

673 See SIFMA 2 Letter; see also NIBA Letter.

674 See SIFMA 2 Letter.

675 See Raymond James 2 Letter.

excess net capital and based on the Commission's expert judgment, increased the bank equity capital threshold from 10% to 15%.[676]

In response to comments on the proposed rule (including comments suggesting a due diligence standard instead of an objective threshold), the Commission modified the final rule text in ways that are designed to substantially mitigate the costs identified by commenters. While the final rule amendment excludes the amount of any cash on deposit at an affiliated bank from being used to meet a broker-dealer's reserve requirement, the Commission eliminated the provision that would have excluded the amount of a deposit that exceeds 50% of a broker-dealer's excess net capital. This provision would have impacted small and mid-size broker-dealers when they deposited cash into large commercial banks since the cash deposits of these firms would exceed the broker-dealer excess net capital threshold before exceeding the bank equity capital threshold.

The elimination of the broker-dealer excess net capital threshold, combined with the increase of the bank equity capital threshold from 10% to 15%, is intended to substantially mitigate the costs, burdens and inefficiencies that commenters believed would be imposed on small and mid-size broker-dealers if such firms had to open multiple bank accounts as a result of the proposed rule. The rule, as adopted, will allow small and mid-size broker-dealers to maintain reserve accounts at one bank if they so choose, provided that the bank equity capital threshold is not exceeded. In contrast to the proposed thresholds, the final rule amendments should reduce the costs associated with implementing the necessary changes to systems, operations, and contractual agreements related to a broker-dealer's reserve bank accounts.

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676 See Amendments to Financial Responsibility Rules, 72 FR at 12864.

Further, in response to comments, increasing the threshold from 10% to 15% of the bank's equity capital is intended to address concerns raised by large broker-dealers with large deposit requirements that the 10% threshold would have resulted in increased costs of having to spread out deposits over a number of banks. The decrease in the cost of opening and maintaining multiple accounts resulting from the increased threshold to 15% of the bank's equity capital may counterbalance the increase in the cost of transferring cash deposits to an unaffiliated bank. In summary, the rule, as adopted, with an increase to a 15% threshold will, in the Commission's expert judgment, substantially mitigate the cost concerns raised by commenters, while still providing adequate customer protection consistent with the goal of the rule to promote the broker-dealer's ability to have quick access to the deposit.

With respect to qualified securities, one commenter argued that if a broker-dealer elects to use qualified securities as opposed to cash to meet its reserve requirement, the broker-dealer will likely have a significant amount of additional operational and transactional costs.[677] In addition, this commenter stated that while large broker-dealers may be able to reallocate existing trading desk, operational, regulatory reporting, and treasury functions to assist in ongoing maintenance activities, small and mid-sized broker-dealers may be required to hire additional staff to manage and maintain a securities portfolio.[678] In response to the commenter, many large broker-dealers already hold large amounts of their reserve deposits in qualified securities. As the commenter

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677 See JP Morgan Letter. The commenter noted that "[c]ertain broker-dealers may be required to hire additional staff to manage and maintain a securities portfolio." Id. "Managing a pool of qualified securities involves a myriad of tasks such as monitoring income collection, redemption processing, marking the securities to market, collateral substitutions and collateral segregation amongst other tasks." Id. The commenter did not quantify the costs of managing a pool of qualified securities or the costs of additional staff to manage the securities portfolio.

678 Id.

noted, if a large broker-dealer needed to shift more of its reserve deposits into qualified securities as opposed to cash, then these firms would most likely reallocate existing functions to assist in ongoing maintenance activities, thus offsetting any costs associated with the shift of reserve deposits into qualified securities. Finally, with the elimination of the 50% excess net capital threshold in the rule as amended, most small and mid-sized firms likely would not have ongoing costs, because under the final rules, all firms will now only have to comply with the bank equity capital threshold, which as confirmed by comments, would be of concern primarily for the large firms. Therefore, under the final rule, broker-dealers should not incur significant operational or transactional costs in complying with the amendment.[679]

(IV). Compliance Cost Estimates

In the proposing release, in quantifying costs, the Commission estimated that, of the 216 firms with reserve deposit requirements, only 11 broker-dealers would need to open new bank accounts or substitute cash for qualified securities in an existing reserve account,[680] and that this would result in an estimated total one-time cost of approximately $2,630 per broker-dealer[681] and approximately $28,930 in the aggregate.[682] As noted above, the Commission requested comment on the proposed cost estimates. Commenters were asked to identify the metrics and sources of any empirical data that support their

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679 See JP Morgan Letter.

680 The Commission estimated in the proposing release that it would take approximately 10 hours to implement these changes. See Amendments to Financial Responsibility Rules, 72 FR at 12881.

681 Id.

682 11 broker-dealers x $2,630 = $28,930. Id. at 12881.

cost estimates. The Commission received seven comment letters in response to the proposed cost estimates.[683]

One commenter stated that the estimate is inaccurate and arbitrary, and does not take into account situations where a broker-dealer will need to establish numerous banking relationships.[684] Commenters also stated that the Commission failed to consider the ongoing costs of maintaining and monitoring multiple bank accounts.[685] One commenter believes that limiting Rule 15c3-3 deposits at a single bank to 50% of a broker-dealer's excess net capital will require a significant number of broker-dealers to open a number of additional cash and/or securities accounts and devote ongoing operational resources to the management of such accounts.[686] This commenter stated that at any one time, approximately 10% to 15% of broker-dealer customers could be impacted by the proposed rule change and many of those customers would be required to open accounts at multiple institutions.[687]

Commenters also stated that the proposed amendments would impose requirements whose costs are not adequately justified by their benefits and that the Commission substantially underestimated the costs.[688] One commenter noted that there are significant costs associated with implementing the necessary changes to systems, operations, and contractual agreements that the Commission did not appear to take into

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683 See Curian Clearing Letter; SIFMA 2 Letter; Clearing House Letter; ABASA Letter; Deutsche Bank Letter; E*Trade Letter; P Morgan Letter.

684 See Curian Clearing Letter.

685 See Curian Clearing Letter; SIFMA 2 Letter; ABASA Letter; The Clearing House Letter; E*Trade Letter; JP Morgan Letter.

686 See JP Morgan Letter.

687 Id.

688 See SIFMA 2 Letter; ABASA Letter.

account.[689] Another commenter stated that the proposal also fails to quantify the inherent inefficiency of forcing broker-dealers to set up numerous bank accounts to satisfy the restrictive broker-dealer net capital and bank equity capital requirements.[690] Another commenter suggested that the Commission consider higher percentage limits for cash deposits held at very large money center banks, stating that a higher percentage limit would strike a better balance between the Commission's concerns regarding the safety of cash deposits and the substantial costs imposed on broker-dealers by overly restrictive deposit limitations.[691] Two commenters believed that the upfront and ongoing cost to each broker-dealer is far higher than the one-time estimate of $2,630 that the Commission estimated in the proposing release.[692] One commenter stated that conducting due diligence and opening new accounts and the ongoing monitoring and periodic re-evaluation of such additional accounts would require much more time than the 10 hours originally estimated by the Commission.[693] One commenter, referencing the SIFMA 2 Letter, stated that it agreed with SIFMA that the Commission significantly underestimated the cost of the proposal to smaller firms.[694] Finally, commenters did not provide the Commission with revised cost estimates or data related to these amendments.

In quantifying costs, the Commission is increasing its estimate of the number of broker-dealers that will likely incur the cost of opening a new account at an unaffiliated bank (or substituting cash for qualified securities in their reserve accounts) from the estimated 11 broker-dealers in the proposing release to 50 broker-dealers, as described

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689 See SIFMA 2 Letter.

690 See ABASA Letter.

691 See SIFMA 2 Letter.

692 See JP Morgan Letter; E*Trade Letter.

693 See SIFMA 2 Letter.

694 See NIBA Letter.

above.[695] In addition, in response to the commenter's concern that conducting due diligence and opening new accounts would require much more time than the 10 hours originally estimated by the Commission,[696] the Commission also is increasing the one-time hour estimates discussed in the proposing release from 10 to 25 hours.[697] In response to the commenters pointing that the amendments would require ongoing monitoring of bank equity capital levels,[698] the Commission is including an annual cost estimate in this release (in addition to the estimated one-time costs) to account for incremental ongoing costs to monitor compliance with the rule.[699] The Commission further estimates that the average cost per firm to make these changes will be approximately $4,925 on a one-time basis and $12,675 on an annual basis.[700] For these reasons, the Commission estimates that the total cost to broker-dealers will be approximately $246,250 on a one-time basis and $633,750 on an annual basis.[701]

Finally, using FOCUS Report data and top decile bank equity capital data at year end 2011,[702] the Commission estimates that approximately 30 broker-dealers are no

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695 The Commission estimates that the responsibility for the one-time opening a new reserve bank account or substituting qualified securities for cash in an existing account likely would be undertaken by a Senior Treasury/Cash Management Manager at $197 per hour. See Amendments to Financial Responsibility Rules, 72 FR at 12881.

696 See SIFMA 2 Letter.

697 See Amendments to Financial Responsibility Rules, 72 FR at 12881. The Commission estimates that the Senior Treasury/Cash Management Manager will spend approximately 25 hours performing these changes on a one-time basis.

698 See SIFMA 2 Letter.

699 The Commission estimates that the responsibility for the annual compliance review of these rule amendments likely would be split between a Senior Treasury/Cash Management Manager at $197 per hour and a Compliance Attorney at $310 per hour, and will likely take 50 hours per year.

700 $197 per hour x 25 hours = $4,925; ($197 per hour x 25 hours) + ($310 x 25 hours) = $12,675.

701 50 broker-dealers x $4,925 = $246,250; 50 broker-dealers x $12,675 = $633,750.

702 See https://cdr.ffiec.gov/public/.

longer required to sustain the cost of maintaining multiple bank accounts, as a result of removing the 50% excess net capital threshold and increasing the bank equity capital threshold to 15%. This change to the final rule may result in potential cost savings to broker-dealers, which may have been required to maintain multiple bank accounts under the rule, as proposed.

c. Allocation of Customers' Fully Paid and Excess Margin Securities to Short Positions

The amendment to paragraph (d)(4) of Rule 15c3-3 requires broker-dealers to take prompt steps to obtain possession or control over fully paid and excess margin securities on the broker-dealer's books or records that allocate to a short position of the broker-dealer or a short position for another person, excluding positions covered by paragraph (m) of Rule 15c3-3, for more than 30 calendar days.[703] This amendment protects broker-dealer customers by helping to ensure that customer securities are available to be returned in the event of a broker-dealer failure. Therefore, in addition to broker-dealer customers, the amendment benefits the SIPC fund to the extent that it mitigates potential outlays from the fund to make advances to customers of a failed broker-dealer that cannot return all customer securities.

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. In particular, the Commission requested comment on whether there would be additional costs to broker-dealers as a consequence of these proposals and whether these proposals would impose costs on other market participants, including broker-dealer customers. The Commission also requested that commenters identify sources of empirical data that could be used for the metrics they

[703] 17 CFR 240.15c3-3(d)(4).

proposed. The Commission received one comment in response to these requests.[704] The commenter stated that the proposed amendments would "greatly increase the cost of proprietary and customer short positions that were established and maintained in accordance with all applicable short sale regulations at the time entered."[705] However, this commenter did not quantify its cost estimates in terms of dollars, nor did it provide data to support its conclusion.

In response to this comment, modifications were made to the final rule that should mitigate the commenter's concern because the changes were designed to reduce operational burdens and to more closely align the final rule with current regulations related to short sales. More specifically, as discussed in section II.A.4., as adopted, final paragraph (d)(4) of Rule 15c3-3 contains a uniform 30 calendar day period and clarifies that the 30 calendar day period with respect to a syndicate short position established in connection with an offering does not begin to run until the underwriter's participation in the distribution is complete as determined pursuant to Rule 100(b) of Regulation M. In addition, the proposed amendment was designed to require that the aging process commence at the time a deficit in securities allocating to a short position arises. These modifications clarify the rule amendment, while continuing to strengthen customer protections under Rule 15c3-3.

Three commenters argued that the credit item added to the reserve formula computation when a customer's fully paid or excess margin securities are allocated to a short position provides the customer with adequate protection.[706] The Commission considered this alternative, as well as the cost concerns raised above, in adopting these

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704 See Raymond James 2 Letter.

705 Id.

706 See First Clearing Letter; Deutsche Bank Securities Letter; Citigroup Letter.

final rule amendments. It has been a long-standing industry practice for carrying broker-dealers to use securities of PAB account holders in their business activities. In contrast, as stated above in section II.A.4. of this release, customers under Rule 15c3-3, which include the carrying broker-dealer's retail customers, have an expectation that the fully paid and excess margin securities reflected on their account statements are, in fact, in the possession or control of the carrying broker-dealer. However, as described above, this expectation may be frustrated where the securities are allocated to a short position carried by the broker-dealer, as the securities are not in the possession or control of the carrying broker-dealer. This gap in the existing rule, in effect, permits the broker-dealer to partially monetize the Rule 15c3-3 customer's securities. Also, under some circumstances (e.g., a change in the market value of the securities), the amount the broker-dealer may have on deposit in the reserve account as a consequence of the credit item may be less than the value of the securities. Consequently, if the broker-dealer fails, sufficient funds may not be readily available to purchase the securities to return them to customers. The use of customer securities in this manner is contrary to the customer protection goals of Rule 15c3-3 and the expectations of a broker-dealer's customers.[707] Therefore, the Commission believes that any increased costs related to this final rule amendment are justified by the enhancements to the customer protection goals of Rule 15c3-3. For these reasons, and those discussed throughout this release, the Commission is adopting the amendment.

The Commission estimates this requirement will result in a one-time cost to firms that carry customer securities to update systems for complying with the possession or control requirements in Rule 15c3-3. Based on FOCUS Report data, as of December 31,

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[707] See section II.A.1. of this release.

2011, the Commission estimates that approximately 287 broker-dealers carry customer accounts.[708] The Commission further estimates these firms will spend, on average, approximately 40 hours of employee resources per firm updating their systems to implement changes that will be necessitated by the amendment.[709] Therefore, the Commission estimates that the average cost per firm to make these changes will be approximately $11,280.[710] The Commission estimates that the total one-time cost to broker-dealers will be approximately $3,237,360.[711]

In addition to systems costs, broker-dealers may incur other costs to comply with the rule amendment because they may be required to change their existing practices. For example, the amendment could result in some broker-dealers borrowing securities to cover proprietary short positions rather than using customer securities, resulting in increased borrowing costs. However, under the current baseline, when broker-dealers use customer securities to cover short positions they are required to add a credit item in the Rule 15c3-3 reserve formula equal to the value of the securities. This credit item can result in higher reserve deposit requirements, which must be made using the broker-dealer's own capital. Thus, in response to commenters concerns regarding the costs of this amendments,[712] the increased costs associated with having to borrow securities to cover a short position likely will be offset by decreased costs associated with devoting capital to customer reserve requirements.

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708 This is an update of the proposing release estimate of 350 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12881.

709 For the purposes of this cost analysis, the Commission estimates that this work will be undertaken by a Senior Programmer at $282 per hour.

710 $282 per hour x 40 hours = $11,280.

711 287 broker-dealers x $11,280 = $3,237,360. In the proposing release, the Commission estimated that the total one-time cost to broker-dealers would be $3,752,000. See Amendments to Financial Responsibility Rules, 72 FR at 12881.

712 See First Clearing Letter; Deutsche Bank Securities Letter; Citigroup Letter.

d. Importation of Rule 15c3-2 Requirements into Rule 15c3-3

Today's amendment to Rules 15c3-2 and 15c3-3 imports requirements in Rule 15c3-2[713] to Rule 15c3-3 and eliminates Rule 15c3-2 as a separate rule in the Code of Federal Regulations.[714] Rule 15c3-2 requires a broker-dealer holding free credit balances to provide its customers (defined as any person other than a broker-dealer) at least once every three months with a statement of the amount due the customer and a notice that the funds are not being segregated, but rather are being used in the broker-dealer's business and that the funds are payable on demand. The Commission believes it is appropriate to eliminate Rule 15c3-2 because it is largely irrelevant in light of the requirements of Rule 15c3-3 (which was adopted after Rule 15c3-2).

This amendment will benefit broker-dealers by streamlining and consolidating relevant provisions of Rule 15c3-2 into Rule 15c3-3, promoting efficiency in the rulemaking process while not modifying the legal requirements. These provisions include the requirements that broker-dealers inform customers of the amounts due to them and that such amounts are payable on demand, which have been moved to new paragraph (j)(1) of Rule 15c3-3.[715] Finally, the definition of customer for purposes of the imported Rule 15c3-2 requirements will be the definition of customer in Rule 15c3-3,[716] which is somewhat narrower than the definition in Rule 15c3-2. The application of the

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713 17 CFR 240.15c3-2.

714 See Amendments to Financial Responsibility Rules, 72 FR at 12867.

715 The provisions in Rule 15c3-2 that are being re-codified in Rule 15c3-3, include the requirements that broker-dealers inform customers of the amounts due to them and that such amounts be payable on demand. In addition, Rule 15c3-2 contains an exemption for broker-dealers that are also banking institutions supervised by a Federal authority. This exemption will not be imported into Rule 15c3-3 because there are no broker-dealers that fit within this exemption.

716 17 CFR 240.15c3-3(a)(1).

narrower definition of customer in Rule 15c3-3 should not increase related costs. Alternatively, it may result in decreased costs because the narrowing of the rule's scope may reduce the compliance burden on broker-dealers.

The Commission considered reasonable alternatives with regard to the proposed deletion of Rule 15c3-2 and the importation of certain requirements into paragraph (j)(1) of Rule 15c3-3. Not adopting the rule amendment and thus leaving Rule 15c3-2 in the Code of Federal Regulations was a considered alternative. The Commission, however, believes consolidating the relevant provisions in Rule 15c3-3 is a more appropriate alternative because it promotes efficiency in the rulemaking process, and streamlines the Commission's customer protection rules.

The amendments – because they only re-codify provisions of Rule 15c3-2 into Rule 15c3-3[717] – should not be a new source of costs as compared to the baseline because these provisions are continuations of existing requirements. However, the re-codification and placement of these provisions into Rule 15c3-3 may cause broker-dealers to review and update their existing procedures from time-to-time and, therefore, could result in incremental costs.[718]

e. Treatment of Free Credit Balances

(I). Summary of Amendments

Today, the Commission is adopting the amendment to add new paragraph (j)(2) to Rule 15c3-3 that prohibits a broker-dealer from converting, investing, or transferring to another account or institution, free credit balances held in a customer's account except as provided in paragraphs (j)(2)(i) and (ii) of the rule. As adopted, the amendment defines a

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717 See paragraph (j)(1) of Rule 15c3-3.

718 Based on the estimated hour burdens in section IV.D.5. of this release, there could be one-time internal costs of $1,464,750 and annual internal costs of $585,900, if the review and update is performed by a Compliance Attorney at $310 per hour.

Sweep Program as "a service provided by a broker or dealer where it offers to its customer the option to automatically transfer free credit balances in the securities account of the customer to either a money market mutual fund product as described in § 270.2a-7 of this chapter or an account at a bank whose deposits are insured by the Federal Deposit Insurance Corporation."[719]

With regard to the treatment of free credit balances outside the context of a Sweep Program, paragraph (j)(2)(i) of Rule 15c3-3 permits a broker-dealer to invest or transfer to another account or institution free credit balances held in a customer's account only upon a specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization, or draft.[720] Two commenters suggested that the proposal should be clarified to permit a broker-dealer to obtain a one-time consent to ongoing transfers of any free credit balances to a customer to another account, entity or product (outside of a Sweep Program). As discussed above, this scenario was covered by the proposed rule and is being adopted under paragraph (j)(2)(i) of Rule 15c3-3.

With regard to the treatment of free credit balances in the context of a Sweep Program, new paragraph (j)(2)(ii) of Rule 15c3-3 requires broker-dealers to meet conditions that vary depending on the date when a customer's account was opened. For accounts opened on or after the effective date of the rule, a broker-dealer must meet the conditions of (j)(2)(ii)(A) and (B) of the rule. For any account, the broker-dealer must meet the conditions in paragraphs (j)(2)(ii)(B) of the rule. Under paragraph (j)(2)(ii)(A), for accounts opened on or after the effective date of the rule, the amendment to Rule 15c3-3 requires a broker-dealer to obtain the written affirmative consent of a new

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719 See paragraph (a)(17) of Rule 15c3-3.

720 See Amendments to Financial Responsibility Rules, 72 FR at 12866.

customer to have free credit balances in the customer's securities account included in the Sweep Program. Under paragraph (j)(2)(ii)(B), a broker-dealer must comply with the remaining three conditions for any account: (1) providing the customer with the disclosures and notices regarding the Sweep Program required by each SRO of which the broker-dealer is a member; (2) providing notice to the customer, as part of the customer's quarterly statement of account, that the balance in the bank deposit account or shares of the money market mutual funds in which the customer has a beneficial interest can be liquidated on the customer's order and the proceeds returned to the securities account or remitted to the customer; and (3) providing the customer written notice at least 30 calendar days before the broker-dealer makes certain changes to the Sweep Program and describes the options available to the customer if the customer does not accept the new terms and conditions or product.[721]

Free credit balances constitute money that a broker-dealer owes its customers. Customers may maintain these balances at the broker-dealer in anticipation of future stock purchases. Under current practices, customer account agreements set forth how the broker-dealer will invest these balances. For example, the broker-dealer may sweep them into a money market fund or, alternatively, pay an amount of interest on the funds. On occasion, broker-dealers may change the product to which a customer's free credit balances are swept – most frequently from a money market fund to an interest bearing bank account. Because of differences in these two types of products, there may be investment consequences when changing from one to the other.[722]

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721 See new paragraph (j)(ii)(B)(1)–(3) of Rule 15c3-3, as adopted.

722 Differences include the type of protection afforded the customer in the event of an insolvency, and the amount of interest or dividends earned on the product. See Amendments to Financial Responsibility Rules, 72 FR at 12866.

New paragraph (j)(2) to Rule 15c3-3 should serve to enhance customer protection by prohibiting a broker-dealer from transforming the credit risk faced by a customer through transfer of the broker-dealer's obligation to another entity without the required notice to, or approval from, the customer.

