SIPC

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Nancy M. Morris
Secretary
United States Securities and Exchange Commission
100 F Street, N. E.
Washington, D. C. 20549-1090

RE: File No. S7-08-07

Dear Ms. Morris:

The Securities Investor Protection Corporation ("SIPC") is pleased to comment on the Commission's proposed amendments to the broker-dealer financial responsibility rules. SIPC believes that the decline in brokerage firm failures over the past few years can be attributed to rigorous enforcement of the Commission's Rules. Indeed, SIPC has praised the Commission and self-regulators for that rigor.[1] Although, as discussed below, SIPC has some concerns about the proposed changes, it believes that, on balance, the Proposals are salutary and will provide further protection for customers. SIPC's comments are as follows:

Proprietary Accounts of Broker Dealers (Rules 15c3-1(c)(2)(iv)(E); 15c3-3(a)(16); 15c3-3(b); 15c3-3(e); 15c3-3(f); 15c3-3(g); 15c3-3a):

The protections afforded by Rule 15c3-3 and the Securities Investor Protection Act, 15 U.S.C. section 78aaa et seq. ("SIPA"), are closely related.[2] The Commission adopted Rule 15c3-3 pursuant to a mandate in SIPA that required the Commission to identify unsafe and unsound practices in the securities industry and to take steps to eliminate those practices. 15 U.S.C. §78kkk(g). Rule 15c3-3 and SIPA are intended to work in tandem. Customers' assets must be safeguarded under the Rule, but if the broker fails to safeguard them, the SIPC protection is available as a safety net. In the scheme of customer protection, Rule 15c3-3 also acts as an early warning system. A broker's failure to comply with the Rule may be an early sign of trouble and signal that SIPC protection is needed.

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[1] See 2005 and 2006 SIPC Annual Reports, Message from the Chairman

[2] For convenience, references below to provisions of SIPA shall omit "15 U.S.C."

The Commission proposes to amend Rule 15c3-3 to require that proprietary accounts of broker-dealers be treated like other customer accounts for purposes of the reserve formula in, and segregation under, Rule 15c3-3. Broker-dealers carrying accounts for other brokerages would have to perform a reserve computation and establish and fund a separate reserve account for the benefit of such "customers." Since as "customers," broker-dealers are eligible under SIPA to share in any fund of customer property and general estate, the proposed amendments would give them the same protections as those received by other customers. A broker-dealer cannot have its claim satisfied with monies advanced by SIPC unless it is acting on behalf of its underlying customers who are themselves eligible for protection. Thus, the proposed amendments also would provide safeguards not currently available to the underlying customers. So long as the "customer" stands to share in customer assets, SIPC sees no reason to exclude the customer's assets from the proposed requirements whether the assets are in the proprietary account of an introducing broker or a foreign broker-dealer or in the account of a bank acting as a broker-dealer or in the account of any other person who is a "customer" under SIPA but who is ineligible to have its claim satisfied with SIPC funds.

Expansion of Definition of Qualified Securities (Rule 15c3-3(a)(6)(ii)):

A broker may deposit only cash and "qualified securities" into the bank account in order to meets its customer reserve deposit requirements. The Commission proposes to broaden the definition of "qualified securities" to include certain money market funds. Notwithstanding the asserted convenience and reliability of such investments, SIPC endorses the Proposal with reservation for at least two reasons. One, the Proposal introduces an intermediary (namely, the holding company or money market fund) at which problems might arise. And two, a number of SIPA liquidations have involved the mishandling of money market or mutual fund shares or the confirmation of purchases of nonexistent "money market funds." Experience suggests that a money market fund that "invests in nothing but qualified securities" may be more easy to falsify than the qualified securities themselves.

Treatment of Free Credit Balances (Rule 15c3-3(j)):

SIPC concurs in the Trustee's proposals regarding the transfer of free credit balances. We submit, however, that additional consideration should be given to the disclosures and notices provided by the broker to new customers in connection with the change of the sweep option from a money market fund to a bank deposit account, or vice versa. Among other things, under the Commission's Proposal, the broker must comply with the notices and disclosures required by any self-regulatory organization of which the broker is a member. The Commission cites New York Stock Exchange Information Memo 05-11 (February 15, 2005) ("Information Memo 05-11") as an example of the kinds of notices and disclosures to be provided. Although Information Memo 05-11 is correct in describing the kinds of losses that are not protected by SIPC, it fails to address the protection that <u>is</u> available. Money market mutual funds are deemed "securities" under SIPA, and therefore, the customer's protection with respect to such investments, is up to $500,000, so long as the shares are held by the broker for the customer (i.e., on the books of the mutual fund, the "customer" is the broker). On the other hand, if the money market shares are held directly by the fund for the customer, the customer is not protected, but the customer does not need the protection since he may, at any time, redeem his shares through the mutual fund, irrespective of the condition of the broker-dealer. If proceeds from the redemption of fund shares are owed to the customer, his claim is for cash. The limit of protection of claims for cash is $100,000.

Holding Futures Positions in a Securities Portfolio Margin Account (Rules 15c3-3(a)(8), 15c3-3a):

The Commission has proposed various amendments that would extend the requirements of Rule 15c3-3 and the protections of SIPA to all positions in a securities portfolio margin account. Under rules of the exchanges allowing such margin computation, securities and futures positions may be combined in a portfolio margin account. The Commission believes that the amendments are warranted because the futures positions hedge the securities positions and thereby reduce the investor's risk of loss. The proposed amendments are a "practical" response to the commingled nature of the positions and margin in the accounts and to the important function that the futures positions serve.