(II). Baseline and Incremental Economic Effects

In the absence of new paragraph (j)(2) of Rule 15c3-3, current practices represent the existing baseline. As compared to the baseline, new paragraph (j)(2) to Rule 15c3-3 will enhance customer protection by requiring broker-dealers to obtain the written affirmative consent of a new customer before including a customer's free credit balances in a Sweep Program, as well as to provide certain disclosures and notices to all customers with regard to the broker-dealer's Sweep Program. The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. The Commission did not receive any comments in response to this request.

Relative to the baseline, broker-dealers carrying free credit balances will incur incremental one-time and periodic costs (e.g., systems changes, outside counsel, and notification costs) to comply with new paragraph (j)(2) of Rule 15c3-3. The Commission requested comment on whether there would be additional costs to broker-dealers as a consequence of the proposals. The Commission also requested comment on whether the proposals would impose costs on other market participants, including broker-dealer customers. Commenters were requested to identify sources of empirical data that could be used for the metrics they proposed. The Commission did not receive any comments in response to these requests.

(III). Alternatives

As stated above in section II.A.5.ii. of this release, the Commission is adopting new paragraph (j)(2) to Rule 15c3-3 with substantial modifications from the proposed rule in response to comments and to clarify certain portions of the rule.

Commenters generally agreed with the fundamental principle embodied in the proposal – that customer free credit balances should not be transferred from an obligation of the broker-dealer to an obligation of another entity without the customer's authorization.[723] Other commenters supported the proposed disclosures but suggested additional disclosures be made to customers including clarification with respect to other protections available to the customer.[724] Two commenters stated that the practice of sweep programs should be banned entirely or that the Commission should adopt a "harder stance" and require more than just disclosure.[725] One commenter responded to the Commission's request for comment as to the cost burdens that would result if the first condition (set forth in proposed paragraph (j)(2)(ii)(A)) to obtain a new customer's prior agreement were to be applied to existing customers. The commenter stated that such costs would be substantial because broker-dealers would be required to amend their agreements with all existing customers.[726] One commenter stated that the amendments in the proposing release did not adequately address situations in which broker-dealers

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723 See SIFMA 2 Letter; First Clearing Letter; Pace Letter.

724 See SIPC Letter.

725 See Ellis Letter; Dworkin Letter. One commenter stated that broker-dealers profit from "excessive" fees charged to customers who opt out of the sweep programs. See Ellis Letter. The second commenter suggested that the broker-dealer's "customer has been effectively denied the opportunity to opt out of bank account sweeps by [the broker-dealer] preventing him or her from utilizing any other vehicle to park his or her free credit balances . . . ." See Dworkin Letter.

726 See SIFMA 2 Letter.

change customer account elections without first obtaining customer authorization.[727] Commenters also raised concerns about limitations on the types of products broker-dealers can use for sweep arrangements.[728]

The Commission considered alternatives, including whether to adopt the amendments and, in adopting the final rule, the Commission modified the language in the final rule in response to commenters and to clarify its application. In response to comments that the Commission should ban sweep programs or adopt a "harder stance," the Commission notes that sweep programs provide a mechanism for excess cash in a customer's securities account to be held in a manner that allows the customer to earn interest on the funds but retain the flexibility to quickly access that cash to purchase securities or withdraw it.[729] In effect, transferring this excess cash to a bank account or money market fund is an alternative to retaining a credit balance in the customer's securities account. The final rule is intended to appropriately balance commenters' concerns while providing broker-dealers with flexibility in the operation of sweep programs.[730]

In addition, in response to the comments that the Commission should not limit the types of products broker-dealers can use for sweep accounts to money market funds and bank deposit products,[731] as discussed above in section II.A.5.ii. of this release, the Commission does not view sweep accounts as a mechanism for investing customers' excess cash in longer term or more volatile assets without specific consent from

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727 See Waddell Letter.

728 See SIFMA 2 Letter; First Clearing Letter; Raymond James 2 Letter.

729 See Ellis Letter; Dworkin Letter.

730 See Ellis Letter; Dworkin Letter; Waddell Letter.

731 See SIFMA 2 Letter; First Clearing Letter; Raymond James 2 Letter.

customers. Therefore, the Commission believes that it is not appropriate to modify the final rule amendments to expand the permitted products for Sweep Programs.

In response to commenters' concern regarding cost burdens resulting from the application of the affirmative consent requirement to existing accounts, the final rule retains the proposed requirement to require a broker-dealer to obtain a customer's prior affirmative consent for accounts opened on or after the effective date of the rule before transferring the customer's free credit balance to a product in the firm's Sweep Program, and makes explicit that the consent must be in writing. This will provide new customers with the opportunity to evaluate the broker-dealer's Sweep Program before consenting to the transfer of the customer's free credit balances into such program. In the proposing release, the Commission requested comment as to the cost burdens that would result if the condition to obtain a new customer's prior agreement were to be applied to existing customers. One commenter stated that such costs would be substantial because broker-dealers would be required to amend their agreements with existing customers. The Commission considered this alternative and agrees with the commenter that requiring a broker-dealer to amend its existing agreements with customers would be substantial. Therefore, to address the burden that would have been associated with having broker-dealers re-paper existing account documentation, the prior affirmative consent requirement will continue to apply only to accounts opened on or after the effective date of the rule.

However, as discussed above in section II.A.5.ii. of this release, all customers will be provided written notice at least 30 days before a broker-dealer changes certain terms and conditions or products of its Sweep Program. This notice must also contain a description of the options available to the customer if the customer does not accept the new terms and conditions or product. This is intended to benefit new and existing

customers by giving them sufficient opportunity to make an informed decision and evaluate the effects of changes in the terms and conditions or product of the sweep program and the options available.

(IV). Compliance Cost Estimates

Broker-dealers will incur one-time and periodic costs to implement the changes necessitated by the amendment. These changes include providing customers with the disclosures and notices (including the description of the options available if a customer does not accept the new terms or conditions or product) in order to have the flexibility to change the treatment of customers' free credit balances. This would require that broker-dealers update their systems (including processes for generating customer account statements) to incorporate the necessary changes.[732] Additionally, broker-dealers may incur one-time costs of outside counsel in implementing these system changes, particularly with respect to the language in the disclosures and notices required by paragraph (j)(2) of the rule.

The Commission further estimates that broker-dealers will incur costs to process an affirmative consent for new customers.[733] Specifically, the Commission estimates that broker-dealers may incur aggregate one-time and annual costs of approximately $14.4 million[734] and $23.2 million,[735] respectively related to the changes necessitated by these rule amendments.[736]

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[732] The internal hours would likely be performed by a senior programmer. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Senior Programmer at $282 per hours x 37,800 hours = $10,659,600. See section IV.D.6. of this release.

[733] The internal hours would likely be performed by a compliance clerk. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Compliance Clerk at $63 per hour x 368,311 hours = $23,203,593. See section IV.D.6. of this release.

[734] See section IV.D.6. of this release. ($10,659,600 + $3,780,000 (outside counsel costs) = $14,439,600).

f. "Proprietary Accounts" under the Commodity Exchange Act

Some broker-dealers also are registered as futures commission merchants under the CEA. These firms carry both securities and commodities accounts for customers. The definition of free credit balances in paragraph (a)(8) of Rule 15c3-3 does not include funds carried in commodities accounts that are segregated in accordance with the requirements of the CEA.[737] However, regulations promulgated under the CEA exclude proprietary accounts from the CEA's segregation requirements.[738] This exclusion from the segregation requirements under the CEA has raised a question as to whether a broker-dealer must treat payables to customers in proprietary commodities accounts as "free credit balances" when performing a customer reserve computation.[739] For these reasons, the specific amendment to the definition of the term free credit balances in paragraph (a)(8) of Rule 15c3-3 clarifies that funds held in a commodities account meeting the definition of a proprietary account under CEA regulations are not to be included as free credit balances in the customer reserve formula.

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735 Id. ($23,203,593).

736 In the proposing release, the Commission estimated that broker-dealers would incur one-time costs of approximately $3.68 million ($2.68 million internal costs and $1.0 million for outside counsel) and annual costs of approximately $24.6 million. See Amendments to Financial Responsibility Rules, 72 FR at 12882.

737 17 CFR 240.15c3-3(a)(8).

738 Rule 1.20 requires a futures commission merchant to segregate customer funds. See 17 CFR 1.20. Rule 1.3(k) defines the term customer for this purpose. See 17 CFR 1.3(k). The definition of customer excludes persons who own or hold a proprietary account as that term is defined in Rule 1.3(y). See 17 CFR 1.3(y). Generally, the definition of proprietary account refers to persons who have an ownership interest in the futures commission merchant. Id.

739 See Part 241-Interpretive Releases Relating to the Securities Exchange Act of 1934 and General Rules and Regulations Thereunder, Exchange Act Release No. 9922 (Jan. 2, 1973), 38 FR 1737 (Jan. 18, 1973) (interpreting the credit balance used in Item 1 of the Rule 15c3-3a formula "to include the net balance due to customers in non-regulated commodities accounts reduced by any deposits of cash or securities with any clearing organization or clearing broker in connection with the open contracts in such accounts").

One commenter requested that the Commission clarify that the relevant definition of proprietary account for purposes of this amendment will be the definition contained in 17 CFR 1.3(y).[740] The Commission considered this alternative suggested by the commenter. While Rule 1.3(y) under the CEA currently contains the relevant definition of proprietary account for the purpose of the amendment, the definition could be codified in a different rule in the future. Consequently, the Commission is adopting the final rule amendment to paragraph (a)(8) of Rule 15c3-3, as proposed. Thus, the final rule does not include specific references to a specific rule. Rather, the amendment to paragraph (a)(8) to Rule 15c3-3, as adopted, more generally refers to a "proprietary account as that term is defined in regulations under the Commodity Exchange Act."

In addition, one commenter stated that, due to the changes to the swap markets mandated by Title VII of the Dodd-Frank Act, swap accounts (in addition to commodities accounts) are now subject to customer protection rules under the CEA. This commenter suggested that the Commission make it clear that funds in swap accounts also do not constitute free credit balances, whether those funds are required to be segregated by rules under the CEA (e.g., cleared swap accounts or uncleared swap accounts that have opted for segregation) or excepted from segregation under the CEA (e.g., cleared swaps proprietary accounts or uncleared swap accounts that have not opted for segregation). The commenter noted this treatment "would be consistent with the treatment of funds in commodities accounts and with the regulation of swap accounts under the CEA."[741] The Commission agrees there may be additional accounts under the CEA, as amended by the Dodd-Frank Act that should explicitly be excluded from the definition of free credit balances under Rule 15c3-3. However, the amendments today are designed to clarify the

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740 See SIFMA 2 Letter.

741 Id.

specific question raised with respect to the treatment of funds in proprietary commodities accounts under the CEA and, consequently, the suggestions by this commenter are beyond the scope of this rulemaking.

The Commission considered reasonable alternatives in adopting the final rule amendment. These alternatives included adopting the proposed rule, with modifications suggested by commenters described above, as well as leaving the current rule in place without the amendments. The Commission believes that the adoption of the final rule is the more appropriate approach at this time because the final rule amendment will benefit broker-dealers that are registered as futures commission merchants by eliminating any ambiguity with respect to such accounts and avoiding situations where they unnecessarily increase reserve amounts.

The Commission does not anticipate that the amendments will result in any costs to broker-dealers and, as funds in certain commodities accounts are not protected under SIPA, will not expose the SIPC fund to increased liabilities. Because this amendment is intended to be a clarification of existing interpretations, broker-dealers are not expected to incur additional costs against the baseline of current Rule 15c3-3 and its existing interpretations. This clarification is designed to provide broker-dealers with more certainty as to the Commission's stated legal requirements.

ii. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The amendments to the customer protection rule (Rule 15c3-3) regarding PAB accounts,[742] cash deposits at special reserve bank accounts,[743] allocation of short

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[742] See section II.A.2. of this release.

[743] See section II.A.3. of this release.

positions,[744] the treatment of free credit balances,[745] and the clarification of the treatment of proprietary accounts under the CEA are designed to protect and preserve customer property held at broker-dealers.[746] These protections are primarily intended to reduce the risks borne by investors.

In particular, first, the final rule amendment on PAB accounts is intended to fill a gap in the definition of customer between Rule 15c3-3 and SIPA, reducing the risk that customers could face losses in the case of a liquidation of a carrying broker-dealer. The final rule codifies many of the provisions of the PAIB Letter. The Commission believes that it is prudent, and will provide greater regulatory clarity, to incorporate into Rule 15c3-3 specified provisions of the PAIB Letter. Further, the Commission understands that the relief in the PAIB Letter has been widely, if not universally, utilized by broker-dealers that carry customer accounts. Thus, the benefits associated with codifying specified provisions of the PAIB Letter will continue to provide SIPA customers with the protections currently provided by broker-dealers complying with the PAIB Letter. Setting forth these requirements in a Commission rule will benefit the securities markets by helping to diminish the risks and incidences of non-compliance.

Second, the final rule amendments regarding the banks where reserve deposits may be held are intended to protect customers' cash deposits by mitigating the risk that the funds in the customer reserve account will not be readily available to be withdrawn by the broker-dealer.

Third, the final rule amendments regarding the allocation of customers' fully paid and excess margin securities to a broker-dealer short position are designed to enhance the

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744 See section II.A.4. of this release.

745 See section II.A.5.ii. of this release.

746 See section II.A.6.i. of this release.

customer protection goals of Rule 15c3-3, which seek to ensure that broker-dealers do not use customer assets for proprietary activities.

Fourth, the final rule amendments regarding the importation of Rule 15c3-2 requirements into paragraph (j)(1) of Rule 15c3-3 and the elimination of Rule 15c3-2 streamline the regulatory requirements for broker-dealers. Also, the addition of new paragraph (j)(2) to Rule 15c3-3 is intended to protect a customer's free credit balances from being swept to products or programs without the appropriate approval, notice or disclosure.

Fifth, the final rule amendment establishing that the funds in certain commodities accounts need not be treated as free credit balances or other credit balances may enhance efficiency at the broker-dealers by freeing up cash that may have been required to be deposited into a broker-dealer's customer reserve account, and clarifying an ambiguity in Rule 15c3-3.

By strengthening requirements designed to protect customer assets, these amendments will mitigate potential exposure to the SIPC fund that is used to make advances to customers whose securities or cash are unable to be returned by a failed broker-dealer. To the extent that the amendments to Rule 15c3-3 achieve this goal, investors might be more willing to transact business in securities with broker-dealers. The possible positive effects on investor participation in the securities markets may promote capital formation as investor assets are able to be allocated more efficiently across the opportunity set.

As discussed above, the Commission recognizes that the amendments to Rule 15c3-3 adopted today may impose certain costs on broker-dealers that might place a burden on competition among broker-dealers. However, the Commission is of the opinion that these costs are justified by the significant benefits described in this

economic analysis, as well as in the discussion of the rule amendments above. Amendments to Rule 15c3-3 should not place a burden on competition for non-carrying broker-dealers, which are generally small broker-dealers, because the amendments primarily affect broker-dealers that perform PAB and customer reserve computations, carry customer accounts, and carry free credit balances. In addition, for those carrying broker-dealers that already follow the PAIB Letter, any difference from the baseline with regard to cost burdens should be marginal. In sum, the costs of compliance resulting from the requirements in the amendments to Rule 15c3-3 should not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act in light of the benefits discussed above.

2. Holding Futures Positions in a Securities Portfolio Margining Account

i. Economic Analysis

As discussed in section II.B. of this release, the Commission is adopting amendments to Rule 15c3-3 to accommodate futures positions in a securities account that is margined on a portfolio basis. The amendments revise the definition of free credit balances and other credit balances in paragraphs (a)(8) and (a)(9) of Rule 15c3-3, respectively, by expanding these definitions to include funds in a portfolio margin account relating to certain futures and futures options positions. Consequently, as part of free credit balances and other credit balances, these funds will be included as a credit item on the credit side of the customer reserve formula. The Commission is also adopting, as proposed, an amendment to Rule 15c3-3a Item 14 that permits a broker-dealer to include as a debit item, on the debit side of the customer reserve formula, the amount of customer margin required and on deposit at a derivatives clearing organization related to futures positions carried in a portfolio margin account.

The amendments are designed to provide greater protection to customers with portfolio margin accounts, through the reserve requirements of Rule 15c3-3 and SIPA, by requiring a broker-dealer to include all cash balances (including portfolio margin cash balances) of its customers' securities accounts in the computation of the customer reserve. The customer reserve computation under Rule 15c3-3 is designed to ensure that the funds a broker-dealer owes to customers are available to be returned to customers in the event the broker-dealer fails.

Subsequent to the Commission's proposals, the Dodd-Frank Act amended the definitions of customer, customer property, and net equity in section 16 of SIPA to take into account futures and options on futures held in a portfolio margin account carried as a securities account pursuant to a Commission-approved portfolio margining program.[747] As a result, persons who hold futures positions in a portfolio margining account carried as a securities account are now entitled to SIPA protection.

While the Dodd-Frank Act addressed the protection under SIPA of futures and futures options held in a securities portfolio margin account, the Commission's amendments to Rule 15c3-3 and 15c3-3a will still serve an important purpose. In particular, they complement the Dodd-Frank SIPA amendments, and will provide additional protections to customers by requiring broker-dealers to treat these futures positions in accordance with the segregation requirements in Rules 15c3-3 and 15c3-3a. Consequently, the Commission is adopting the amendments with modifications to address, in part, comments. As noted above, the requirements of Rule 15c3-3 and Rule 15c3-3a are designed to enable the prompt return of customer securities and cash in the event the broker-dealer falls into financial difficulty or becomes insolvent. The goal is to

[747] See Pub. L. No. 111–203 § 983.

place a broker-dealer in a position where it is able to wind down in an orderly self-liquidation without the need for financial assistance from SIPC.

The Commission received six comments on the proposed amendments.[748] Three commenters generally supported the amendments.[749] One commenter supported the development of rules for portfolio margining and the Commission's effort to provide greater legal certainty regarding the SIPA treatment of futures positions in a portfolio margin account.[750] This commenter, however, in a subsequent comment letter, stated that this amendment is no longer necessary in light of the Dodd-Frank Act amendments, and recommended that the Commission withdraw it.[751] Another commenter stated that the Commission's proposal is premature in that the inclusion of futures in a portfolio margin account, which is a securities account, would conflict with the segregation provisions under the CEA[752] and that SIPC has not determined that protection should be extended to futures.[753] Commenting in 2007 before the adoption of the Dodd-Frank Act, SIPC stated that the proposed rules seek to extend SIPC protection to all positions in the portfolio margin account, irrespective of whether the positions are securities under SIPA or are on deposit in connection with a securities transaction.[754]

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748 See SIFMA 2 Letter; CME Letter; SIPC Letter; Citigroup Letter; American Bar Association Letter; SIFMA 4 Letter.

749 See SIFMA 2 Letter; Citigroup Letter; American Bar Association Letter.

750 See SIFMA 2 Letter.

751 See SIFMA 4 Letter.

752 See, e.g., 17 CFR 1.20-1.29.

753 See CME Letter; see also SIPC Letter (expressing "grave concerns" about potential conflict between the proposed amendments and SIPA).

754 See SIPC Letter. SIPC also urged the Commission to reconsider its adoption of the portfolio margin proposals, stating that if the changes are in order, the Commission should seek to have them made by legislative amendment and not rulemaking.

The Commission agrees, in part, with the commenter who stated that the Dodd-Frank Act SIPA amendments make the Commission's proposed amendments to Rules 15c3-3 and 15c3-3a unnecessary.[755] As noted above, the definitions of customer, customer property, and net equity in section 16 of SIPA were amended by the Dodd-Frank Act to take into account futures and options on futures held in a portfolio margin account carried as a securities account pursuant to a Commission-approved portfolio margining program.[756] Consequently, in a proceeding under SIPA, futures and options on futures positions held in a portfolio margin account carried as a securities account would be included in determining a customer's net equity claim.[757] Therefore, the proposed amendment relating to the unrealized value of a futures option is not necessary to achieve the objective of providing SIPA protection for such positions. As a result, the Commission is modifying the final rule to delete the proposed language in paragraph (a)(8) of Rule 15c3-3 that would have treated the unrealized value of a futures option in a portfolio margin account on the filing date of a SIPA proceeding as a free credit balance for purposes of Rule 15c3-3.[758]

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755 See SIFMA 4 Letter.

756 See Pub. L. No. 111–203 § 983.

757 Under the Dodd-Frank Act SIPA amendments, a customer's net equity now includes all positions in futures contracts and options on futures contracts held in a portfolio margining account carried as a securities account pursuant to a portfolio margining program approved by the Commission, including all property collateralizing such positions, to the extent that such property is not otherwise included herein. See 15 U.S.C. § 78lll(11)(A)(ii). Further, the amendments provided that a claim for a commodity futures contract received, acquired, or held in a portfolio margining account pursuant to a portfolio margining program approved by the Commission or a claim for a security futures contract, shall be deemed to be a claim with respect to such contract as of the filing date, and such claim shall be treated as a claim for cash. See 15 U.S.C. § 78lll(11).

758 Specifically, the final rule does not include the proposed language: ", and, in the event the broker-dealer is the subject of a proceeding under SIPA, the market value as of the "filing date" as that term is defined in SIPA (15 U.S.C. 78lll(7)) of any long options on futures contracts."

While the legislation provides additional certainty with respect to how futures in a portfolio margin account would be treated in a SIPA liquidation, the Commission's amendments will require that positions are subject to the protections of Rule 15c3-3, thus enhancing customer protection. Therefore, while the Commission has considered the suggested alternatives in developing the final rule amendments (including not adopting the amendments), the Commission has determined that adopting the portfolio margining amendments was a more appropriate approach in furtherance of enhancing customer protection.

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify, including the identification of sources of empirical data that could be used for such metrics. The Commission did not receive any comments in response to these requests.

Current SRO portfolio margin rules permit futures to be held in a securities portfolio margin account.[759] However, pending further regulatory action by the Commission and the CFTC, the ability to combine securities and futures products into a single portfolio margin account will be unavailable.[760] Therefore, under the current baseline of SRO portfolio margin rules, with the inclusion of only securities positions in the securities account, this amendment would have no effect as compared to the baseline

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759 See, e.g., FINRA Rule 4210.

760 See Section 713 of the Dodd-Frank Act. Section 713 of the Dodd-Frank Act amends the Exchange Act and CEA to facilitate portfolio margining by allowing cash and securities to be held in a futures account and futures and options on futures and related collateral to be held in a securities account by a dually-registered broker-dealer and futures commission merchant pursuant to an approved portfolio margin program, subject to certain requirements, including regulatory action by the Commission and CFTC (pursuant to an exemption, or by rule or regulation). See generally, A Joint Report of the SEC and the CFTC on Harmonization of Regulation (Oct. 19, 2009).

until the Commission and CFTC take such further action with respect to portfolio margining.[761]

The requirements imposed by the portfolio margin amendments will be elective. The requirements will apply only to broker-dealers choosing to offer their customers portfolio margin accounts. The Commission estimates that approximately 35 broker-dealers will elect to offer their customers portfolio margin accounts that will include futures and futures options.[762] The amendment to the definition of free credit balances in Rule 15c3-3 will require broker-dealers to include in the reserve formula credit balances related to futures positions in a portfolio margin account. The amendment to Rule 15c3-3a Item 14 in the reserve formula will enable broker-dealers to include as a debit item the amount of customer margin required and on deposit at a derivatives clearing organization. Accordingly, these amendments will require changes to the systems broker-dealers use to compute and account for their reserve requirements. Consistent with the proposing release,[763] the Commission assumes that the responsibility for updating these systems will be undertaken by a Senior Programmer.[764] Therefore, the Commission estimates that the program and systems changes would result, on average, in

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761 See generally, A Joint Report of the SEC and the CFTC on Harmonization of Regulation (Oct. 19, 2009).

762 This estimate is based on OCUS Report data. This is an update from the estimate in the proposing release of 33 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12883.

763 See Amendments to Financial Responsibility Rules, 72 FR at 12883.

764 The SIFMA 2012 Report as Modified indicates the average hourly cost of this position is approximately $282. Consistent with the proposing release, the Commission estimates the Senior Programmer will spend approximately 130 hours modifying software to conform it to the requirements of the amendments. See Amendments to Financial Responsibility Rules, 72 FR at 12883.

a one-time cost of approximately $36,660 per broker-dealer.[765] Thus, the Commission estimates the total one-time cost to broker-dealers will be approximately $1,283,100.[766]

The Commission requested comment on the proposed cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals, such as system costs in addition to those discussed above (e.g., costs associated with purchasing new software and updates to existing software). The Commission also requested comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters were asked to identify the metrics and sources of any empirical data that supported their costs estimates. The Commission did not receive any comments in response to these requests.

ii. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The final rule amendments to Rule 15c3-3 to accommodate futures positions in a securities account margined on a portfolio basis[767] should complement the Congressional amendments and provide additional protections to portfolio margin customers through the strengthened reserve requirements of Rule 15c3-3. These additional protections may reduce the risk of loss of collateral to securities customers, promote participation in the securities markets, and enhance competition and price discovery. Moreover, these additional protections may make portfolio margining more attractive to investors. Portfolio margining may significantly reduce customer margin requirements by offsetting

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765 130 hours x $282 = $36,660. In the proposing release, the Commission estimated this cost would be $34,840. See Amendments to Financial Responsibility Rules, 72 FR at 12883.

766 35 broker-dealers x $36,660 = $1,283,100. In the proposing release, the Commission estimated this cost would be $1,149,720. See Amendments to Financial Responsibility Rules, 72 FR at 12883.

767 See section II.B. of this release.

positions involving securities and futures products, which in turn reduces the costs of trading such products and enhances efficiency. Portfolio margining may also promote better price discovery across securities and futures products by allowing customers to offset a position assumed in one market with a product traded in another market. The enhanced efficiencies as a result of increases in the use of portfolio margin accounts may facilitate capital formation through the availability of additional capital for customers as a result of reduced margin costs.

While today's amendments promote efficiency within the securities markets, the increased costs associated with the rule amendments may impose a burden on competition among broker-dealers. However, the Commission is of the opinion that these costs are justified by the significant benefits described in this economic analysis. In sum, the costs of compliance resulting from the requirements in the portfolio margining amendments to Rule 15c3-3 should not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act in light of the benefits discussed above.

3. Amendments With Respect to Securities Lending and Borrowing and Repurchase/Reverse Repurchase Transactions

i. Economic Analysis

The Commission is adopting amendments to Rules 15c3-1 and 17a-11 to strengthen the financial responsibility of broker-dealers engaging in a securities lending business. First, the amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1 clarifies that broker-dealers providing securities lending and borrowing settlement services are deemed, for purposes of the rule, to be acting as principals and are subject to applicable capital deductions. Under the amendment, these deductions could be avoided if a broker-dealer takes certain steps to disclaim principal liability. Second, the amendment to

paragraph (c)(5) of Rule 17a-11 requires a broker-dealer to: (1) file a notice with the Commission and its DEA whenever the total money payable against all securities loaned, subject to a reverse repurchase agreement or the contract value of all securities borrowed or subject to a repurchase agreement exceeds 2,500% of tentative net capital; or, alternatively, (2) report monthly its securities lending and repurchase activities to its DEA in a form acceptable to its DEA.

Both amendments are intended to strengthen the financial responsibility of broker-dealers engaged in a securities lending or repurchase business. The first amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1 will help eliminate the legal uncertainty among counterparties as to the role played by broker-dealers in such transactions and clarify the nature of the services that securities lending intermediaries provide their counterparties.

Thus, a broker-dealer will be considered a principal unless the broker-dealer has disclosed the identity of each party to the other, and the parties have agreed in writing that the obligations of the broker-dealer do not include a guarantee of performance by the other party and that in the event of default, neither party shall have the right of setoff against the obligations, if any, of the broker-dealer. In addition, this amendment will help avoid ambiguity regarding the applicability to a particular broker-dealer of the stock loan charges in the net capital rule.

In response to comments that standard legal documents currently used in securities lending transactions provide sufficient legal certainty with respect to the status of the parties,[768] the Commission considered whether to adopt the proposed approach or whether to rely on existing industry practice. The Commission considered the

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[768] See section II.C. of this release. See also SIFMA 2 Letter; Citigroup Letter.

alternatives and believes that the rule as adopted appropriately balances the commenters' objections to the proposal with the Commission's concerns about stock lending practices, particularly with regard to the failure of MJK.[769] In recognition of standard stock loan agreement templates, the Commission designed the amendment to accommodate the continued use of these industry model agreements by incorporating their use into the rule's requirements.

The second amendment to paragraph (c)(5) of Rule 17a-11 will help identify broker-dealers with highly leveraged non-government securities lending and borrowing and repo activity.[770] This new provision requires that a broker-dealer notify the Commission whenever the total amount of money payable against all securities loaned or subject to a repurchase agreement, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement exceeds 2,500% of tentative net capital; provided that, for purposes of this leverage threshold, transactions involving government securities, as defined in Section 3(a)(42) of the Exchange Act, are excluded from the calculation.[771] The notice provision is designed to alert regulators to a sudden increase in a broker-dealer's stock loan and repo positions, which could indicate that the broker-dealer is taking on new or additional risk that it may have limited experience or increased difficulty in managing. This amendment will assist securities regulators in monitoring such activities and responding to situations where a broker-dealer experiences financial difficulty due to a large securities lending or repo position. This may help prevent

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769 See section II.C. of this release.

770 17 CFR 240.17a-11(c)(5).

771 15 U.S.C. 78c(a)(42). Government securities generally present less market risk than other types of securities used in securities lending and repo transactions. Consequently, they are excluded from the scope of this rule.

significant losses to the broker-dealer's customers and other broker-dealers, and reduce systemic financial risk.

As adopted, new paragraph (c)(5) of Rule 17a-11 also permits a broker-dealer to report monthly its stock loan and repo activity to its DEA in a form acceptable to its DEA in lieu of the notices required by paragraph (c)(5). This approach will provide each DEA with the flexibility to prescribe how the monthly reports are to be made and will accommodate a DEA that opts to use the FOCUS report as the reporting mechanism.[772] This provision will also accommodate large broker-dealers that are active in this business and regularly maintain stock loan and repo balances that exceed the threshold. The Commission expects that these broker-dealers have experience in managing the risks associated with these types of transactions and have established controls to address those risks. Consequently, notice under Rule 17a-11 from these broker-dealers will not be as useful to regulators. On the other hand, the monthly reports will provide securities regulators with information useful, for example, to develop trend analysis, if deemed appropriate. This analysis can be used to identify leverage levels that are outside the normal trend range and that may be indicative of a material change in the firm's business model (e.g., taking on higher levels of leverage, branching into new products, or experiencing operational or financial difficulties).

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. Commenters were requested to identify sources of empirical data that could be used for the metrics they propose. The Commission did not receive any comments in response to these requests.

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[772] As proposed, the amendment to Rule 17a-11 would have provided that a broker-dealer that submitted a monthly report of its stock loan and repo activity to its DEA not be required to file the Rule 17a-11 notices required by paragraph (c)(5). See Amendments to Financial Responsibility Rules, 72 FR at 12870.

The Commission expects that broker-dealers may incur costs related to the implementation of the rule amendments. Using current Rule 15c3-1 and Rule 17a-11 as a baseline, the Commission expects that some broker-dealers may incur costs in connection with the implementation of these rule amendments.

With regard to the amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1, the Commission understands that most existing standard securities lending master agreements in use today already contain language requiring agent lenders to disclose principals and for principals to agree not to hold the agents liable for a counterparty default. Thus, the standard agreement used by the vast majority of broker-dealers should contain the representations and disclosures required by the proposed amendment. However, a small percentage of broker-dealers may need to modify their standard agreements. The Commission estimates that the total one-time cost to broker-dealers for this change will be approximately $45,480.[773]

The Commission requested comment on the cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals, such as costs arising from making systems changes. The Commission also requested comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters were also asked to identify the metrics and sources of any empirical data that support their costs estimates. The Commission did not receive any comments in response to these requests.

With regard to the amendment to Rule 17a-11, the Commission received several suggested alternatives from commenters which contributed to the modification of the

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[773] In the proposing release, the Commission estimated that the total one-time cost to broker-dealers would be approximately $62,604. See Amendments to Financial Responsibility Rules, 72 FR at 12884. The internal hours would likely be performed by an in-house Attorney at $379 per hour, resulting in the estimated internal cost calculated as follows: 120 hours at $379 per hour = $45,480. See section IV.D.1. of this release.

final rule from the proposal. Three commenters addressed the proposed monthly notification requirement. They stated that the monthly report in lieu of the notification should be provided as part of the monthly FOCUS report many broker-dealers file with their DEA.[774] The Commission agrees that the FOCUS report may be an appropriate mechanism for reporting stock loan and repo positions in lieu of the proposed monthly notification requirement.[775] Consequently, the Commission modified the final rule amendment to delete the phrase "submits a monthly report of" and replace it with the phrase "reports monthly." In addition, as adopted, in order to provide that the monthly report shall be sent to a broker-dealer's DEA, the Commission added the phrase "to its designated examining authority in a form acceptable" before "to its designated examining authority." This approach, as adopted, is intended to provide each DEA with the flexibility to tailor the reporting requirements.

Based on FOCUS Report data, the Commission estimates that approximately one notice per year will be sent pursuant to this amendment.[776] Therefore, approximately one broker-dealer per year will incur costs to prepare and send the notice.[777] Consequently, the Commission estimates that the costs to broker-dealers associated with this requirement will be de minimis.

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774 See Abbey National Letter; Citigroup Letter; SIFMA 2 Letter.

775 Carrying broker-dealers are generally required to submit FOCUS reports on a monthly basis.

776 This estimate is derived from FOCUS Report data, and adjusted based on staff experience. This estimate has been updated from the proposing release estimate of 11. No comments were received on this estimate.

777 The internal hours would likely be performed by junior stock loan manager for 10 minutes at $134 per hour x 1 notice = $22.33. See section IV.D.8. of this release.

In addition, the Commission estimates that six broker-dealers will choose the option of reporting monthly[778] and will incur a one-time cost to update their systems to generate the information for the report.[779] The Commission also estimates that these broker-dealers will incur annual costs generating and filing the monthly reports or preparing the information to include in monthly FOCUS Reports (as applicable).[780] Therefore, the Commission estimates that the total one-time cost and annual costs to broker-dealers will be approximately $169,200[781] and $9,648[782] respectively. The Commission's total one-time and annual cost estimates have decreased from the proposing release primarily due to an overall decrease in the number of broker-dealers.

As noted above, the Commission requested comment on the proposed cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals. The Commission also requested comment on whether these proposals would impose costs on other market participants, including market participants active in the securities lending and repurchase markets. Commenters were asked to identify the metrics and sources of any empirical data that

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778 This is an update from the proposing release estimate of 21 broker-dealers. See Amendments to Financial Responsibility Rules, 72 FR at 12884.

779 The internal hours would likely be performed by a senior programmer. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Senior Programmer for 100 hours at $282 per hour = $28,200. See section IV.D.8. of this release. This is an update from the proposing release estimate of $26,800. See Amendments to Financial Responsibility Rules, 72 FR at 12884.

780 The internal hours would likely be performed by a junior stock loan manager. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Junior Stock Loan Manager for 12 hours at $134 per hour = $1,608. See section IV.D.8. of this release. This is an update from the proposing release estimate of $2,496 per firm. See Amendments to Financial Responsibility Rules, 72 FR at 12884.

781 6 firms x $28,200 = $169,200. This is an update from the proposing release estimate of $562,800. See Amendments to Financial Responsibility Rules, 72 FR at 12884.

782 6 firms x $1,608 = $9,648. This is an update from the proposing release estimate of $52,416. See Amendments to Financial Responsibility Rules, 72 FR at 12884.

supported their cost estimates. The Commission did not receive any comments in response to these requests.

ii. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

As described above, the amendment to subparagraph (c)(2)(iv)(B) of Rule 15c3-1 and new paragraph (c)(5) of Rule 17a-11 are designed to address two areas of concern that emerged from the Commission's experience with the failure of MJK.[783] First, broker-dealers with principal liability in a stock loan transaction may be deemed to be acting in an agency capacity and therefore not taking appropriate capital charges. Second, broker-dealers that historically have not been very active in stock loan activities may rapidly expand their balance sheets and increase leverage to a level that poses significant financial risk to the firm and counterparties. Either potential event could result in significant, adverse consequences for customers and counterparties of the broker-dealer. For the customers, the fact that the broker-dealer could avoid taking appropriate capital charges would imperil the broker-dealer's ability to self-liquidate, thereby impeding the ability of customers to be promptly paid in full. For the counterparties, the fact that the broker-dealer could rapidly escalate its leverage increases the likelihood that the broker-dealer could fail and its counterparties could experience, losses of value associated with the rapid unwinding of positions with the failing broker-dealer.

Overall, the amendments to Rule 15c3-1 and Rule 17a-11 will help enhance the monitoring of securities lending or repurchase activities by securities regulators, thereby reducing the effect on customers and counterparties of the potential impact of a financial

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783 See section II.C. of this release.

collapse of the broker-dealer.[784] This will strengthen the securities markets and make them more attractive to investors, thereby enhancing efficiency and capital formation. Moreover, the language in the final rule that provides each DEA with the flexibility to prescribe how the monthly reports are to be made may enhance efficiencies for broker-dealers by providing the ability for a DEA to tailor the reporting requirements. Finally, the costs of compliance with the amendments to Rules 15c3-1 and 17a-11 should not impose a burden on competition not necessary or appropriate in the furtherance of the purposes of the Exchange Act in light of the benefits discussed above.

4. Documentation of Risk Management Procedures

i. Economic Analysis

As discussed in section II.D. of this release, the Commission is adopting new paragraph (a)(23) to Rule 17a-3 to require certain broker-dealers to make and keep current a record documenting the credit, market, and liquidity risk management controls established and maintained by certain broker-dealers to assist them in analyzing and managing the risks associated with their business activities, including, for example, securities lending and repo transactions, OTC derivative transactions, proprietary trading, and margin lending.[785] The amendment will apply only to broker-dealers that have more than $1,000,000 in aggregate credit items as computed under the customer reserve formula of Rule 15c3-3, or $20,000,000 in capital including debt subordinated in accordance with Appendix D to Rule 15c3-1.

These amendments require large broker-dealers to document the controls they have implemented to address the risks they face as a result of their business activities. As proposed, the amendment would have required a broker-dealer to create a record

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[784] Id.

[785] 17 CFR 240.17a-3(a)(23).

documenting its "internal risk management controls," rather than its market, credit, and liquidity risk controls. Commenters generally raised concerns with the proposed amendment stating, for example, that the proposed documentation of internal management controls over risks arising from the broker-dealer's business activities was overly broad and ambiguous.[786] The Commission considered the proposed approach and, as discussed above, in part in response to comments, the Commission narrowed the application of the amendment so that the final rule now requires the documentation of internal risk management controls established to manage market, credit, and liquidity risk.[787] The final rule benefits firms and their customers by mitigating the risk of losses associated with a firm's normal activities, while at the same time placing an increased recordkeeping burden on broker-dealers by requiring them to document certain risks in writing.

A well-documented system of internal controls designed to manage material risk exposures related to market, credit, and liquidity risk reflects the expectations of a firm's management as to how its business activities should be conducted in light of such exposures. Written risk management procedures enable management to better identify, analyze, and manage the risks inherent in the firm's business activities with a view to preventing material losses and to review whether the firm's activities are being conducted in a manner that is consistent with such procedures and controls. This will likely benefit market participants and reduce systemic financial risk.

In addition, by making the documented controls a required record under Rule 17a-3, a broker-dealer's regulator likely will have better access to them, as this benefit will only be realized to the extent that a broker-dealer has existing market, credit, and

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786 See E*Trade Letter; Citigroup Letter.

787 See section II.D. of this release.

liquidity risk management controls in place because the rule does not specify the type of controls a broker-dealer must establish to manage these risks. It simply requires documentation of the procedures that the broker-dealer has established. The final rule amendment will require any such records of the market, credit, and liquidity risk management controls to be available to the broker-dealer's regulators so that they can review whether the broker-dealer is adhering to these controls.

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. Commenters were requested to identify sources of empirical data that could be used for the metrics they proposed. The Commission did not receive any comments in response to these requests.

These amendments apply to a limited number of broker-dealers, namely, those firms with more than $1 million in customer credits or $20 million in capital and amend recordkeeping requirements in Rules 17a-3 and 17a-4. Therefore, against the existing baseline of these current rules, the Commission expects that the requirement will result in a one-time cost to some of these firms to the extent that they have established controls that have not been documented. However, since most firms are expected to be already compliant, the incremental costs are expected to be small. For example, broker-dealers that are approved to compute capital using internal models are already subject to Rule 15c3-4, which requires these firms to establish, document, and maintain a system of internal risk controls to assist them in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.[788]

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[788] 17 CFR 240.15c3-4; 17 CFR 240.15c3-1(a)(7)(iii). Based on staff experience monitoring broker-dealer risk management procedures, the internal hours would likely be coordinated by a broker-dealer's in-house attorney (19,600 hours), working with operation specialists (24,500 hours), and overseen by an associate general counsel (4,900 hours). Therefore, the estimated internal costs for this hour burden would be calculated as follows: [(Attorney for 19,600 hours at $379 per hour) + (Operations Specialist for

These firms would most likely incur no or minimal costs to comply with the final rule. In addition, this rule amendment does not mandate any specific control, procedure, or policy be established; rather, the Commission is requiring that a control, procedure, or policy be documented if it is in place. For these reasons, the Commission estimates that the one-time hourly burden to meet the requirements of these rules will range from zero hours for some firms to hundreds of hours for other firms. Taking this into account, the Commission estimates that the total one-time cost to broker-dealers to document controls in compliance with this amendment will be approximately $13,783,700.[789] The Commission also estimates that the annual cost to broker-dealers to ensure compliance with the amendment to Rule 17a-3 will be approximately $8,356,950.[790]

As noted above, the Commission requested comment on the proposed cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals, such as costs arising from making changes to systems and costs associated with maintaining these records. The Commission also requested comment on whether the proposals would impose costs on other market participants, including broker-dealer customers. Commenters were also asked to identify the metrics and sources of any empirical data that support their cost estimates. The Commission did not receive any comments in response to these requests.

24,500 hours at $126 per hour) + (Associate General Counsel for 4,900 hours at $467) = $12,803,700. Broker-dealers are also expected to incur one-time outside counsel costs of $980,000 for a total one-time cost of $13,783,700. See section IV.D.7. of this release.

789 See section IV.D.7. of this release. In the proposing release, the Commission estimated this cost would be approximately $14,201,990. See Amendments to Financial Responsibility Rules, 72 FR at 12885.

790 The internal hours would likely be performed by a broker-dealer's in-house attorney. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Attorney at $379 per hour x 22,050 hours = $8,356,950. See section IV.D.7. of this release.

ii. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

The amendments to Rules 17a-3 and 17a-4 require firms to document their market, credit, and liquidity risk management controls. The amendments will help strengthen broker-dealer internal controls. Documenting internal controls will encourage enhanced consideration of, and thus a firmer grasp upon, the risks attendant to a broker-dealer's business activities. This is designed to reduce the risks inherent to the business of operating as a broker-dealer. The final approach the Commission has taken with these rule amendments – encouraging effective internal controls while preserving flexibility – will enhance a broker-dealer's financial soundness and, consequently, may help to reduce the likelihood of broker-dealer failures with possible positive effects on investor participation, competition, and capital formation. The amendments may also increase efficiencies in broker-dealer examinations through the ready availability of records for examiners.

Finally, the Rule 17a-3 and 17a-4 amendments are not expected to place a burden on competition for small non-carrying broker-dealers because such firms would not be subject to these amendments.[791] As discussed above, there will be some incremental costs to compliance related to these amendments for carrying broker-dealers but the costs of compliance should not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act and in light of the benefits discussed above.

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[791] The amendments only apply to broker-dealers that have more than $1,000,000 in aggregate credit items as computed under the customer reserve formula of Rule 15c3-3, or $20,000,000 in capital including debt subordinated in accordance with Appendix D to Rule 15c3-1.

5. Amendments to the Net Capital Rule

i. Economic Analysis

a. Requirement to Deduct From Net Worth Certain Liabilities or Expenses Assumed By Third Parties

(I). Summary of Amendments

The amendments to Rule 15c3-1 add a new paragraph (c)(2)(i)(F) requiring a broker-dealer to adjust its net worth when calculating net capital by including any liabilities that are assumed by a third party if the broker-dealer cannot demonstrate that the third party has the resources, independent of the broker-dealer's income and assets, to pay the liabilities. This amendment is intended to assist investors and regulators by requiring broker-dealers to provide a more accurate picture of their financial condition. This should help regulators react more quickly if a broker-dealer experiences financial difficulty and benefit customers of the troubled broker-dealer as well as its counterparties.

The purpose of the requirement in new paragraph (c)(2)(i)(F) of Rule 15c3-1 is to address the practices of a broker-dealer that raise concerns when a broker-dealer shifts liabilities to an entity with no revenue or assets independent of the broker-dealer to inappropriately increase its reported net capital, by excluding the liability from the calculation of net worth. The final rule is designed to prohibit a practice that could misrepresent a broker-dealer's actual financial condition, mislead the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition.

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. Commenters were requested

to identify sources of empirical data that could be used for the metrics they proposed. The Commission did not receive any comments in response to these requests.

(II). Baseline and Incremental Economic Effects

As discussed in section II.E.1. of this release, the baseline of this rule amendment is current Rule 15c3-1 and existing guidance and interpretations. The Commission staff has provided guidance with respect to the treatment and recording of certain broker-dealer expenses and liabilities that is consistent with the rule amendment.[792] Consequently, as against the current baseline, the Commission does not expect significant incremental benefits and costs to the extent that they already comply with existing guidance and interpretations.[793]

While the amendments apply to all broker-dealers, they will impact only those few that shift liabilities to entities with no revenue or assets independent of the broker-dealer (i.e., shell corporations) to boost the broker-dealer's reported net capital. Based on staff experience in supervising broker-dealer compliance with Rule 15c3-1, the vast majority of broker-dealers likely either do not seek to transfer responsibility for their liabilities to a third party or, if they do so, rely on a third party that has the financial resources – independent of the assets and revenue of the broker-dealer – to pay the obligations as they become due. Because of this, it is difficult to quantify the benefits and costs impact of this rule amendment.

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792 See, e.g., Third Party Expense Letter; see also FINRA Notice to Members 03-6, Expense Sharing Agreements.

793 Under this amendment, some broker-dealers may request permission in writing from their DEA to withdraw capital within one year of contribution under the rule, resulting in annual costs to broker-dealers of approximately $144,150 (465 hours x $310 per hour for a Compliance Attorney). See section IV.D.2. of this release.

The Commission conservatively estimates that the amendment may impact all broker-dealers that do not report any liabilities. FOCUS Report data, as of December 31, 2011, indicates that approximately 289 broker-dealers report having no liabilities. While this number is likely at the upper boundary of the total number of broker-dealers affected by this amendment, the number of broker-dealers reporting no liabilities likely represents a reasonable sample of broker-dealers on which to base the cost estimates.

Requiring these broker-dealers to book liabilities will decrease the amount of equity capital held by the firms and in some cases may require them to obtain additional capital. The majority of broker-dealers reporting no liabilities are introducing broker-dealers that have a $5,000 minimum net capital requirement, while the reported average of total liabilities is approximately $491,355 per broker-dealer. Therefore, conservatively estimating that each of the 289 broker-dealers will have to raise $491,355 in additional capital as result of the requirement, the total aggregate amount of additional capital that will need to be raised is $142 million.[794]

Further, relative to the proposing release, the Commission is revising the cost of capital from approximately 5%, which was determined based on historical interest rates published by the Federal Reserve, to 12% as the average cost of equity capital determined using the capital asset pricing model ("CAPM").[795] Therefore, the Commission

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[794] 289 broker-dealers x $491,355 = $142,001,595. This is an update from the proposing release estimate of 702 broker-dealers with aggregate liabilities of $280,354 per firm, resulting in an estimated amount of additional capital that would have to be raised in the amount of $196,808,508 (702 broker-dealers x $280,354 = $196,808,508). See Amendments to Financial Responsibility Rules, 72 FR at 12885, n.189 and accompanying text.

[795] The CAPM is a central model in modern financial theory and is widely used in applications, such as estimating the cost of capital for firms and evaluating the performance of managed portfolios. Based on conventional assumptions and historical stock price data available on Bloomberg, the Commission estimates a risk-free rate of 2.5% and an equity risk premium of 7.8%. Using, five-year, as well as two-year,

conservatively estimates that the total annual cost to broker-dealers will be approximately $17 million,[796] which is an increased estimate relative to the proposing release. For the broker-dealers to whom this increased estimate applies, the Commission expects that there would be greater costs imposed. However, the Commission expects that the benefits outlined above would also accrue to the customers of these broker-dealers.

The Commission requested comment on the proposed cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals. The Commission also requested comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters were also asked to identify the metrics and sources of any empirical data that support their costs estimates. The Commission received five comments in response to this request for comment.[797]

One commenter noted that the Commission has provided no evidence that the public has been endangered or has been left financially unprotected as a result of the practice of having another entity book some or all of a member's liabilities.[798] This commenter asserted that the amendment will affect 14% of total member firms and that member firms may be shut down, sold or merged as an unintended consequence of the

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monthly returns for a sample of listed broker-dealers, the Commission estimates an adjusted beta of approximately 1.25.

796 $142,001,595 x 12.25% = $17,395,195. In the proposing release, the Commission estimated that this cost would be approximately $10 million. See Amendments to Financial Responsibility Rules, 72 FR at 12885.

797 See Beer Letter; Beer 2 Letter; Lowenstein Letter; Levene Letter; NIBA 2 Letter.

798 See Lowenstein Letter.

amendment.[799] The commenter questioned how many member firms will fail as a result of this proposal.[800]

Another commenter stated that the true costs of the amendment should be calculated and verified before a proposed amendment is offered and that the true costs of these amendments were given little time, research, and consideration.[801] This commenter also argued that the estimated 5% cost of capital has no basis and a firm would be fortunate to borrow funds for double the estimate of 5%.[802] This same commenter also stated that the proposal would require 702 debt-free introducing broker-dealers to needlessly take on debt of approximately $280,354.[803] Another commenter stated that it is unclear and unlikely how this amendment would achieve any of the desired results and may conversely impair a firm's ability to continue as a going concern.[804] None of the commenters provided the Commission with revised cost estimates.

One commenter stated that if small firms were required to raise over $300,000 in capital each, there would be the largest dissolution of small broker-dealers in the history of the regulated securities industry.[805] This commenter also stated that the Commission's estimate of a gross cost of capital of 7.5% (5% + 2.5%) is a totally unrealistic cost of capital for small broker-dealers and that these broker-dealers will categorically have costs significantly higher than 7.5%.[806] Finally, the commenter stated that, until the Commission convenes a small broker-dealer representative panel to assist it with

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799 Id.

800 Id.

801 See Beer 2 Letter.

802 Id.

803 See Beer Letter; Lowenstein Letter.

804 See Levene Letter.

805 See NIBA 2 Letter.

806 Id.

establishing such costs, the Commission is speculating on such costs, and is therefore without adequate information to consider the effects of such costs and changes on small firms.[807]

(III). Alternatives

The Commission considered all comments received[808] and the alternative of not adopting the rule, and decided to adopt the amendments substantially as proposed. In response to the comment regarding the unrealistic cost of capital,[809] the Commission has increased the cost of capital to 12% as an average cost of equity capital for broker-dealers. As discussed in section II.E.1 of this release, the baseline of this amendment is current Rule 15c3-1 and existing guidance and interpretations. The Commission staff has provided guidance with respect to the treatment and recording of certain broker-dealer expenses and liabilities that is consistent with the rule amendment.[810] Existing broker-dealer recordkeeping rules require a broker-dealer to record its income and expenses.[811] For example, paragraph (a)(2) of Rule 17a-3 requires a broker-dealer to make and keep current ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts.[812] Consequently, as against the current baseline, the above estimates are intended to be conservative. The Commission expects that broker-dealers will incur costs to comply with this amendment, including costs to obtain additional capital, only to the extent they are not currently complying with existing guidance and interpretations.

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807 Id.

808 See Beer Letter; Beer 2 Letter; Lowenstein Letter; Levene Letter; NIBA 2 Letter.

809 See NIBA 2 Letter.

810 See, e.g., Third Party Expense Letter; see also FINRA Notice to Members 03-6, Expense Sharing Agreements.

811 17 CFR 240.17a-3; 17 CFR 240.17a-4.

812 17 CFR 240.17a-3(a)(2).

In response to comments,[813] the Commission does not expect broker-dealers to incur significant costs to comply with this amendment to the extent that they are appropriately recording their assets and liabilities under current Commission rules and interpretive guidance, because these items will already appear on a broker-dealer's balance sheet and be included in its net capital computation. Consequently, the rule amendment, as adopted, should not: (1) cause firms to be classified as "a going concern;"[814] (2) cause firms to fail, dissolve, or otherwise close;[815] (3) impose undue burdens; or (4) present serious implementation difficulties to firms (small or large) if they are appropriately recording their assets and liabilities under current Commission rules and interpretive guidance.[816] Further, as stated above, the estimates are intended to be conservative, and therefore, the Commission expects that the "true" costs[817] that may be incurred by broker-dealers should be less than the maximum estimated. Therefore, the Commission does not believe a longer time period for compliance or the formation of a small broker-dealer advisory cost committee is necessary.[818]

b. Requirement to Subtract From Net Worth Certain Non-Permanent Capital Contributions

(I). Summary of Amendments

As discussed in section II.E.2. of this release, the amendment adds paragraph (c)(2)(i)(G) to Rule 15c3-1, requiring a broker-dealer to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it. The rule,

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813 See Beer Letter; Beer 2 Letter; Lowenstein Letter; Levene Letter; NIBA 2 Letter.

814 See Levene Letter.

815 See NIBA 2 Letter.

816 See, e.g., Third Party Expense Letter; see also FINRA Notice to Members 03-6, Expense Sharing Agreements.

817 See Beer 2 Letter.

818 See NIBA 2 Letter.

as adopted, also requires that a broker-dealer treat as a liability any capital contribution that is withdrawn within a year of its contribution unless the broker-dealer receives permission in writing from its DEA.[819] The amendment to Rule 15c3-1 is intended to assist investors and regulators by requiring broker-dealers to provide a more accurate picture of their financial condition. This amendment will help regulators react more quickly if a broker-dealer experiences financial difficulty and benefits customers of a troubled broker-dealer as well as its counterparties.

The Commission requested comment on available metrics to quantify these benefits and any other benefits a commenter may identify. Commenters were requested to identify sources of empirical data that could be used for the metrics they proposed. The Commission did not receive any comments in response to these requests.

(II). Baseline and Incremental Economic Effects

As discussed in section II.E.2. of this release, the baseline of this rule amendment is current Rule 15c3-1 and existing guidance and interpretations. The Commission estimates that the amendments requiring broker-dealers to treat certain capital contributions as liabilities should not result in significant incremental benefits and costs, as compared to the baseline. Because of existing Commission and staff guidance

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[819] One commenter suggested that the rule be amended to explicitly exclude any withdrawals that would fall under paragraph (e)(4)(iii) of Rule 15c3-1. See American Bar Association Letter. It is unnecessary to explicitly exclude any withdrawals that would fall under paragraph (e)(4)(iii) of Rule 15c3-1because these requirements will not apply to withdrawals covered by paragraph (e)(4)(iii) of Rule 15c3-1, namely, withdrawals used to make tax payments or to pay reasonable compensation to partners. 17 CFR 240.15c3-1(e)(4)(iii). These types of payments are ordinary business expenditures and do not raise the types of concerns the proposed rule is designed to address. See Amendments to Financial Responsibility Rules, 74 FR at12872, n.79.

regarding the permanency of capital,[820] broker-dealers typically do not enter into agreements permitting an owner to withdraw capital at any time. To the extent some firms may have engaged in this practice, they may need to raise capital to meet the rule requirement.

While the amendments apply to all broker-dealers, they will impact only the few broker-dealers that provide investors with the option to withdraw capital at any time or within one year. Because of existing Commission and staff interpretations related to temporary capital contributions,[821] most broker-dealers likely do not accept capital contributions under agreements permitting the investor to withdraw the capital at any time or within one year. Therefore, it is difficult to quantify the cost impact of this rule amendment.

Based on staff experience with the treatment of capital contributions and the application of Rule 15c3-1, the Commission estimates that no more than $100 million in capital at broker-dealers is subject to such agreements.[822] Further, with regard to the treatment of temporary capital contributions, in the proposing release, the Commission assumed an incremental cost of capital of 2.5%,[823] and estimated that the amendment would result in an annual cost of approximately $2.5 million.[824]

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820 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991). See also Net Capital Requirements for Brokers and Dealers Exchange Act Release No. 18417 (Jan. 13, 1982), 47 FR 3512 (Jan. 25, 1982). See also Temporary Capital Letter; Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 92–231 (1971) (recommending improvement of adequacy and permanency of capital); and Letter from Nelson Kibler, Assistant Director, Division of Market Regulation to John Pinto, National Association of Securities Dealers, Inc. (Sept. 8, 1980).

821 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991); and Temporary Capital Letter.

822 See Amendments to Financial Responsibility Rules, 72 FR at 12885.

823 Id. at 12886–12887.

824 $100,000,000 x 2.5% = $2,500,000.

The Commission requested comment on the proposed cost estimates. In particular, the Commission requested comment on additional costs to broker-dealers that would arise from the proposals. The Commission also requested comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters were also asked to identify the metrics and sources of any empirical data that support their costs estimates.

The Commission received three comments.[825] One commenter stated that the Commission's estimate that no more than $100 million of capital at broker-dealers is subject to agreements permitting an owner to withdraw capital at any time greatly underestimates the impact of the proposed rule.[826] The commenter stated that the Commission makes no case for deviating from the already established standards.[827] Another commenter believed that the proposal would raise its cost of capital to such an extent that it would be impossible for the firm to raise capital from unrelated third parties.[828]

One commenter stated that the Commission's estimate of a gross cost of capital of 7.5% (5% + 2.5%) is a totally unrealistic cost of capital for small broker-dealers and that these broker-dealers will categorically have costs significantly higher than 7.5%.[829] Finally, the commenter stated that, until the Commission convenes a small broker-dealer representative panel to assist it with establishing such costs, the Commission is "speculating" on such costs, and is therefore without adequate information to consider the effects of such costs and changes on small firms.[830]

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825 See Chicago Capital Management Letter; SIG Letter; NIBA 2 Letter.

826 See SIG Letter.

827 Id.

828 See Chicago Capital Management Letter.

829 See NIBA 2 Letter.

830 Id.

In response to comments,[831] the Commission is revising this estimate in the final rule to an estimated cost of capital of approximately 12%, which is determined as the average cost of equity capital of broker-dealers using the CAPM. The overall estimated cost of capital is not incremental to the amendment discussed above regarding third party liabilities. The estimated cost of capital would be 12% for a broker-dealer seeking additional equity capital. Therefore, with regard to the treatment of temporary capital contributions, the Commission estimates the amendment will result in an annual cost of approximately $12.0 million,[832] which is an increased estimate relative to the proposing release. For the broker-dealers to whom this increased estimate applies, and who may not be complying with the rule amendments, the Commission expects that there would be greater costs imposed. However, the Commission expects that the benefits outlined above would also accrue to the customers of these broker-dealers.[833]

(III). Alternatives

The Commission considered all comments discussed above and the alternative of not adopting the rule, and decided to adopt the amendments substantially as proposed. In response to commenters' concerns about the impact on capital and the $100 million estimate,[834] as discussed above, the final rule amendment is a codification of existing Commission staff guidance,[835] and thus should not represent a change for broker-dealers with respect to capital withdrawals. Moreover, with respect to commenters' concerns about obtaining capital,[836] the rule does not prohibit an investor from withdrawing capital

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831 See NIBA 2 Letter.

832 $100,000,000 x 12.25% = $12,250,000.

833 $100,000,000 x 12.25% = $12,250,000.

834 See Chicago Capital Management Letter; SIG Letter; NIBA 2 Letter.

835 See Temporary Capital Letter. See also section II.E.2. of this release.

836 See Chicago Capital Management Letter; SIG Letter; NIBA 2 Letter.

at any time. Rather, it prohibits a broker-dealer from treating temporary cash infusions as capital for purposes of the net capital rule. Finally, the final rule amendment provides a mechanism for a broker-dealer to apply to its DEA to make a withdrawal within one year of the capital contribution without triggering the deduction under certain circumstances.

In the final rule, the Commission has increased the estimated cost of capital from 2.5% to 12%, in response to comments regarding the unrealistic cost of capital, and because the estimated cost of capital is not incremental to the estimated cost of capital to the amendment to Rule 15c3-1 regarding third party liabilities.[837] The estimated cost of capital would be 12% for a broker-dealer seeking a loan for any additional capital. In addition, based on staff experience with the treatment of capital contributions and for the reasons discussed above, the Commission continues to believe that the estimate of $100 million regarding the temporary capital contributions is reasonable.[838]

Further, the final rule amendments relating to temporary capital contributions have been revised to clarify that a withdrawal of capital made within one year of its contribution to the broker-dealer is deemed to have been intended to be withdrawn within one year, unless the withdrawal has been approved in writing by the broker-dealer's DEA.[839] The Commission made this change to eliminate a potential ambiguity as to whether a withdrawal of capital within one year could ever be approved by a broker-dealer's DEA. The final rule amendment clarifies the intent to provide a mechanism for broker-dealers to apply for approval to withdraw capital within one year and to be granted such approval where appropriate.

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[837] See NIBA 2 Letter.

[838] See SIG Letter.

[839] See section II.E.2. of this release.

While owners of most broker-dealers have the option of withdrawing capital, most owners likely do not have agreements that provide the option of withdrawing capital at any time.[840] Paragraph (e) of Rule 15c3-1 contains mechanisms to permit a broker-dealer to make capital withdrawals for specified purposes.[841] If there is a specific need for a broker-dealer to seek permission to make a capital withdrawal within one year of contribution, the final rule already provides a mechanism for the broker-dealer to seek permission in writing from its DEA to make such a withdrawal.[842] Based on the discussion above, the Commission believes the final cost estimates are appropriate.[843]

c. Requirement to Deduct the Amount by which a Fidelity Bond Exceeds SRO Limits

As discussed in section II.E.3. of this release, this amendment requires broker-dealers to deduct from net capital, with regard to fidelity bonding requirements prescribed by a broker-dealer's examining authority, the excess of any deductible amount over the amount permitted by SRO rules.

Under SRO rules, certain broker-dealers that do business with the public or are required to become SIPC members must comply with mandatory fidelity bonding requirements.[844] SRO rules typically permit a broker-dealer to have a deductible

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840 See SIG Letter.

841 See paragraphs (e)(1)(iii)(B) and (e)(4)(iii) of Rule 15c3-1. See also Amendments to Financial Responsibility Rules, 72 FR at 12872, n.79 ("These requirements would not apply to withdrawals covered by paragraph (e)(4)(iii) of Rule 15c3-1, namely, withdrawals used to make tax payments or pay reasonable compensation to partners. These types of payments are ordinary business expenditures and do not raise the types of concerns the proposed rule is designed to address.")

842 See paragraph (c)(2)(i)(G)(2) of Rule 15c3-1.

843 See NIBA 2 Letter.

844 See, e.g., FINRA Rule 4360, CBOE Rule 9.22, and NASDAQ OMX PHLX Rule 705. SRO fidelity bonding requirements typically contain agreements covering the following areas: a "Fidelity" insuring clause to indemnify against loss of property through dishonest or fraudulent acts of employees; an "On Premises" agreement insuring against losses resulting from crimes such as burglary and theft and from misplacement of property of

provision included in the bond; however, such rules provide that the deductible must not exceed certain amounts. With regard to firms that maintain deductible amounts over certain specified amounts, a number of SRO rules provide that the broker-dealer must deduct this specified amount from net worth when calculating net capital under Rule 15c3-1.[845]

Rule 15c3-1, however, does not specifically reference the SRO deductible requirements as a charge to net worth, meaning that a broker-dealer would not be required for the purposes of Commission rules to show the impact of the deduction in the net capital computation required by an SRO on the FOCUS Report.[846] To address the reporting inconsistency, the Commission is amending Rule 15c3-1 to add paragraph (c)(2)(xiv), which will require broker-dealers to deduct the amount specified by rule of the Examining Authority of the broker-dealer with respect to a requirement to maintain fidelity bond coverage. This rule amendment will provide consistency in broker-dealer reporting requirements.[847]

This amendment will also codify in a Commission rule capital charges that broker-dealers are currently required to take pursuant to the rules of various SROs. Consequently, any economic effects, including costs and benefits, should be compared to a baseline of current practices. The amendment should not impose additional costs on broker-dealers with respect to the purchasing or carrying of fidelity bond coverage. Nor

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the insured; an "In Transit" clause indemnifying against losses occurring while property is in transit; a "Forgery and Alteration" agreement insuring against loss due to forgery or alteration of various kinds of negotiable instruments; and a "Securities Loss" clause protecting against losses incurred through forgery and alteration of securities. Id.

845 See, e.g., FINRA Rule 4360 and CBOE Rule 9.22.

846 See 17 CFR 240.17a-5.

847 Conversely, not adopting this rule amendment would have resulted in continued inconsistency among existing SRO rules and Rule 15c3-1.

will the amendment cause broker-dealers to incur additional costs in determining or reporting excess deductible amounts over the deductible permitted. Broker-dealers already make such determinations under SROs rules, and the manner in which such excesses are typically reported (i.e., through periodic FOCUS Reports and other reports) would remain the same.

The Commission received one comment opposing the fidelity bond amendment, stating that FINRA Rule 4360 and the Commission's amendment would result in a de facto increase in minimum net capital requirements for some broker-dealers.[848] Any increase in net capital cited by the commenter would result from existing SRO rules.[849] Stated differently, broker-dealers that are members of an SRO with such a fidelity bonding rule must already account for the deduction in complying with the net capital requirements of SROs and nothing in the Commission's amendment to paragraph (c)(2)(xiv) of Rule 15c3-1 would alter this status quo. Consequently, while there is currently no deduction required under the baseline of current Rule 15c3-1 relating to fidelity bond deductibles, because SRO rules currently require this deduction, the adoption of this amendment under Rule 15c3-1 should not impose any additional costs on broker-dealers that they are not already incurring under existing SRO rules.

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848 See NIBA 2 Letter.

849 For example, the Commission approved FINRA Rule 4360 through the SRO rule filing process. See Order Approving Proposed Rule Change to Adopt FINRA Rule 4360 (Fidelity Bonds) in the Consolidated FINRA Rulebook, Exchange Act Release No. 63961 (Feb. 24, 2011), 76 FR 11542 (Mar. 2, 2011). Pursuant to Section 19(b)(1) of the Exchange Act, each SRO must file with the Commission any proposed change in, addition to, or deletion from the rules of the exchange electronically on a Form 19b-4 through the Electronic Form 19b-4 Filing System, which is a secure website operated by the Commission. 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4.

d. Broker-Dealer Solvency Requirement

As discussed in section II.E.4., the amendment to paragraph (a) of Rule 15c3-1 states that no broker-dealer shall be "insolvent" as that term is defined under paragraph (c)(16) of the rule. The companion amendment to paragraph (b)(1) of Rule 17a-11 requires insolvent broker-dealers to provide notice to regulatory authorities.

Allowing an insolvent broker-dealer to continue conducting a securities business during the period of its insolvency, notwithstanding its net capital position, could jeopardize customers and other market participants because a broker-dealer that has made an admission of insolvency, or is otherwise deemed insolvent or entitled to protection from creditors, does not possess the financial resources necessary to operate a securities business. Continuing to operate in such circumstances poses a significant credit risk to counterparties and to the clearance and settlement system, and, in the event the firm ends up in a liquidation proceeding under SIPA, may impair the ability of the SIPA trustee to make the customers of the broker-dealer whole and satisfy the claims of other creditors out of the assets of the general estate.[850]

Consequently, the amendment to Rule 15c3-1 benefits the securities markets, and indirectly, all other market participants, by removing risks associated with the continued operation of a financially unstable firm. For example, the amendment will limit the potential that an insolvent firm would take on new customers and place their assets at risk. Furthermore, the broker-dealer will not be able to enter into proprietary transactions with other broker-dealers and place them or clearing agencies at further risk of counterparty default. The broker-dealer's existing customers also will benefit from

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[850] See Amendments to Financial Responsibility Rules, 72 FR at 12872.

preservation of any remaining capital of the firm, which could be used to facilitate an orderly liquidation.

The amendment to Rule 17a-11 also benefits the securities markets in that it will provide regulators with the opportunity to more quickly take steps to protect customers and counterparties at the onset of the insolvency, including, if appropriate, notifying SIPC of the need to commence a SIPA liquidation.

The baseline for this proposed amendment is current Rules 15c3-1 and 17a-11, which currently do not contain requirements to cease conducting a securities business (or to notify the Commission) if certain insolvency events were to occur. The amendments generally will have no impact on broker-dealers when compared to the current baseline. Should a broker-dealer become subject to an insolvency proceeding, it will incur the cost of sending notice of that fact to the Commission and its DEA. The Commission estimated in the PRA that it will occur approximately two[851] times a year for all broker-dealers.[852] For these reasons, the Commission estimates that any costs arising from this amendment will be de minimis.

One commenter stated that involuntary bankruptcy proceedings do not necessarily indicate that the broker-dealer is insolvent, as such proceedings can be frivolous, malicious, or otherwise lacking in merit, and noted standard industry forms generally provide a grace period for a party to such a proceeding to obtain a stay or dismissal before an event of default is deemed to have occurred. The Commission considered this alternative approach and notes that if a firm believes that it is the subject of an

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851 This estimate is based on the 2012 SIPC Annual Report, which indicates that over the last ten year-period, the annual average of new customer protection proceedings was three. A copy of the 2012 Annual Report is available at http://www.sipc.org/.

852 The internal hours would likely be performed by a compliance clerk. Therefore, the estimated internal costs for this hour burden would be calculated as follows: Compliance Clerk at $63 per hour x 20 minutes = $21.00. See section IV.D.8. of this release.

unwarranted involuntary bankruptcy proceeding and that its case will not be dismissed within the 30 day timeframe, as is the case with existing net capital requirements, pursuant to Rule 15c3-1(b)(3), the Commission may, upon written application, exempt the broker-dealer from the requirement.

In addition, one commenter objected to the amendments as unnecessary, citing the Rule 15c3-1 prohibition on broker-dealers effecting securities transactions if their net capital is below certain minimums.[853] The commenter stated that the net capital of an insolvent broker-dealer would, by definition, be below those minimums.[854] The Commission considered the commenter's view and the alternative of not adopting the amendments. The purpose of the amendment is to address cases where the broker-dealer is subject to an insolvency event but maintains that it is in compliance with the net capital rule. Therefore, the Commission is adopting this amendment, because, while such instances may be rare, an insolvent broker-dealer could seek the protection of the bankruptcy laws but continue to effect transactions with the public, potentially jeopardizing customers and other creditors of the broker-dealer, including counterparties.

As noted above, the Commission requested comment on this cost estimate. In particular, the Commission requested comment on whether there would be costs to broker-dealers as a consequence of the proposal. The Commission also requested comment on whether this proposal would impose costs on other market participants, including broker-dealer customers. Commenters were asked to identify the metrics and sources of any empirical data that supported their costs estimates. The Commission did not receive any comments in response to these requests.

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853 See St. Bernard Financial Services Letter.

854 Id.

e. Amendment to Rule Governing Restrictions of Withdrawals of Capital

As discussed in section II.E.5. of this release, paragraph (e) of Rule 15c3-1, which places certain conditions on a broker-dealer when withdrawing capital,[855] also allows the Commission to issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under certain circumstances.[856] The rule, however, limits such orders to withdrawals, advances, or loans that, when aggregated with all other withdrawals, advances, or loans on a net basis during a 30 calendar day period, exceed 30% of the firm's excess net capital.[857]

The Commission has determined that the requirement is difficult to enforce, as it generally would not be clear when the 30% threshold had been reached, due to the inherent unreliability of a troubled broker-dealer's books and records. The Commission considered retaining the 30% threshold, but determined that a more appropriate approach would be to eliminate the 30% threshold requirement from the rule, rather than retain a provision that is difficult to enforce. Consequently, the Commission proposed, and is adopting, a change to delete this provision and instead to allow the Commission to restrict all withdrawals, advances, and loans so long as the other conditions under the rule (all of which remain unchanged) were met.

The amendment to paragraph (e) of Rule 15c3-1 benefits the securities markets by protecting customers and counterparties of a financially stressed broker-dealer. For example, by prohibiting unsecured loans to a stockholder or withdrawal of equity capital while the order is outstanding, the amendment will help to preserve the assets and

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855 See 17 CFR 240.15c3-1(e).

856 See 17 CFR 240.15c3-1(e)(3).

857 Id.

liquidity of the broker-dealer and enable the Commission and its staff, as well as other regulators, to examine the broker-dealer's financial condition, net capital position, and the risk exposure to the customers and creditors of the broker-dealer.

The current rule permitting the Commission to restrict withdrawals of capital from a financially distressed broker-dealer was adopted in 1991.[858] This rule is the baseline for purposes of this economic analysis. When the Commission adopted this paragraph of Rule 15c3-1 more than twenty years ago, the Commission stated that it was intended to be an emergency provision, applicable only to the most exigent of circumstances where the continued viability of the broker-dealer appears to be at stake.[859] In the ensuing years, the Commission has only utilized this provision one time.[860] Based on this experience with the rule, and the fact that the rule is intended as an emergency provision only, as compared to the current baseline, the Commission estimates that the amendment will result in no or de minimis costs to broker-dealers.

As noted above, the Commission requested comment on this cost estimate. The Commission also requested comment on whether the proposal would impose costs on other market participants. Commenters were asked to identify the metrics and sources of any empirical data that support their cost estimates. One commenter supported the amendment but believed that the rule is intended to protect the capitalization of large firms while ignoring small firms, and proposed that the Commission state all the conditions that need to exist for a firm to withdraw, repay or redeem any amount that

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858 See Net Capital Rule, Exchange Act Release No. 28927 (Feb. 28, 1991), 56 FR 9124 (Mar. 5, 1991).

859 Net Capital Rule, Exchange Act Release No. 28927, 56 FR 9124, 9128.

860 Order Regarding Withdrawals, Unsecured Loans or Advances from Refco Securities, LLC and Refco Clearing, LLC, Exchange Act Release No. 52606 (Oct. 13, 2005).

does not endanger the firm or its customers.[861] The commenter also stated that it opposes regulation that arbitrarily reduces the value of small broker-dealers and their competitive position relative to larger broker-dealers. A second commenter noted that the proposed amendment would impose additional compliance burdens on broker-dealers and would significantly limit broker-dealers' flexibility in the event of a liquidity crisis.[862]

In adopting the final rule, the Commission considered the alternatives and modifications suggested by commenters. In response to these comments, the Commission notes that the amendment would eliminate the 30% threshold from paragraph (e)(3)(i) of Rule 15c3-1, which relates to the Commission's authority to temporarily restrict withdrawals of net capital. It cannot impose these restrictions without concluding that "such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970."[863] While paragraph (e)(3)(i) of Rule 15c3-1 would apply to all broker-dealers, the stringent conditions under which the Commission may exert its authority under the rule to temporarily restrict a broker-dealer's withdrawals of net capital would apply to only the circumstances where the continued viability of the broker-dealer appears to be at stake.[864] The Commission, however, agrees with the importance of maintaining flexibility in the context of ordering restrictions on withdrawals, advances, and loans.

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861 See NIBA 2 Letter.

862 See Raymond James 2 Letter.

863 See 17 CFR 240.15c3-1(e)(3)(i).

864 Net Capital Rule, Exchange Act Release No. 28927, 56 FR 9124, 9128.

Therefore, the Commission modified the amendment, as adopted, to add language to paragraph (e)(3)(i) to state (following the phrase "employee or affiliate") that such orders will be issued, "under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors . . . ."[865]

In summary, the Commission does not believe that the deletion of the 30% threshold will affect the competitiveness or unduly restrict the ongoing business operations of small broker-dealers as compared to larger firms. All broker-dealers remain subject to the other notice and withdrawal limitations on equity capital set forth in paragraphs (e)(1) and (e)(2) of Rule 15c3-1, which are not the subject of this rule amendment.

f. Amendment to Rule 15c3-1 Appendix A

As discussed in section II.E.6.i. of this release, the amendment to paragraph (b)(1)(vi) of Rule 15c3-1a will make permanent the reduced net capital requirements that apply to listed option positions in major market foreign currencies and high-capitalization and non-high-capitalization diversified indexes in non-clearing option specialist and market maker accounts. This change will benefit the broker-dealers that have been calculating charges under a temporary amendment the Commission originally adopted in 1997.[866] The temporary amendment expired on September 1, 1997, subject to extension.[867] The Commission staff subsequently issued a no-action letter on January 13, 2000, which stated that the staff would not recommend enforcement action if broker-

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865 See paragraph (e) of Rule 17a-3, as adopted. See generally, 15 U.S.C. 78mm(a)(1).

866 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

867 See 17 CFR 15c3-1a(b)(1)(iv)(B).

dealers continued to rely on the temporary amendment.[868] The Commission considered whether to keep the amendment temporary but determined that making the temporary amendment permanent, as proposed, was the more appropriate alternative because it creates certainty for broker-dealers relying on the rule.

Because this amendment seeks to match capital requirements with actual risks, it should not have an adverse impact on the financial strength of broker-dealers. Moreover, because broker-dealers are already operating under the temporary relief, which is the current baseline, the amendment should not result in any costs for broker-dealers as compared to the current baseline.

The Commission requested comment on available metrics to quantify the benefits identified above and any other benefits the commenter may identify. In addition, the Commission requested comment on whether the proposal would result in any costs. Commenters were asked to identify the metrics and sources of any empirical data that support their cost estimates. The Commission did not receive any comments in response to these requests.

ii. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Rule 15c3-1 is designed to help ensure that a broker-dealer holds at all times liquid assets sufficient to pay its non-subordinated liabilities and retain a "cushion" of liquid assets used to pay customers without delay in the event that the broker-dealer fails. For example, a broker-dealer that inappropriately excludes certain liabilities when

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[868] Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Richard Lewandowski, Vice President, Regulatory Division, The Chicago Board Options Exchange, Inc. (Jan. 13, 2000) (stating that the Division of Trading and Markets "will not recommend . . . enforcement action if non-clearing option specialists and market-makers continue to rely on subparagraph (b)(1)(iv) of Appendix A to Rule 15c3-1 under the Exchange Act until such time as the Commission has determined whether it should be extended").

presenting its financial position[869] or includes non-permanent capital contributions in its financial statements[870] distorts the view of the firm's financial condition and undermines the rule. In either event, such practices jeopardize the broker-dealer's ability to self-liquidate and promptly pay customers.

The Commission's experience with the broker-dealer financial responsibility rules, underscored by the 2008 financial crisis, highlights the effects that the failure of a broker-dealer, particularly a large carrying broker-dealer, could have on customers and other market participants. Losses resulting from the disorderly winding down of a broker-dealer may often undermine the participation of investors in the U.S. capital markets, with possible negative effects on capital formation and market efficiency. Thus, it is imperative that broker-dealers operate in compliance with Rule 15c3-1 and that the Commission takes the necessary steps to help ensure that broker-dealers are prohibited from engaging in practices that obscure noncompliance.

The amendments to Rule 15c3-1 are designed to reduce the risk of a disorderly failure of a broker-dealer and lessen the potential that market participants may seek to rapidly withdraw assets and financing from broker-dealers during a time of market stress. These Rule 15c3-1 amendments may affect efficiency and capital formation through their positive impact on competition among broker-dealers. Specifically, markets that are competitive can, all other things equal, be expected to promote an efficient allocation of capital.[871]

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869 See section II.E.1. of this release.

870 See section II.E.2. of this release.

871 See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70213, 70315 (Nov. 23, 2012).

The amendments to Rule 15c3-1 – (1) requiring a broker-dealer to account for certain liabilities or treat certain capital contributions as liabilities,[872] (2) requiring a broker-dealer to deduct certain fidelity bond deductibles,[873] (3) requiring an insolvent broker-dealer to cease conducting a securities business and provide notice under the amendment to Rule 17a-11,[874] (4) eliminating the qualification on Commission orders restricting withdrawals, advances, and unsecured loans to instances where recent withdrawals, advances or loans, in the aggregate, exceed 30% of the broker-dealer's excess net capital,[875] and (5) making permanent the reduced net capital requirements under Appendix A for market makers[876] – are consistent with promoting efficiency, competition, and capital formation in the market place.

First, a broker-dealer that fails to include liabilities that depend on the broker-dealer's assets and revenues and accepts temporary capital contributions is obscuring its true financial condition. This also interferes with the process by which regulators monitor the financial condition of broker-dealers and, thereby, impedes their ability to take proactive steps to minimize the harm resulting from a broker-dealer failure to customers, counterparties, and clearing agencies.

Second, requiring broker-dealers to take net capital charges for excess fidelity bond deductibles imposed under SRO rules will promote efficiency by providing consistency among Rule 15c3-1 and SRO rules. Because fidelity bond requirements provide a safeguard with regard to broker-dealer financial responsibility, the amendment will enhance competition through the operation of more financially sound firms.

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872 See sections II.E.1. and 2. of this release.

873 See section II.E.3. of this release.

874 See section II.E.4. of this release.

875 See section II.E.5. of this release.

876 See section II.E.6.i. of this release.

Third, the continued operation of an insolvent broker-dealer or the withdrawal of capital from a broker-dealer that may jeopardize such broker-dealer's financial integrity poses financial risk to its customers, counterparties, and the registered clearing agencies. These risks increase costs and decrease efficiency of the marketplace.

Fourth, the elimination of the limitation on Commission orders restricting capital withdrawals under paragraph (e)(3) of Rule 15c3-1 from a financially troubled broker-dealer will provide greater protection to customers and counterparties of the firm and registered clearing agencies. While such orders are expected to be infrequent, when issued they should lower costs to these entities associated with having an outstanding obligation from the troubled broker-dealer, thereby promoting efficiency and facilitating capital formation.

One commenter expressed concern that the proposed amendments to Rule 15c3-1 would be particularly burdensome on small broker-dealers, negatively impacting capital formation for small issuers and increasing the cost of capital for small broker-dealers.[877] For example, the commenter stated that it believed that the proposed changes requiring a broker-dealer to subtract from net worth certain non-permanent capital contributions and to deduct from net worth certain liabilities or expenses assumed by third parties would negatively impact capital formation for small issuers and increase the cost of capital for small broker-dealers.[878]

While the Commission is cognizant that the Rule 15c3-1 amendments may impose burdens on broker-dealers, including non-carrying broker-dealers, the commenter is treating the amendments as entirely new additions to the net capital rule. Yet, as discussed in section II.E. of this release, the Commission has emphasized that capital

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877 See NIBA 2 Letter.

878 Id.

contributions to broker-dealers should not be temporary. Further, the Commission staff has explained that a capital contribution should be treated as a liability if it is made with the understanding that such contribution can be withdrawn at the option of the investor.[879] Based on the Commission's experience with the application of Rule 15c3-1, the majority of broker-dealers operate consistent with past Commission and staff rules and guidance regarding the nature of capital and, thus, the Rule 15c3-1 amendments should not represent a substantial change for most broker-dealers. Therefore, the final rule should not negatively impact capital formation for small issuers, nor increase the cost of capital for small broker-dealers, to the extent that these firms already comply with current guidance and interpretations.[880] For those firms that will need to raise capital to comply with the amendments to Rule 15c3-1, the rule amendments potentially may negatively impact capital formation. However, the potential costs to some broker-dealers could be offset by the aggregate increase in capital formation related to heightened confidence in broker-dealer financial requirements.

Finally, the Commission recognizes that, as discussed above, the amendments to Rule 15c3-3 adopted today impose certain costs on broker-dealers that could affect competition among broker-dealers. However, the Commission is of the opinion that these costs are justified by the significant benefits described in this economic analysis. In sum, the costs of compliance resulting from the requirements in the amendments to Rule 15c3-3 should not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act in light of the benefits discussed above.

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879 See section II.E.2. of this release.

880 See NIBA 2 Letter.

VI. FINAL REGULATORY FLEXIBILITY ANALYSIS

The Commission proposed amendments to Rules 15c3-1, 15c3-1a, 15c3-2, 15c3-3, 15c3-3a, 17a-3, 17a-4, and 17a-11 under the Exchange Act. An Initial Regulatory Flexibility Analysis ("IRFA") was included in the proposing release.[881] This Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with the provisions of the RFA.[882]

The Commission requested comment with regard to matters discussed in the IRFA, including comments with respect to the number of small entities that may be affected by the proposed rule amendments.[883] The Commission also requested that commenters specify the costs of compliance with the proposed amendments, and suggest alternatives that would accomplish the goals of the amendments.[884] The Commission received one general comment on the IRFA.[885] In addition, the Commission received a number of comments regarding the impact on small entities with respect to specific aspects of the proposed rule amendments, including comments relating to amendments under Rule 15c3-3 with respect to where special reserve deposits may be held, and amendments under Rule 15c3-1 relating to the requirement to subtract from net worth certain liabilities or expenses assumed by third parties.[886] The general comment on the IRFA is discussed directly below. The specific comments are discussed in the applicable sections below.

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881 See Amendments to Financial Responsibility Rules, 72 FR 12862.

882 5 U.S.C. 604(a).

883 See Amendments to Financial Responsibility Rules, 72 FR at 12888.

884 Id.

885 See Angel Letter.

886 These comments are discussed in the applicable section below.

A. General Issues Raised by Public Comments

The commenter stated that the Commission should pay "explicit attention to regulatory trends in the rest of the world" because doing so "benefits not only small entities (by reducing their regulatory burden) but all entities, as larger entities can experience more consistent regulatory procedures around the world."[887] The commenter suggested that the Commission consider a "Basel II type approach to net capital requirements."[888] In response to the commenter, the Commission notes that the amendments relate to discrete areas of the broker-dealer financial responsibility rules (i.e., they do not establish new financial responsibility standards such as would be the case if the Commission were to adopt a "Basel II type approach to net capital requirements."). As noted above, the commenter's suggestion is beyond the scope of this rulemaking.[889]

B. Amendments to the Customer Protection Rule

1. Need for and Objectives of the Rule Amendments

The final rule amends certain provisions of Rule 15c3-3.[890] The amendment that requires broker-dealers to perform a PAB reserve computation is designed to address a disparity between Rule 15c3-3 and the SIPA, and to incorporate provisions of the PAIB Letter into Commission rules.[891] The amendment that will require broker-dealers to

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887 See Angel Letter.

888 Id.

889 The commenter cited the JP Morgan Letter in support of the suggestion to "consider regulatory trends in the rest of the world." Id. The JP Morgan Letter recommends that the Commission adopt a due diligence standard – citing a U.K. regulation – with respect to the amendments regarding customer reserve account cash deposits. See JP Morgan Letter. The Commission addresses this comment above in section V.D.1.i.b.(III) of this release.

890 17 CFR 240.15c3-3.

891 See section II.A.2. of this release.

exclude cash deposited at an affiliated bank and cash deposited with an unaffiliated bank to the extent that the amount exceeds 15% of the bank's equity capital from being used to meet a broker-dealer's reserve requirements is designed to avoid the situation where a carrying broker-dealer's cash deposits constitute a substantial portion of the bank's deposits.[892] The amendment that will require broker-dealers to obtain possession and control of customers' fully paid and excess margin securities allocated to a short position is designed to address the fact that Rule 15c3-3 currently permits a broker-dealer to monetize customer securities, which is contrary to the customer protection goals of Rule 15c3-3, which seeks to ensure that broker-dealer's do not use customer assets for proprietary purposes.[893] The amendment that will require broker-dealers to provide certain notices and disclosures before changing the terms and conditions under which the broker-dealer treats customer free credit balances is intended to help ensure that the use of customer free credit balances accords with customer preferences.[894] The importation of certain provisions of Rule 15c3-2 into Rule 15c3-3 streamlines the customer protection rules and eliminates irrelevant provisions in Rule 15c3-2 due to Rule 15c3-3.[895] The amendments clarifying that funds in certain commodities accounts are not to be treated as free credit balances or other credit balances are intended to remove uncertainty with respect to their treatment under Rule 15c3-3.[896]

The amendments to Rule 15c3-3 are intended to strengthen the protections afforded to customer assets held at a broker-dealer. The amendments are designed to

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892 See section II.A.3. of this release.

893 See section II.A.4. of this release.

894 See section II.A.5. of this release.

895 Id.

896 See section II.A.6. of this release.

minimize the risk that customer assets will be lost, tied-up in a liquidation proceeding, or held in a manner that is inconsistent with a customer's expectations.

2. Significant Issues Raised by Public Comment

The Commission received numerous comments with respect to the amendment under paragraph (e)(5) of Rule 15c3-3 that will require broker-dealers to exclude cash deposited at an affiliated bank and cash deposited with an unaffiliated bank to the extent that the amount exceeds 15% of the bank's equity capital from being used to meet a broker-dealer's reserve requirements.[897] As proposed, new paragraph (e)(5) of 15c3-3 would have provided that, in determining whether a broker-dealer maintains the minimum reserve deposits required (customer and PAB), the broker-dealer must exclude any cash deposited at an affiliated bank. In addition, the proposed amendment would have required a broker-dealer to also exclude cash deposited at an unaffiliated bank to the extent the cash deposited exceeds (1) 50% of the broker-dealer's excess net capital (based on the broker-dealer's most recently filed FOCUS Report),[898] or (2) 10% of the bank's equity capital (based on the bank's most recently filed Call Report or Thrift Financial Report).[899]

With respect to the proposed limits on the amounts that could be deposited in unaffiliated banks, some commenters argued that the percentages were too restrictive while other commenters suggested alternative approaches to the proposed percentage limitations.[900] One commenter stated that the percentage thresholds would negatively impact smaller broker-dealers because these firms would still be required under the

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897 See section II.A.3. of this release.

898 Under Rule 17a-5 broker-dealers must file FOCUS Reports. 17 CFR 240.17a-5.

899 See Amendments to Financial Responsibility Rules, 72 FR at 12864.

900 See Deutsche Bank Securities Letter; SIFMA 2 Letter; First Clearing Letter; ICI Letter; BlackRock Letter.

proposed rule to maintain at least two reserve bank accounts at different banks.[901] This commenter noted that limiting Rule 15c3-3 deposits at a single bank to 50% of a broker-dealer's excess net capital could impact 10 to 15% of its broker-dealer customers in that many of these customers would be required to open accounts at multiple institutions.[902] This commenter suggested the Commission consider higher percentages for cash deposits at large money-centered banks, since the proposed percentage thresholds would negatively impact small broker-dealers because they would exceed the 50% of excess net capital threshold at lower deposit levels.[903] This commenter also noted that conducting due diligence and opening new accounts and the ongoing monitoring and periodic re-evaluation of such additional accounts would require much more time than the 10 hours originally estimated by the Commission.[904] A second commenter concurred with this cost assessment, stating that the Commission significantly underestimated the cost of the proposal to smaller firms.[905]

With respect to the use of qualified securities to meet reserve requirements, one commenter noted that broker-dealers will "likely have a significant amount of additional operational and transactional costs."[906] The commenter believes that "[w]hile larger broker-dealers may be able to reallocate existing trading desk, operational, regulatory reporting and treasury functions to assist in ongoing maintenance activities, midsized and

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901 See SIFMA 2 Letter ("[T]he [percentage] tests could prevent a smaller firm from maintaining reserve account deposits at any single bank, even though those deposits are relatively small compared to the size of the bank – e.g., a broker- dealer with excess net capital of $500,000 could not maintain more than $250,000 in reserve account cash deposits at any one bank, regardless of the ratio between such bash deposits and the overall size or equity capital of the bank.").

902 Id.

903 Id.; see also SIFMA 4 Letter.

904 See SIFMA 2 Letter.

905 See NIBA 2 Letter.

906 See JP Morgan Letter.

smaller broker-dealers may be required to hire additional staff to manage and maintain a securities portfolio."[907]

In response to commenters concerns, the Commission has eliminated the provision that would have excluded the amount of a deposit that exceeds 50% of the broker-dealer's excess net capital. After review of the comment letters, the Commission believes that this provision likely would have disproportionately impacted small and mid-size broker-dealers when they deposited cash into large commercial banks since they would exceed the excess net capital threshold well before exceeding the bank equity capital threshold.[908] The bank equity capital threshold is the more important metric since it relates directly to the financial strength of the bank, which is the entity holding the account. In particular, if the carrying broker-dealer's deposit constitutes a substantial portion of the bank's total deposits, the bank may not have the liquidity to quickly return the deposit to the broker-dealer. The elimination of the excess net capital threshold should mitigate concerns expressed by small broker-dealers that they would need to open multiple bank accounts to make cash deposits or hire additional staff, if they sought to deposit qualified securities in a reserve account in order to avoid opening multiple accounts. This is because the excess net capital threshold likely would have impacted smaller broker-dealers, which – consistent with their size – maintain less net capital than larger firms.

Second, with respect to the bank equity capital threshold, in response to comments, the Commission has increased the trigger level from 10% to 15% of the

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907 Id. The commenter noted that managing pools of qualified securities involves various tasks, such as "monitoring income collection, redemption processing, marking the securities to market, collateral substitutions and collateral segregation amongst other tasks." Id.

908 See SIFMA 2 Letter; JP Morgan 2 Letter.

bank's equity capital. The increase of the threshold to 15% is designed to address concerns raised by commenters that the proposed percentage tests were unduly restrictive in certain respects and should be modified, particularly with respect to large broker-dealers with large deposit requirements. Consequently, the increase from 10% to 15% is designed to mitigate commenters concerns that the 10% threshold would require broker-dealers to spread out deposits over an excessive number of banks, while still providing adequate protection against undue concentrations of deposits, particularly where smaller banks are concerned.

The elimination of the 50% of excess net capital threshold and increase of the bank capital threshold from 10% to 15% is designed to appropriately address concerns raised by commenters that they would have to substantially alter their current cash deposit practices in light of the goal of the rule to promote the broker-dealer's ability to have quick access to the deposit.

With the elimination of the broker-dealer excess net capital threshold, and the increase in the bank equity capital threshold, it is likely that very few broker-dealers (including small broker-dealers) would be required to maintain reserve accounts at multiple banks, unless they chose to do so for operational, business or other reasons. Therefore for the reasons discussed above, as adopted, paragraph (e)(5) of Rule 15c3-3, should not significantly impact a substantial number of small entities.

3. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0-10[909] states that the term small business or small organization, when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the

[909] 17 CFR 240.0-10(c)(1).

prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d);[910] and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

Based on FOCUS Report data, as of December 31, 2011, the Commission estimates there are approximately 5 broker-dealers that performed a customer reserve computation pursuant to Rule 15c3-3 and were "small" for the purposes Rule 0-10.

4. Reporting, Recordkeeping, and other Compliance Requirements

The amendments (1) require broker-dealers to perform a PAB reserve computation, (2) limit the amount that a broker-dealer may deposit in a reserve account at any individual bank in the form of cash, (3) require broker-dealers to obtain possession and control of customers' fully paid and excess margin securities allocated to a short position by borrowing equivalent securities or through other means within a specified period of time, and (4) require broker-dealers to obtain the written affirmative consent of a new customer before including a customer's free credit balances in a Sweep Program, as well as provide certain disclosures and notices to all customers with regard to the broker-dealer's Sweep Program.

5. Agency Action to Minimize Effect on Small Entities

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small entities. In connection with adopting the final rules, the Commission considered, as alternatives, establishing different compliance or reporting requirements that take into account the resources available to smaller entities, exempting smaller entities from

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[910] 17 CFR 240.17a-5(d).

coverage of the disclosure requirements, and clarifying, consolidating, or simplifying disclosure for small entities.[911]

As discussed above, the impact on individual small broker-dealers, as well as all small broker-dealers, should be minimal, and thus the Commission is not establishing different compliance or reporting requirements or timetables; clarifying, consolidating, or simplifying compliance and reporting requirements under the rule for small entities; or exempting small entities from coverage of the rule, or any part thereof. The amendments impose performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the amendments.

C. Holding Futures Positions in a Securities Portfolio Margining Account

1. Need for and Objectives of the Amendments

The amendments to Rule 15c3-3 and 15c3-3a are designed to accommodate futures positions in a securities account that is margined on a portfolio basis.[912] Under SRO portfolio margin rules, a broker-dealer can combine securities and futures positions in a portfolio margin securities account to compute margin requirements based on the net market risk of all positions in the account. The amendments to Rule 15c3-3 and 15c3-3a complement the amendments to SIPA in the Dodd-Frank Act, as well as provide additional protections to customers through the strengthened reserve requirements of Rule 15c3-3. In particular, the changes will apply the protections in Rules 15c3-3 and Rule 15c3-3a to all positions in a portfolio margin account.

These additional protections should make portfolio margining more attractive to investors. Portfolio margining can significantly reduce customer margin requirements for

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[911] 5 U.S.C. 604(a)(5).

[912] See Amendments to Financial Responsibility Rules, 72 FR at 12868–12870.

offsetting positions involving securities and futures products, which in turn reduces the costs of trading such products.

2. Significant Issues Raised by Public Comments

The Commission did not receive any specific comments with respect to this portion of the IRFA.

3. Small Entities Subject to the Rules

As discussed above in section V.D.2. of this release, based on FOCUS Report data, as of December 31, 2011, the Commission estimates that approximately 35 broker-dealers will elect to offer their customers portfolio margin accounts that will include futures and futures options. None of these broker-dealers are "small" for purposes of Rule 0-10.

4. Reporting, Recordkeeping, and other Compliance Requirements

These amendments (1) revise the definition of free credit balances and other credit balances in Rule 15c3-3 to include funds in a portfolio margin account relating to certain futures and futures options positions, and (2) add a debit line item to the customer reserve formula in Rule 15c3-3a consisting of margin posted by a broker-dealer to a derivatives clearing organization.

5. Agency Action to Minimize Effect on Small Entities

As stated above, the Commission does not believe that any of the broker-dealers that will elect to offer portfolio margining are "small" for purposes of Rule 0-10. Further, the requirements imposed by the portfolio margin amendments will be elective. Therefore, the Commission does not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities; or

exempting small entities from coverage of the rule, or any part thereof. The amendments also contain performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed amendments.

D. Securities Lending and Borrowing and Repurchase/Reverse Repurchase Transactions

1. Need for and Objectives of the Amendments

These rules amend subparagraph (c)(2)(iv)(B) of Rule 15c3-3 to clarify that broker-dealers providing securities lending and borrowing settlement services are deemed, for purposes of the rule, to be acting as principals and are subject to applicable capital deductions, unless the broker-dealer takes certain steps to disclaim principal liability.[913] In addition, the Commission is adopting paragraph (c)(5) to Rule 17a-11 to require that a broker-dealer notify the Commission whenever the total amount of money payable against all securities loaned or subject to a repurchase agreement exceeds 2,500 percent of tentative net capital.[914] The final rule also exempts a broker-dealer from this 17a-11 notice requirement if it reports monthly its securities lending and borrowing and repurchase and reverse repurchase activity to its DEA in a form acceptable to its DEA.

In 2001, MJK Clearing, a broker-dealer with a substantial number of customer accounts, failed when it could not meet its securities lending obligations. This failure has highlighted the risks associated with securities lending and repurchase and reverse repurchase agreements and the need to manage those risks. More specifically, two concerns arose from the failure of MJK, namely, (1) that broker-dealers with principal liability in a stock loan transaction may erroneously be considering themselves as acting

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913 See section II.C. of this release.

914 Id.

in an agency capacity and, consequently, not taking appropriate capital charges; and (2) that broker-dealers that have historically not been very active in stock loan transactions may be rapidly expanding their balance sheets with such transactions, and thereby, increase leverage to a level that poses significant financial risk to the firm and its counterparties.

These amendments are intended to strengthen the documentation controls broker-dealers employ to manage their securities lending and borrowing and securities repurchase and reverse repurchase activities and to enhance regulatory monitoring. The intended result of the amendments is to avoid ambiguity regarding the applicability of the stock loan charges in the net capital rule to a particular broker-dealer. As the failure of MJK illustrated, disputes can arise over whether a broker-dealer is acting as a principal or agent in a stock loan transaction.[915]

The amendments to paragraph (c)(5) to Rule 17a-11 will help identify broker-dealers with highly leveraged non-government securities lending and borrowing and repo operations and make it easier for regulators to respond more quickly and protect customers in the event a firm is approaching insolvency.[916] This notice provision is designed to alert regulators to a sudden increase in a broker-dealer's stock loan and repo positions, which could indicate that the broker-dealer is taking on new risk that it may have limited experience in managing, as well as to help identify those broker-dealers highly active in securities lending and repos. Finally, the objective of the exemption from the notice provision of paragraph (c)(5) of Rule 17a-11 through monthly reporting is designed to accommodate large broker-dealers that are active in this business and regularly maintain stock loan and repo balances that exceed the threshold.

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[915] See, e.g., Nomura v. E*Trade, 280 F.Supp.2d 184 (S.D.N.Y. 2003).

[916] 17 CFR 240.17a-11(c)(5).

2. Significant Issues Raised by Public Comments

The Commission did not receive any specific comments with respect to this portion of the IRFA.

3. Small Entities Subject to the Rule

Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that none of the broker-dealers that engage in securities lending and borrowing or securities repurchase and reverse repurchase activity are "small" for the purposes Rule 0-10. Therefore, the amendments should not affect "small" broker-dealers.

4. Reporting, Recordkeeping, and Other Compliance Requirements

These amendments require broker-dealers to (1) disclose the principals and obtain certain agreements from the principals in a transaction where they provide settlement services in order to be considered an agent (as opposed to a principal) for the purposes of the net capital rule, and (2) provide notice to the Commission and other regulatory authorities if the broker-dealer's securities lending or repo activity reaches a certain threshold or, alternatively, report monthly the broker-dealer's securities lending and repo activity to the broker-dealer's DEA, in a form acceptable to the DEA.

5. Agency Action to Minimize Effect on Small Entities

As noted above, the Commission estimates that this amendment will have no impact on small entities. Thus, the Commission does not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables, nor is it clarifying, consolidating, or simplifying compliance and reporting requirements under the rule for small entities; or exempt small entities from coverage of the rule, or any part thereof. The amendments also use performance standards and do not dictate for

entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed amendments.

E. Documentation of Risk Management Procedures

1. Need for and Objectives of the Amendments

Requiring certain large broker-dealers to document and preserve their internal credit, market, and liquidity risk management controls under paragraph (a)(23) to Rule 17a-3 and (e)(9) to Rule 17a-4 will assist firms in evaluating and adhering to their established internal risk management controls and regulators in reviewing such controls.[917]

These amendments are intended to strengthen the controls certain large broker-dealers employ to manage risk. These amendments are designed to lower systemic risk primarily in the securities markets by enhancing risk management through reinforcement of documentation practices and making it easier for regulators to access a broker-dealer's procedures and controls, to ensure a broker-dealer is adhering to such documented controls.

Additionally, by making the documented controls a required record under Rule 17a-3, a broker-dealer's regulator likely will have better access to them, as this benefit will only be realized to the extent a broker-dealer has existing market, credit and liquidity risk management controls in place because the rule does not specify the type of controls a broker-dealer must establish to manage these risks. It simply requires the documentation of the procedures the broker-dealer has established. The final rule amendment will require any such records of the market, credit, and liquidity risk management controls be

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[917] See section II.D. of this release.

available to the broker-dealer's regulators so they can review whether the broker-dealer is adhering to these controls.

2. Significant Issues Raised by Public Comments

The Commission did not receive any specific comments with respect to this portion of the IRFA.

3. Small Entities Subject to the Rule

These amendments apply to a limited number of broker-dealers, namely, those firms with more than $1 million in customer credits or $20 million in capital. Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that none of the broker-dealers that will be subject to this amendment will be "small" for the purposes Rule 0-10.

4. Reporting, Recordkeeping, and Other Compliance Requirements

These amendments will require broker-dealers to document any credit, market, and liquidity risk management controls established and maintained by the broker-dealer to assist it in analyzing and managing the risks associated with its business activities. The Commission is not mandating any specific controls, procedures, or policies that must be established by a broker-dealer to manage market, credit, or liquidity risk. Rather, the Commission is requiring that a control, procedure, or policy be documented if it is in place.

5. Agency Action to Minimize Effect on Small Entities

As noted above, these amendments will have no impact on "small" broker-dealers. Thus, the Commission is not establishing different compliance or reporting requirements or timetables; clarifying, consolidating, or simplifying compliance and

reporting requirements under the rule for small entities; nor exempting small entities from coverage of the rule, or any part thereof.

The amendments also use performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the amendments.

F. Amendments to the Net Capital Rule

1. Need for and Objectives of the Amendments

The amendments to Rule 15c3-1 are designed to address several areas of concern regarding the financial responsibility requirements for broker-dealers. Some broker-dealers have excluded from their regulatory financial reports certain liabilities that have been shifted to third parties that lack the resources – independent of the assets and revenue of the broker-dealer – to pay the liabilities, or have utilized infusions of temporary capital. These practices may misrepresent the true financial condition of the broker-dealer and, thereby, impede the ability of regulators to take proactive steps to reduce the harm to customers, counterparties and clearing agencies that may result from the broker-dealer's failure. To address these issues, the Commission is adopting an amendment to Rule 15c3-1 to add a new paragraph (c)(2)(i)(F) requiring a broker-dealer to adjust its net worth when calculating net capital by including any liability or expense for which a third party has assumed the responsibility, unless the broker-dealer can demonstrate that the third party has adequate resources, independent of the broker-dealer to pay the liability or expense.[918] In addition, the Commission is adopting amendments to paragraph (c)(2)(i)(G)(2) of Rule 15c3-1, to require a broker-dealer to subtract from net worth any contribution of capital to the broker-dealer: (1) under an agreement that

[918] See section II.E.1. of this release.

provides the investor with the option to withdraw the capital; or (2) that is intended to be withdrawn within a period of one year of its contribution. Under the final rule, any withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the broker-dealer's DEA.[919]

Further, currently, broker-dealers are required to take net capital charges pursuant to SRO rules relating to fidelity bond deductibles, but Rule 15c3-1 does not explicitly incorporate such charges for purposes of computing net capital. To address this inconsistency, the Commission is adopting paragraph (c)(2)(xiv) to Rule 15c3-1.[920]

In addition, a number of broker-dealers have sought to obtain protection under the bankruptcy laws while still engaging in a securities business. Permitting an insolvent broker-dealer to continue to transact a securities business endangers its customers and counterparties and places securities clearing agencies at risk. To address this concern, the Commission is adopting an amendment to paragraph (a) of Rule 15c3-1 to require a broker-dealer to cease its securities business activities if certain insolvency events were to occur, as defined in new paragraph (c)(16) to Rule 15c3-1.[921]

Finally, an important goal of the Commission is to protect the financial integrity of the broker-dealer so that if the firm must liquidate it may do so in an orderly fashion. Allowing a capital withdrawal that may jeopardize the financial integrity of a broker-dealer exposes customers and creditors of the broker-dealer to unnecessary risk. Paragraph (e) of Rule 15c3-1, which places certain conditions on a broker-dealer when

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[919] See section II.E.2. of this release.

[920] See section II.E.4. of this release.

[921] See section II.E.5. of this release.

withdrawing capital,[922] allows the Commission to issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under certain circumstances.[923] The rule, however, limits such orders to withdrawals, advances, or loans that, when aggregated with all other withdrawals, advances, or loans on a net basis during a thirty calendar day period, exceed 30% of the firm's excess net capital. The Commission is amending paragraph (e) to remove the 30% of excess net capital limitation because the Commission has determined that the requirement is difficult to enforce, as it generally would not be clear when the 30% threshold had been reached, due to the inherent unreliability of a troubled broker-dealer's books and records.[924]

Finally, the Commission is making permanent a temporary amendment to Appendix A of Rule 15c3-1, which permits broker-dealers to employ theoretical option pricing models to calculate haircuts for listed options and related positions that hedge those options.[925] The temporary amendment decreased the range of pricing inputs to the approved option pricing models, which effectively reduced the haircuts applied by the carrying firm with respect to non-clearing option specialist and market maker

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922 See 17 CFR 240.15c3-1(e).

923 See 17 CFR 240.15c3-1(e)(3).

924 See section II.E.6. of this release.

925 17 CFR 240.15c3-1a; See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997). See also Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Richard Lewandowski, Vice President, Regulatory Division, The Chicago Board Options Exchange, Inc. (Jan. 13, 2000) (stating that the Division of Market Regulation "will not recommend . . . enforcement action if non-clearing option specialists and market-makers continue to rely on subparagraph (b)(1)(iv) of Appendix A to Rule 15c3-1 under the Exchange Act until such time as the Commission has determined whether it should be extended"). The letter did not grant any other relief.

accounts.[926] The amendment is intended to better align the capital requirements with the risks these requirements are designed to address.

2. Significant Issues Raised by Public Comments

The Commission received three comments in response to requests for comment related to the amendments to the net capital rule requiring broker-dealers to add back to its net worth certain liabilities assumed by third parties and treat certain temporary capital contributions as liabilities.[927]

One commenter noted that there should be no circumstance in which a broker-dealer accepted a capital contribution for net capital purposes that could be withdrawn at the option of the investor.[928] This commenter also noted that if small firms were required to raise over $300,000 in capital each, there will be the largest dissolution of small broker-dealers in the history of the regulated securities industry.[929] The commenter requested that the Commission state a reasonable time period for broker-dealers to raise capital to meet these new standards.[930] This commenter also stated that the Commission's estimate of a gross cost of capital of 7.5% (5% + 2.5%) is a totally unrealistic cost of capital for small broker-dealers and that these broker-dealers will categorically have costs significantly higher than 7.5%.[931]

Further, the commenter stated that, until the Commission convenes a small broker-dealer representative panel to assist it with establishing such costs, the

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926 See Net Capital Rule, Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

927 See Beer Letter; Levene Letter; NIBA 2 Letter.

928 See NIBA 2 Letter.

929 Id.

930 Id.

931 Id.

Commission is "speculating" on such costs, and is therefore without adequate information to consider the effects of such costs and changes on small firms.[932] This commenter specifically requested the Commission consider the needs of small firms that will likely require additional net capital over the next decade.[933]

Additionally, this commenter believed that the rule is intended to protect the capitalization of large firms while ignoring small firms. The commenter also noted that it opposes regulation that arbitrarily reduces the value of small broker-dealers and their competitive position relative to larger broker-dealers.[934] Finally, the commenter expressed concern that the proposed amendments to Rule 15c3-1 would be particularly burdensome on small broker-dealers, negatively impacting capital formation for small issuers and increasing the cost of capital for small broker-dealers.[935]

Another commenter stated that this proposal will require the 702 mentioned debt-free introducing broker-dealers to needlessly take on debt of approximately $280,354.[936] Further, the commenter stated that, if the proposed is approved, it would force the majority of small firms out of business and ultimately deny investors the right and

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932 Id.

933 Id. The commenter stated that any rule that would "restrict small broker-dealers from raising capital as a result of uncertainty of investors or owner-operators related to the return of their capital in a reasonable time frame will create a disproportionate and impossible hurdle for small broker-dealers to overcome." See NIBA 2 Letter.

934 See NIBA 2 Letter.

935 Id. The commenter noted that broker-dealers "are dealing with a relatively static commission and fees matrix versus what they may charge customers." Consequently, the commenter believes "broker-dealers will be unable to pass any of these costs increases directly to customers, irrespective of the type of customer or type of business that they are conducting with small broker-dealers, which further threatens the financial profit potential and return on equity of small broker-dealers." Id. The commenter further believes that the cost increases over a short period of time will threaten the viability of all small broker-dealers. Id.

936 See Beer Letter.

opportunity to deal with smaller, more personalized and debt-free member firms.[937] One commenter stated that it also must be considered that any implementation and enforcement of these proposed changes should not be made retroactive, because to subject firms to a new set of rules and guidelines will effectively penalize small firms that have been in full compliance with the rules and regulations.[938]

The Commission considered all comments discussed above and the potential impact on small broker-dealers.[939] The Commission continues to believe that the estimated cost of capital is not unrealistic for small broker-dealers. However, as discussed above in section V. of this release, in response to comments, the Commission increased the estimated cost of capital for these amendments is 12%.

Moreover, as discussed in section II.E.1 and 2. of this release, the baseline of these rules is current Rule 15c3-1 and existing guidance and interpretations. The Commission staff has provided guidance with respect to the treatment and recording of certain broker-dealer expenses and liabilities that is consistent with the rule amendment.[940] In addition, existing broker-dealer recordkeeping rules require that a broker-dealer record its income and expenses.[941] For example, paragraph (a)(2) of Rule 17a-3, requires a broker-dealer to make and keep current ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts.[942] Therefore, the Commission does not expect small broker-dealers to incur significant costs

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937 Id.

938 See Levene Letter.

939 See Beer Letter; Levene Letter; NIBA 2 Letter.

940 See, e.g., Third Party Expense Letter; see also FINRA Notice to Members 03-6, Expense Sharing Agreements.

941 17 CFR 240.17a-3; 17 CFR 240.17a-4.

942 17 CFR 240.17a-3(a)(2).

or burdens to comply with the amendment regarding broker-dealers and payment of expenses by third parties.[943]

At the same time, the purpose of the requirement in new paragraph (c)(2)(i)(F) of Rule 15c3-1 is to address the practices of a broker-dealer that raise concerns when a broker-dealer shifts liabilities to an entity with no revenue or assets independent of the broker-dealer to inappropriately increase its reported net capital, by excluding the liability from the calculation of net worth. Therefore, the final rule, as discussed above in section II.E.1. of this release, is designed to prohibit a practice that could misrepresent a broker-dealer's actual financial condition, deceive the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition.

Moreover, in response to comments,[944] the rule amendment, as adopted, should not impose burdens or present serious implementation difficulties to small broker-dealers[945] that are appropriately recording their assets and liabilities under current Commission rules and interpretive guidance.[946] These broker-dealers also should not be required to obtain loans to increase their capital as a result of the Rule 15c3-1 amendments. Therefore, the Commission does not believe a longer time period for compliance or the formation of a small broker-dealer advisory cost committee is necessary.[947]

In response to the commenters' concerns about the negative impact of the rule amendments on the capital of small broker-dealers,[948] as discussed above, the final rule

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943 See NIBA 2 Letter.

944 Id.

945 See Beer Letter; Levene Letter; NIBA 2 Letter.

946 See, e.g., Third Party Expense Letter.

947 See NIBA 2 Letter.

948 See Beer Letter; Levene Letter; NIBA 2 Letter.

amendment is a codification of existing Commission staff guidance,[949] and thus should not represent a change for small broker-dealers with respect to capital withdrawals. Moreover, with respect to commenters' concerns about obtaining capital,[950] the rule does not prohibit an investor from withdrawing capital at any time. Rather, it prohibits a broker-dealer from treating temporary cash infusions as capital for purposes of the net capital rule. Finally, the final rule amendments provide a mechanism for a broker-dealer to apply to its DEA to make a withdrawal within one year of the capital contribution without triggering the deduction under certain circumstances (e.g., de minimis withdrawals).

3. Small Entities Subject to the Rule

Based on FOCUS Report data, as of December 31, 2011, the Commission estimates that there are approximately 2,506 introducing and carrying broker-dealers that are "small" for the purposes Rule 0-10. The amendments relating to certain subtractions from net worth and the restrictions on the withdrawal of capital will apply to all "small" broker-dealers in that they will be subject to the requirements in the amendments. The amendment to Appendix A of Rule 15c3-1 likely should have no, or little, impact on "small" broker-dealers, because based on staff experience, most, if not all, of these firms do not carry non-clearing option specialist or market maker accounts.

4. Reporting, Recordkeeping, and Other Compliance Requirements

The amendments will require an "insolvent" broker-dealer to cease conducting a securities business and provide the securities regulators with notice of its insolvency. The amendments also will require broker-dealers to deduct from net worth certain

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949 See Temporary Capital Letter. See also section II.E.2. of this release.

950 See Beer Letter; NIBA 2 Letter.

liabilities and certain temporary capital contributions, as well as require broker-dealers to deduct from net capital, certain specified amounts as required by SRO fidelity bond rules. Finally, under the amendment to the rule on Commission orders restricting withdrawals of capital, a broker-dealer subject to an order will not be permitted to withdraw capital. Finally, the amendments will make permanent a temporary rule that reduced the haircut for non-clearing options specialist and market maker accounts under Appendix A to Rule 15c3-1.

5. Agency Action to Minimize Effect on Small Entities

As discussed in detail above, the Commission considered all comments received and adopted the amendment substantially as proposed.[951] The Commission understands the concerns relating to small broker-dealers raised by commenters[952] and reiterates that the rule is designed to address situations where there is no legitimate reason to book liabilities to a separate legal entity that otherwise would accrue to the broker-dealer. Moreover, the final rule is consistent with current staff interpretations regarding third-party expense sharing and thus should not represent a change for broker-dealers. The Commission also notes that the final rule is designed to prohibit a practice that could misrepresent a broker-dealer's actual financial condition, deceive the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition. Moreover, the rule change, as adopted, should not impose undue burdens or present serious implementation difficulties for large or small broker-dealers. As the Commission explained in the proposing release, a broker-dealer can demonstrate the adequacy of the third party's financial resources by maintaining records such as the third party's most

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951 See section II.E.1. of this release.

952 See Beer Letter; Beer 2 Letter; Levene Letter; Lowenstein Letter; NIBA 2 Letter. See also discussion in section II.E.1. of this release.

recent (i.e., as of a date within the previous twelve months) audited financial statements, tax returns, or regulatory filings containing financial reports.[953] Given that the entity to which the broker-dealer is seeking to shift one or more liabilities typically is an affiliate, the staff's experience is that such records should be available to the broker-dealer. Further, because the proposed rule change is consistent with prior staff guidance regarding the need to be able to demonstrate the third party's financial adequacy, the broker-dealer seeking to shift a liability to a third party already would, under existing staff interpretations, expect to be ready to provide such evidence of the third party's financial resources. Taken together, these realities should mitigate the implementation and burden concerns raised by commenters as they relate to small broker-dealers.

One or more of these record types are generally readily available. The general availability of a satisfactory measure of financial resources should mitigate the implementation and burden concerns raised by the commenters.

As discussed above, given the minimal impact these amendments will have on small entities, the Commission is not establishing different compliance or reporting requirements or timetables; clarifying, consolidating, or simplifying compliance and reporting requirements under the rule for small entities; nor exempting small entities from coverage of the rule, or any part thereof.

The amendments use performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the amendments.

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[953] Amendments to Financial Responsibility Rules, 72 FR at 12872. The Commission specifically requested comment regarding the records by which a broker-dealer could demonstrate financial resources. It received no comments in response to this request.

VII. STATUTORY AUTHORITY

The Commission is adopting amendments to Rules 15c3-1, 15c3-3, 17a-3, 17a-4 and 17a-11 under the Exchange Act pursuant to the authority conferred by the Exchange Act, including Sections 15, 17, 23(a) and 36.[954]

Text of Final Rules

List of Subjects

17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, the Commission hereby proposes that Title 17, Chapter II of the Code of Federal Regulation be amended as follows.

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

1. The general authority for Part 240 continues to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et. seq., and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; and Pub. L. 111-203, 939A, 124 Stat. 1376, (2010), unless otherwise noted.

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2. Section 240.15c3-1 is amended by:

a. Revising the first sentence of the introductory text of paragraph (a);

[954] 15 U.S.C. 78o, 78q, 78w and 78mm.

b. Removing from paragraph (a)(6)(iii)(A) the phrase "paragraph (c)(2)(x)(A)(1) through (9) of this section" and in its place adding the phrase "Appendix A (§ 240.15c3-1a)";

c. Revising the introductory heading of paragraph (c)(2)(i);

d. Adding paragraphs (c)(2)(i)(F) and (G);

e. Revising paragraphs (c)(2)(iv)(B), (c)(2)(iv)(E), and (c)(2)(vi)(D)(1);

f. Adding paragraph (c)(2)(xiv);

g. Adding paragraph (c)(16) and an undesignated center heading;

h. Revising paragraph (e)(3)(i); and

i. Removing from the second sentence in paragraph (e)(3)(ii) the text "The hearing" and in its place adding the phrase "A hearing on an order temporarily prohibiting the withdrawal of capital".

The revisions and additions read as follows:

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

(a) Every broker or dealer must at all times have and maintain net capital no less than the greater of the highest minimum requirement applicable to its ratio requirement under paragraph (a)(1) of this section, or to any of its activities under paragraph (a)(2) of this section, and must otherwise not be "insolvent" as that term is defined in paragraph (c)(16) of this section. * * *

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(c) * * *

(2) * * *

(i) Adjustments to net worth related to unrealized profit or loss, deferred tax provisions, and certain liabilities.* * *

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(F) Adding to net worth any liability or expense relating to the business of the broker or dealer for which a third party has assumed the responsibility, unless the broker or dealer can demonstrate that the third party has adequate resources independent of the broker or dealer to pay the liability or expense.

(G) Subtracting from net worth any contribution of capital to the broker or dealer:

(1) Under an agreement that provides the investor with the option to withdraw the capital; or

(2) That is intended to be withdrawn within a period of one year of contribution. Any withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer.

* * * * *

(iv) * * *

(B) All unsecured advances and loans; deficits in customers' and non-customers' unsecured and partly secured notes; deficits in omnibus credit accounts maintained in compliance with the requirements of 12 CFR 220.7(f) of Regulation T under the Act, or similar accounts carried on behalf of another broker or dealer, after application of calls for margin, marks to the market or other required deposits that are outstanding 5 business days or less; deficits in customers' and non-customers' unsecured and partly secured accounts after application of calls for margin, marks to market or other required deposits that are outstanding 5 business days or less, except deficits in cash accounts as defined in 12 CFR 220.8 of Regulation T under the Act for which not more than one extension respecting a specified securities transaction has been requested and granted, and deducting for securities carried in any of such accounts the percentages specified in paragraph (c)(2)(vi) of this section or Appendix A, § 240.15c3-1a; the market value of

stock loaned in excess of the value of any collateral received therefor; receivables arising out of free shipments of securities (other than mutual fund redemptions) in excess of $5,000 per shipment and all free shipments (other than mutual fund redemptions) outstanding more than 7 business days, and mutual fund redemptions outstanding more than 16 business days; and any collateral deficiencies in secured demand notes as defined in Appendix D, § 240.15c3-1d; a broker or dealer that participates in a loan of securities by one party to another party will be deemed a principal for the purpose of the deductions required under this section, unless the broker or dealer has fully disclosed the identity of each party to the other and each party has expressly agreed in writing that the obligations of the broker or dealer do not include a guarantee of performance by the other party and that such party's remedies in the event of a default by the other party do not include a right of setoff against obligations, if any, of the broker or dealer.

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(E) Other Deductions. All other unsecured receivables; all assets doubtful of collection less any reserves established therefor; the amount by which the market value of securities failed to receive outstanding longer than thirty (30) calendar days exceeds the contract value of such fails to receive; and the funds on deposit in a "segregated trust account" in accordance with 17 CFR 270.27d-1 under the Investment Company Act of 1940, but only to the extent that the amount on deposit in such segregated trust account exceeds the amount of liability reserves established and maintained for refunds of charges required by sections 27(d) and 27(f) of the Investment Company Act of 1940; Provided, That the following need not be deducted:

(1) Any amounts deposited in a Customer Reserve Bank Account or PAB Reserve Bank Account pursuant to § 240.15c3-3(e),

(2) Cash and securities held in a securities account at a carrying broker or dealer (except where the account has been subordinated to the claims of creditors of the carrying broker or dealer), and

(3) Clearing deposits.

* * * * *

(vi) * * *

(D)(1) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets consist of cash or money market instruments and which is described in § 270.2a-7 of this chapter, the deduction will be 2% of the market value of the greater of the long or short position.

* * * * *

(xiv) Deduction from net worth for excess deductible amounts related to fidelity bond coverage. Deducting the amount specified by rule of the Examining Authority for the broker or dealer with respect to a requirement to maintain fidelity bond coverage.

* * * * *

INSOLVENT

(16) For the purposes of this section, a broker or dealer is insolvent if the broker or dealer:

(i) Is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate such broker or dealer or its property or is applying for the appointment or election of a receiver, trustee, or liquidator or similar official for such broker or dealer or its property;

(ii) Has made a general assignment for the benefit of creditors;

(iii) Is insolvent within the meaning of section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature, and has made an admission to

such effect in writing or in any court or before any agency of the United States or any State; or

(iv) Is unable to make such computations as may be necessary to establish compliance with this section or with § 240.15c3-3.

* * * * *

(e) * * *

(3)(i) Temporary restrictions on withdrawal of net capital. The Commission may by order restrict, for a period of up to twenty business days, any withdrawal by the broker or dealer of equity capital or unsecured loan or advance to a stockholder, partner, sole proprietor, member, employee or affiliate under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors if the Commission, based on the information available, concludes that such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970.

* * * * *

3. Section 240.15c3-1a is amended by:

a. Removing paragraph (b)(1)(iv)(B); and

b. Redesignating paragraphs (b)(1)(iv)(A), (b)(1)(iv)(A)(1), (b)(1)(iv)(A)(2), and (b)(1)(iv)(A)(3) as paragraphs (b)(1)(iv), (b)(1)(iv)(A), (b)(1)(iv)(B), and (b)(1)(iv)(C) respectively.

4. Section 240.15c3-2 is removed and reserved.

5. Section 240.15c3-3 is amended by:

a. Removing from paragraph (a)(1), third sentence, the citation "220.19" and in its place adding the citation "220.12";

b. In paragraph (a)(1)(iii), after the phrase "(15 U.S.C. 78aaa et seq.)" adding "(SIPA)";

c. Removing the ";" at the end of paragraph (a)(1)(iv) and adding a period in its place;

d. Revising paragraphs (a)(3), (a)(4), (a)(7), (a)(8) and (a)(9);

e. Adding paragraphs (a)(16) and (a)(17);

f. In paragraph (b)(2):

(i) in the first sentence, removing the phrase "his physical possession or under his control" and in its place adding "the broker's or dealer's physical possession or under its control";

(ii) in the second sentence, removing the word "he" and in its place adding "it"; and

(iii) in the second sentence, removing the word "his" and in its place adding "its";

g. Removing from paragraphs (b)(3)(iv) and (b)(4)(i)(C) the phrase "the Securities Investor Protection Act of 1970" and in its place adding "SIPA";

h. At the end of paragraph (b)(4)(i)(C) adding the word "and,";

i. In paragraph (b)(4)(v), removing the word "his" and in its place adding "the person's";

j. Adding paragraph (b)(5);

k. In paragraph (c)(2):

(i) removing “a special omnibus” and in its place adding “an omnibus credit”;

(ii) removing the text “section 4(b) of Regulation T under the Act (12 CFR 220.4(b))” and in its place adding “section 7(f) of Regulation T (12 CFR 220.7(f))”; and

(iii) removing the word “he” and in its place adding “it”;

l. In paragraph (c)(3), removing the words “him” and “he” wherever they appear and in their place adding “the broker or dealer”;

m. In the first sentence of paragraph (d) introductory text, removing the word “his” wherever it appears and in its place adding “its”;

n. In paragraph (d)(2), removing the word “his” and in its place adding “the broker’s or dealer’s”;

o. Removing the period at the end of paragraph (d)(3) and in its place adding “; or”;

p. Redesignating paragraph (d)(4) as paragraph (d)(5);

q. Adding a new paragraph (d)(4);

r. Revising paragraphs (e) and (f);

s. Revising the first sentence of paragraph (g);

t. Removing from paragraph (i) the text “his reserve bank account” and in its place adding “its Customer Reserve Bank Account, PAB Reserve Bank Account”;

u. Adding paragraph (j);

v. In paragraph (k)(1)(i), removing the phrase “His dealer transactions” and in its place adding “The broker’s or dealer’s transactions as dealer”, and removing the word “his” the second and third time the word “his” appears and in its place adding “its”;

w. In paragraph (k)(1)(ii), removing the word “His” and in its place adding “The broker’s or dealer’s”;

x. In paragraph (k)(1)(iii), removing the word "He" and in its place adding "The broker or dealer" and removing the word "his" and in its place adding "its";

y. In paragraph (k)(2)(i), removing the word "his" and in its place adding "its" wherever it appears;

z. Revising paragraph (l)(2);

aa. Removing from the last sentence in paragraph (m) before the Note, the text "a special omnibus" and in its place adding "an omnibus credit" and removing the text "section 4(b) of Regulation T [12 CFR 220.4(b)]" and in its place adding "section 7(f) of Regulation T (12 CFR 220.7(f))";

bb. Resdesignate the Note following paragraph (m) as "Note to paragraph (m).";

cc. Removing from the first sentence in paragraph (n) the phrase "paragraphs (d) (2) and (3)" and in its place adding "paragraphs (d)(2), (3) and (4)"; and

dd. Removing from paragraph (o)(2)(i)(A) the phrase "the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.)" and in its place adding "SIPA";

The revisions and additions read as follows:

§ 240.15c3-3 Customer protection–reserves and custody of securities.

(a) * * *

(3) The term fully paid securities means all securities carried for the account of a customer in a cash account as defined in Regulation T (12 CFR 220.1 et seq.), as well as securities carried for the account of a customer in a margin account or any special account under Regulation T that have no loan value for margin purposes, and all margin equity securities in such accounts if they are fully paid: Provided, however, that the term fully paid securities does not apply to any securities purchased in transactions for which the customer has not made full payment.

(4) The term margin securities means those securities carried for the account of a customer in a margin account as defined in section 4 of Regulation T (12 CFR 220.4), as well as securities carried in any other account (such accounts hereinafter referred to as "margin accounts") other than the securities referred to in paragraph (a)(3) of this section.

* * * * *

(7) The term bank means a bank as defined in section 3(a)(6) of the Act and will also mean any building and loan, savings and loan or similar banking institution subject to supervision by a Federal banking authority. With respect to a broker or dealer that maintains its principal place of business in Canada, the term "bank" also means a Canadian bank subject to supervision by a Canadian authority.

(8) The term free credit balances means liabilities of a broker or dealer to customers which are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits or otherwise, excluding, however, funds in commodity accounts which are segregated in accordance with the Commodity Exchange Act or in a similar manner, or which are funds carried in a proprietary account as that term is defined in regulations under the Commodity Exchange Act. The term "free credit balances" also includes, if subject to immediate cash payment to customers on demand, funds carried in a securities account pursuant to a self-regulatory organization portfolio margining rule approved by the Commission under section 19(b) of the Act (15 U.S.C. 78s(b)) ("SRO portfolio margining rule"), including variation margin or initial margin, marks to market, and proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon.

(9) The term other credit balances means cash liabilities of a broker or dealer to customers other than free credit balances and funds in commodity accounts which are

segregated in accordance with the Commodity Exchange Act or in a similar manner, or funds carried in a proprietary account as that term is defined in regulations under the Commodity Exchange Act. The term "other credit balances" also includes funds that are cash liabilities of a broker or dealer to customers other than free credit balances and are carried in a securities account pursuant to an SRO portfolio margining rule, including variation margin or initial margin, marks to market, and proceeds resulting from margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon.

* * * * *

(16) The term PAB account means a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer) other than a delivery-versus-payment account or a receipt-versus-payment account. The term does not include an account that has been subordinated to the claims of creditors of the carrying broker or dealer.

(17) The term Sweep Program means a service provided by a broker or dealer where it offers to its customer the option to automatically transfer free credit balances in the securities account of the customer to either a money market mutual fund product as described in § 270.2a-7 of this chapter or an account at a bank whose deposits are insured by the Federal Deposit Insurance Corporation.

(b) * * *

(5) A broker or dealer is required to obtain and thereafter maintain the physical possession or control of securities carried for a PAB account, unless the broker or dealer has provided written notice to the account holder that the securities may be used in the ordinary course of its securities business, and has provided an opportunity for the account holder to object.

* * * * *

(d) * * *

(4) Securities included on the broker's or dealer's books or records that allocate to a short position of the broker or dealer or a short position for another person, excluding positions covered by paragraph (m) of this section, for more than 30 calendar days, then the broker or dealer must, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities. For the purposes of this paragraph (d)(4), the 30 day time period will not begin to run with respect to a syndicate short position established in connection with an offering of securities until the completion of the underwriter's participation in the distribution as determined pursuant to § 242.100(b) of Regulation M of this chapter (17 CFR 242.100 through 242.105); or

* * * * *

(e) Special reserve bank accounts for the exclusive benefit of customers and PAB accounts. (1) Every broker or dealer must maintain with a bank or banks at all times when deposits are required or hereinafter specified a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (hereinafter referred to as the Customer Reserve Bank Account) and a "Special Reserve Bank Account for Brokers and Dealers" (hereinafter referred to as the PAB Reserve Bank Account), each of which will be separate from the other and from any other bank account of the broker or dealer. Such broker or dealer must at all times maintain in the Customer Reserve Bank Account and the PAB Reserve Bank Account, through deposits made therein, cash and/or qualified securities in amounts computed in accordance with the formula attached as Exhibit A (17 CFR 240.15c3-3a), as applied to customer and PAB accounts respectively.

(2) With respect to each computation required pursuant to paragraph (e)(1) of this section, a broker or dealer must not accept or use any of the amounts under items comprising Total Credits under the formula referred to in paragraph (e)(1) of this section except for the specified purposes indicated under items comprising Total Debits under the formula, and, to the extent Total Credits exceed Total Debits, at least the net amount thereof must be maintained in the Customer Reserve Bank Account and PAB Reserve Bank Account pursuant to paragraph (e)(1) of this section.

(3) Reserve Bank Account computations.

(i) Computations necessary to determine the amount required to be deposited in the Customer Reserve Bank Account and PAB Reserve Bank Account as specified in paragraph (e)(1) of this section must be made weekly, as of the close of the last business day of the week, and the deposit so computed must be made no later than one hour after the opening of banking business on the second following business day; provided, however, a broker or dealer which has aggregate indebtedness not exceeding 800 percent of net capital (as defined in § 240.15c3-1) and which carries aggregate customer funds (as defined in paragraph (a)(10) of this section), as computed at the last required computation pursuant to this section, not exceeding $1,000,000, may in the alternative make the Customer Reserve Bank Account computation monthly, as of the close of the last business day of the month, and, in such event, must deposit not less than 105 percent of the amount so computed no later than one hour after the opening of banking business on the second following business day.

(ii) If a broker or dealer, computing on a monthly basis, has, at the time of any required computation, aggregate indebtedness in excess of 800 percent of net capital, such broker or dealer must thereafter compute weekly as aforesaid until four successive

weekly Customer Reserve Bank Account computations are made, none of which were made at a time when its aggregate indebtedness exceeded 800 percent of its net capital.

(iii) A broker or dealer that does not carry the accounts of a "customer" as defined by this section or conduct a proprietary trading business may make the computation to be performed with respect to PAB accounts under paragraph (e)(1) of this section monthly rather than weekly. If a broker or dealer performing the computation with respect to PAB accounts under paragraph (e)(1) of this section on a monthly basis is, at the time of any required computation, required to deposit additional cash or qualified securities in the PAB Reserve Bank Account, the broker or dealer must thereafter perform the computation required with respect to PAB accounts under paragraph (e)(1) of this section weekly until four successive weekly computations are made, none of which is made at a time when the broker or dealer was required to deposit additional cash or qualified securities in the PAB Reserve Bank Account.

(iv) Computations in addition to the computations required in this paragraph (e)(3), may be made as of the close of any business day, and the deposits so computed must be made no later than one hour after the opening of banking business on the second following business day.

(v) The broker or dealer must make and maintain a record of each such computation made pursuant to this paragraph (e)(3) or otherwise and preserve each such record in accordance with § 240.17a-4.

(4) If the computation performed under paragraph (e)(3) of this section with respect to PAB accounts results in a deposit requirement, the requirement may be satisfied to the extent of any excess debit in the computation performed under paragraph (e)(3) of this section with respect to customer accounts of the same date. However, a deposit requirement resulting from the computation performed under paragraph (e)(3) of

this section with respect to customer accounts cannot be satisfied with excess debits from the computation performed under paragraph (e)(3) of this section with respect to PAB accounts.

(5) In determining whether a broker or dealer maintains the minimum deposits required under this section, the broker or dealer must exclude the total amount of any cash deposited with an affiliated bank. The broker or dealer also must exclude cash deposited with a non-affiliated bank to the extent that the amount of the deposit exceeds 15% of the bank's equity capital as reported by the bank in its most recent Call Report or any successor form the bank is required to file by its appropriate Federal banking agency (as defined by section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)).

(f) Notification of banks. A broker or dealer required to maintain a Customer Reserve Bank Account and PAB Reserve Bank Account prescribed by paragraph (e)(1) of this section or who maintains a Special Account referred to in paragraph (k) of this section must obtain and preserve in accordance with § 240.17a-4 a written notification from each bank with which it maintains a Customer Reserve Bank Account, a PAB Reserve Bank Account, or a Special Account that the bank was informed that all cash and/or qualified securities deposited therein are being held by the bank for the exclusive benefit of the customers and account holders of the broker or dealer in accordance with the regulations of the Commission, and are being kept separate from any other accounts maintained by the broker or dealer with the bank, and the broker or dealer must have a written contract with the bank which provides that the cash and/or qualified securities will at no time be used directly or indirectly as security for a loan to the broker or dealer by the bank and will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

(g) Withdrawals from the reserve bank accounts. A broker or dealer may make withdrawals from a Customer Reserve Bank Account and a PAB Reserve Bank Account if and to the extent that at the time of the withdrawal the amount remaining in the Customer Reserve Bank Account and PAB Reserve Bank Account is not less than the amount then required by paragraph (e) of this section. * * *

* * * * *

(j) Treatment of free credit balances. (1) A broker or dealer must not accept or use any free credit balance carried for the account of any customer of the broker or dealer unless such broker or dealer has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent, together with or as part of the customer's statement of account, whenever sent but not less frequently than once every three months, a written statement informing the customer of the amount due to the customer by the broker or dealer on the date of the statement, and that the funds are payable on demand of the customer.

(2) A broker or dealer must not convert, invest, or transfer to another account or institution, credit balances held in a customer's account except as provided in paragraphs (j)(2)(i) and (ii) of this section.

(i) A broker or dealer is permitted to invest or transfer to another account or institution, free credit balances in a customer's account only upon a specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization, or draft.

(ii) A broker or dealer is permitted to transfer free credit balances held in a customer's securities account to a product in its Sweep Program or to transfer a customer's interest in one product in a Sweep Program to another product in a Sweep Program, provided:

(A) For an account opened on or after the effective date of this paragraph (j)(2)(ii), the customer gives prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified:

(1) Of the general terms and conditions of the products available through the Sweep Program; and

(2) That the broker or dealer may change the products available under the Sweep Program.

(B) For any account:

(1) The broker or dealer provides the customer with the disclosures and notices regarding the Sweep Program required by each self-regulatory organization of which the broker or dealer is a member;

(2) The broker or dealer provides notice to the customer, as part of the customer's quarterly statement of account, that the balance in the bank deposit account or shares of the money market mutual fund in which the customer has a beneficial interest can be liquidated on the customer's order and the proceeds returned to the securities account or remitted to the customer; and

(3)(i) The broker or dealer provides the customer with written notice at least 30 calendar days before:

(A) Making changes to the terms and conditions of the Sweep Program;

(B) Making changes to the terms and conditions of a product currently available through the Sweep Program;

(C) Changing, adding or deleting products available through the Sweep Program; or

(D) Changing the customer's investment through the Sweep Program from one product to another.

(ii) The notice must describe the new terms and conditions of the Sweep Program or product or the new product, and the options available to the customer if the customer does not accept the new terms and conditions or product.

* * * * *

(l) Delivery of securities. * * *

(2) Margin securities upon full payment by such customer to the broker or dealer of the customer's indebtedness to the broker or dealer; and, subject to the right of the broker or dealer under Regulation T (12 CFR 220) to retain collateral for its own protection beyond the requirements of Regulation T, excess margin securities not reasonably required to collateralize such customer's indebtedness to the broker or dealer.

* * * * *

6. Section 240.15c3-3a is revised to read as follows:

§ 240.15c3-3a Exhibit A–Formula for determination of customer and PAB account reserve requirements of brokers and dealers under § 240.15c3-3.

	Credits	Debits
1. Free credit balances and other credit balances in customers' security accounts. (See Note A)……..	$XXX	……..
2. Monies borrowed collateralized by securities carried for the accounts of customers (See Note B)……	XXX	……..
3. Monies payable against customers' securities loaned (See Note C)……..	XXX	……..
4. Customers' securities failed to receive (See Note D)……..	XXX	……..
5. Credit balances in firm accounts which are attributable to principal sales to customers.	XXX	……..
6. Market value of stock dividends, stock splits and similar distributions receivable outstanding over 30 calendar days……	XXX	……..
7. Market value of short security count differences over 30 calendar days old…….....	XXX	……..
8. Market value of short securities and credits (not to be offset by longs or by debits) in all suspense accounts over 30 calendar days.	XXX	……..
9. Market value of securities which are in transfer in excess of 40 calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer during the 40 days……	XXX	……
10. Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection. (See Note E)……..	……..	XXX

11. Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver…….	……..	XXX
12. Failed to deliver of customers' securities not older than 30 calendar days…….	……..	XXX
13. Margin required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in customer accounts. (See Note F)…….	……..	XXX
14. Margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q-1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1) related to the following types of positions written, purchased or sold in customer accounts: (1) security futures products and (2) futures contracts (and options thereon) carried in a securities account pursuant to an SRO portfolio margining rule (See Note G) ……	……..	XXX
Total credits……..	……..	……
Total debits…….	……..	……..
15. Excess of total credits (sum of items 1-9) over total debits (sum of items 10-14) required to be on deposit in the "Reserve Bank Account" (§ 240.15c3-3(e)). If the computation is made monthly as permitted by this section, the deposit must be not less than 105% of the excess of total credits over total debits.	……..	XXX

Notes Regarding the Customer Reserve Bank Account Computation

Note A. Item 1 must include all outstanding drafts payable to customers which have been applied against free credit balances or other credit balances and must also include checks drawn in excess of bank balances per the records of the broker or dealer.

Note B. Item 2 must include the amount of options-related or security futures product-related Letters of Credit obtained by a member of a registered clearing agency or a derivatives clearing

organization which are collateralized by customers' securities, to the extent of the member's margin requirement at the registered clearing agency or derivatives clearing organization. Item 2 must also include the amount of Letters of Credit which are collateralized by customers' securities and related to other futures contracts (and options thereon) carried in a securities account pursuant to an SRO portfolio margining rule.

Note C. Item 3 must include in addition to monies payable against customers' securities loaned the amount by which the market value of securities loaned exceeds the collateral value received from the lending of such securities.

Note D. Item 4 must include in addition to customers' securities failed to receive the amount by which the market value of securities failed to receive and outstanding more than thirty (30) calendar days exceeds their contract value.

Note E. (1) Debit balances in margin accounts must be reduced by the amount by which a specific security (other than an exempted security) which is collateral for margin accounts exceeds in aggregate value 15 percent of the aggregate value of all securities which collateralize all margin accounts receivable; provided, however, the required reduction must not be in excess of the amounts of the debit balance required to be excluded because of this concentration rule. A specified security is deemed to be collateral for a margin account only to the extent it represents in value not more than 140 percent of the customer debit balance in a margin account.

(2) Debit balances in special omnibus accounts, maintained in compliance with the requirements of Section 7(f) of Regulation T (12 CFR 220.7(f)) or similar accounts carried on behalf of another broker or dealer, must be reduced by any deficits in such accounts (or if a credit, such credit must be increased) less any calls for margin, mark to the market, or other required deposits which are outstanding 5 business days or less.

(3) Debit balances in customers' cash and margin accounts included in the formula under Item 10 must be reduced by an amount equal to 1 percent of their aggregate value.

(4) Debit balances in cash and margin accounts of household members and other persons related to principals of a broker or dealer and debit balances in cash and margin accounts of affiliated persons of a broker or dealer must be excluded from the Reserve Formula, unless the

broker or dealer can demonstrate that such debit balances are directly related to credit items in the formula.

(5) Debit balances in margin accounts (other than omnibus accounts) must be reduced by the amount by which any single customer's debit balance exceeds 25% (to the extent such amount is greater than $50,000) of the broker-dealer's tentative net capital (i.e., net capital prior to securities haircuts) unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the Reserve Formula. Related accounts (e.g., the separate accounts of an individual, accounts under common control or subject to cross guarantees) will be deemed to be a single customer's accounts for purposes of this provision.

If the registered national securities exchange or the registered national securities association having responsibility for examining the broker or dealer ("designated examining authority") is satisfied, after taking into account the circumstances of the concentrated account including the quality, diversity, and marketability of the collateral securing the debit balances or margin accounts subject to this provision, that the concentration of debit balances is appropriate, then such designated examining authority may grant a partial or plenary exception from this provision. The debit balance may be included in the reserve formula computation for five business days from the day the request is made.

(6) Debit balances in joint accounts, custodian accounts, participation in hedge funds or limited partnerships or similar type accounts or arrangements that include both assets of a person or persons who would be excluded from the definition of customer ("noncustomer") and assets of a person or persons who would be included in the definition of customer must be included in the Reserve Formula in the following manner: if the percentage ownership of the non-customer is less than 5 percent then the entire debit balance shall be included in the formula; if such percentage ownership is between 5 percent and 50 percent then the portion of the debit balance attributable to the non-customer must be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula; or if such percentage ownership is greater than 50 percent, then the entire debit balance must be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula.

Note F. Item 13 must include the amount of margin required and on deposit with the Options Clearing Corporation to the extent such margin is represented by cash, proprietary qualified securities and letters of credit collateralized by customers' securities.

Note G. (a) Item 14 must include the amount of margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q-1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1) for customer accounts to the extent that the margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by customers' securities.

(b) Item 14 will apply only if the broker or dealer has the margin related to security futures products, or futures (and options thereon) carried in a securities account pursuant to an approved SRO portfolio margining program on deposit with:

(1) A registered clearing agency or derivatives clearing organization that:

(i) Maintains the highest investment-grade rating from a nationally recognized statistical rating organization; or

(ii) Maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at least $2 billion, at least $500 million of which must be in the form of security deposits. For the purposes of this Note G, the term "security deposits" refers to a general fund, other than margin deposits or their equivalent, that consists of cash or securities held by a registered clearing agency or derivative clearing organization; or

(iii) Maintains at least $3 billion in margin deposits; or

(iv) Does not meet the requirements of paragraphs (b)(1)(i) through (b)(1)(iii) of this Note G, if the Commission has determined, upon a written request for exemption by or for the benefit of the broker or dealer, that the broker or dealer may utilize such a registered clearing agency or derivatives clearing organization. The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances, if the Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors; and

(2) A registered clearing agency or derivatives clearing organization that, if it holds funds or securities deposited as margin for security futures products or futures in a portfolio margin account in a bank, as defined in section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)), obtains and preserves written notification from the bank at which it holds such funds and securities or at which such funds and securities are held on its behalf. The written notification will state that all funds and/or securities deposited with the bank as margin (including customer security futures products and futures in a portfolio margin account), or held by the bank and pledged to such registered clearing agency or derivatives clearing agency as margin, are being held by the bank for the exclusive benefit of clearing members of the registered clearing agency or derivatives clearing organization (subject to the interest of such registered clearing agency or derivatives clearing organization therein), and are being kept separate from any other accounts maintained by the registered clearing agency or derivatives clearing organization with the bank. The written notification also will provide that such funds and/or securities will at no time be used directly or indirectly as security for a loan to the registered clearing agency or derivatives clearing organization by the bank, and will be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank. This provision, however, will not prohibit a registered clearing agency or derivatives clearing organization from pledging customer funds or securities as collateral to a bank for any purpose that the rules of the Commission or the registered clearing agency or derivatives clearing organization otherwise permit; and

(3) A registered clearing agency or derivatives clearing organization establishes, documents, and maintains:

(i) Safeguards in the handling, transfer, and delivery of cash and securities;

(ii) Fidelity bond coverage for its employees and agents who handle customer funds or securities. In the case of agents of a registered clearing agency or derivatives clearing organization, the agent may provide the fidelity bond coverage; and

(iii) Provisions for periodic examination by independent public accountants; and

(iv) A derivatives clearing organization that, if it is not otherwise registered with the Commission, has provided the Commission with a written undertaking, in a form acceptable to the

Commission, executed by a duly authorized person at the derivatives clearing organization, to the effect that, with respect to the clearance and settlement of the customer security futures products and futures in a portfolio margin account of the broker or dealer, the derivatives clearing organization will permit the Commission to examine the books and records of the derivatives clearing organization for compliance with the requirements set forth in § 240.15c3-3a, Note G (b)(1) through (3).

(c) Item 14 will apply only if a broker or dealer determines, at least annually, that the registered clearing agency or derivatives clearing organization with which the broker or dealer has on deposit margin related to securities future products or futures in a portfolio margin account meets the conditions of this Note G.

Notes Regarding the PAB Reserve Bank Account Computation

Note 1. Broker-dealers should use the formula in Exhibit A for the purposes of computing the PAB reserve requirement, except that references to “accounts,” “customer accounts, or “customers” will be treated as references to PAB accounts.

Note 2. Any credit (including a credit applied to reduce a debit) that is included in the computation required by § 240.15c3-3 with respect to customer accounts (the “customer reserve computation”) may not be included as a credit in the computation required by § 240.15c3-3 with respect to PAB accounts (the “PAB reserve computation”).

Note 3. Note E(1) to § 240.15c3-3a does not apply to the PAB reserve computation.

Note 4. Note E(3) to § 240.15c3-3a which reduces debit balances by 1% does not apply to the PAB reserve computation.

Note 5. Interest receivable, floor brokerage, and commissions receivable of another broker or dealer from the broker or dealer (excluding clearing deposits) that are otherwise allowable assets under § 240.15c3-1 need not be included in the PAB reserve computation, provided the amounts have been clearly identified as payables on the books of the broker or dealer. Commissions receivable and other receivables of another broker or dealer from the broker or dealer that are otherwise non-allowable assets under § 240.15c3-1 and clearing deposits of another broker or dealer may be included as “credit balances” for purposes of the PAB reserve computation, provided the commissions receivable and other receivables are subject to

immediate cash payment to the other broker or dealer and the clearing deposit is subject to payment within 30 days.

Note 6. Credits included in the PAB reserve computation that result from the use of securities held for a PAB account ("PAB securities") that are pledged to meet intra-day margin calls in a cross-margin account established between the Options Clearing Corporation and any regulated derivatives clearing organization may be reduced to the extent that the excess margin held by the other clearing corporation in the cross-margin relationship is used the following business day to replace the PAB securities that were previously pledged. In addition, balances resulting from a portfolio margin account that are segregated pursuant to Commodity Futures Trading Commission regulations need not be included in the PAB Reserve Bank Account computation.

Note 7. Deposits received prior to a transaction pending settlement which are $5 million or greater for any single transaction or $10 million in aggregate may be excluded as credits from the PAB reserve computation if such balances are placed and maintained in a separate PAB Reserve Bank Account by 12 p.m. Eastern Time on the following business day. Thereafter, the money representing any such deposits may be withdrawn to complete the related transactions without performing a new PAB reserve computation.

Note 8. A credit balance resulting from a PAB reserve computation may be reduced by the amount that items representing such credits are swept into money market funds or mutual funds of an investment company registered under the Investment Company Act of 1940 on or prior to 10 a.m. Eastern Time on the deposit date provided that the credits swept into any such fund are not subject to any right, charge, security interest, lien, or claim of any kind in favor of the investment company or the broker or dealer. Any credits that have been swept into money market funds or mutual funds must be maintained in the name of a particular broker or for the benefit of another broker.

Note 9. Clearing deposits required to be maintained at registered clearing agencies may be included as debits in the PAB reserve computation to the extent the percentage of the deposit, which is based upon the clearing agency's aggregate deposit requirements (e.g., dollar trading volume), that relates to the proprietary business of other brokers and dealers can be identified.

Note 10. A broker or dealer that clears PAB accounts through an affiliate or third party clearing broker must include these PAB account balances and the omnibus PAB account balance in its PAB reserve computation.

7. Section 240.17a-3 is amended by adding paragraph (a)(23) to read as follows:

§ 240.17a-3 Records to be made by certain exchange members, brokers and dealers.

(a) * * *

(23) A record documenting the credit, market, and liquidity risk management controls established and maintained by the broker or dealer to assist it in analyzing and managing the risks associated with its business activities, Provided, that the records required by this paragraph (a)(23) need only be made if the broker or dealer has more than:

(i) $1,000,000 in aggregate credit items as computed under § 240.15c3-3a; or

(ii) $20,000,000 in capital, which includes debt subordinated in accordance with § 240.15c3-1d.

* * * * *

8. Section 240.17a-4 is amended by:

a. Removing from paragraph (b)(1) the citation "§ 240.17a-3(f)" and its place adding the citation "§ 240.17a-3(g)";

b. Removing from paragraph (b)(9) the citation "§ 240.15c3-3(d)(4)" and in its place adding the citation "§ 240.15c3-3(d)(5)"; and

c. Adding paragraph (e)(9).

The addition reads as follows:

§ 240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.

* * * * *

(e) * * *

(9) All records required pursuant to § 240.17a-3(a)(23) until three years after the termination of the use of the risk management controls documented therein.

* * * * *

9. Section 240.17a-11 is amended by:

a. Revising the first sentence of paragraph (b)(1);

b. Removing from the introductory text of paragraph (c) the text "or (c)(4)" and in its place adding ", (c)(4) or (c)(5)"; and

c. Adding paragraph (c)(5).

The revision and addition read as follows:

§ 240.17a-11 Notification provisions for brokers and dealers

* * * * *

(b)(1) Every broker or dealer whose net capital declines below the minimum amount required pursuant to § 240.15c3-1, or is insolvent as that term is defined in § 240.15c3-1(c)(16), must give notice of such deficiency that same day in accordance with paragraph (g) of this section. * * *

* * * * *

(c) * * *

(5) If a computation made by a broker or dealer pursuant to § 240.15c3-1 shows that the total amount of money payable against all securities loaned or subject to a repurchase agreement or the total contract value of all securities borrowed or subject to a

reverse repurchase agreement is in excess of 2500 percent of its tentative net capital; provided, however, that for purposes of this leverage test transactions involving government securities, as defined in section 3(a)(42) of the Act (15 U.S.C. 78c(a)(42)), must be excluded from the calculation; provided further, however, that a broker or dealer will not be required to send the notice required by this paragraph (c)(5) if it reports monthly its securities lending and borrowing and repurchase and reverse repurchase activity (including the total amount of money payable against securities loaned or subject to a repurchase agreement and the total contract value of securities borrowed or subject to a reverse repurchase agreement) to its designated examining authority in a form acceptable to its designated examining authority.

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By the Commission.

Elizabeth M. Murphy
Secretary

July 30, 2013