While SIPC does not question the asserted beneficial effects of the portfolio margin account, it has grave concerns that the proposed amendments conflict with SIPA. Under SIPA section 78lll(2), a "customer" generally is any person with a claim on account of securities received, acquired or held by the broker-dealer from or for the person's securities account for various stated purposes. "Customer" also includes a "person who has deposited cash with the debtor for the purpose of purchasing securities...." Id. In short, under SIPA, customers are protected against the loss of their securities or cash on deposit in connection with securities transactions. "Security" is broadly defined under SIPA. Although it includes security futures as defined in 15 U.S.C. section 78c(a)(55)(A),[3] except as specifically provided, "security" does not include any "futures contract, or any warrant or right to subscribe to or purchase or sell any of the foregoing." 15 U.S.C. §78lll(14).

The proposed Rules seek to extend the SIPC protection to all positions in the portfolio margin account, irrespective of whether they are "securities" under SIPA or were on deposit in connection with a "securities" transaction. The Rules would achieve this outcome by characterizing certain property in the account as free credit balances and thus, "cash," and by expanding the definition of "customer property" under SIPA.

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[3] Under 15 U.S.C. section 78c(a)(55)(A), generally, a security future is a future on a single security or a narrow-based security index.

The Commission proposes to modify the definition of "free credit balance" under Rule 15c3-3(a)(8) to include, with respect to portfolio margin accounts, "proceeds resulting from closing out futures contracts and options thereon, and ... the market value as of the 'filing date' ... of any long options on futures contracts."[4] By reducing all futures positions to "cash," the Commission seeks to confer upon the investor "customer" status under SIPA. The Commission also proposes to amend Rule 15c3-3 Item 14 to include as debit items all margin required and posted with the futures clearing organization for the futures positions in the portfolio margin account. In the Commission's view, as "resources provided through the use or realization of customers' debit cash balances and other customer-related debit items as defined by ... Commission ... rule," such margin would be "customer property" under SIPA. 15 U.S.C. §78lll(4)(B).

Under SIPA, a customer's claim for "cash" derives from a few sources. One, the "cash" arises from the broker's sale of securities for the account of the customer. Two, the "cash" has been deposited by the customer with the broker for the purpose of purchasing securities. Three, the cash consists of dividends or other return generated on securities held by the broker for the customer. 15 U.S.C. §78lll(2). Key is the fact that the cash owed by the broker to the customer is on deposit in connection with the purchase or sale of a "security," as defined in SIPA. The facile labelling of an asset as "cash"does not transform it into a protected asset if unrelated to the purchase or sale of a "security." Thus, for example, cash in a customer's account is not "protected" cash if deposited for the purpose of purchasing an interest in an unregistered limited partnership. See, e.g., Mitchell v. Chicago Partnership Bd., Inc., 246 B. R. 854 (N. D. Ill. 2000). Limited partnership interests are not "securities" under SIPA unless registered with the Commission under the Securities Act of 1933. 15 U.S.C. §78lll(14).

By the same token, the close-out of futures contracts and the valuing of options on futures contracts does not yield cash resulting from the purchase or sale of a "security." Margin deposited to secure a futures position is not cash on deposit in connection with a "security" trade. This is especially evident if the customer's claim is based on trades that, although confirmed by the broker to the customer, never actually occur. In that circumstance, the trustee is left with no guidance on how to resolve the claim. A claim for a security normally is satisfied by the delivery of the security to the customer. 15 U.S.C. §78fff-2(d). Assuming that the broker has falsely confirmed the purchase of an option on a future, the trustee has no statutory authority to purchase the option for the customer. Likewise, if the broker not only falsely confirms the purchase of a futures option but confirms the purchase of one that is fictitious, the trustee has no statutory authority to give the customer cash based on an instrument that is not a "security" under SIPA.

It is axiomatic that the conflict between the Commission's Proposal, if enacted, and SIPA would be tested at the worst possible time, namely, during the financial failure of a very large

[4] The "filing date" usually is the date on which SIPC files the application to have the firm placed in SIPA liquidation. 15 U. S.C. §78lll(7).

member firm. It is not difficult to construct a failure which would align some customers against others, depending upon which assets were missing or otherwise unavailable. Customers having only securities in their accounts would argue that claimants with futures positions should not share in "customer property," to the detriment of "securities" customers, under the clear exclusion of futures contracts and futures options in the security definition of SIPA. Resolution of the conflict would breed controversy, expense and delay in the liquidation proceeding under circumstances where they can least be afforded.

In light of the foregoing, SIPC urges the Commission to reconsider its adoption of the aforementioned Proposals. If the changes are in order, the Commission should seek to have them made by legislative amendment and not rulemaking.

On a related note, SIPC endorses the Proposal clarifying that funds held in a proprietary commodity account as defined by CFTC Rule, are not free credit balances for purposes of the customer reserve formula. Proposed Rule 15c3-3(a)(8).

Documentation of Risk Management Procedures (Rules 15c-1(c)(2)(iv)(B); 17a-11(c)(5); 17a-3(a)(23) and 17a-4(e)(9)):

SIPC supports the Commission's Proposals concerning securities lending and borrowing transactions and the documentation of risk management procedures, particularly with respect to the largest broker-dealers. We note that as a subset of liquidity risk, "concentration risk," involving a limited number of securities as a high percentage of the brokerage's lending portfolio, contributed to the failure of MJK Clearing, Inc.

Amendments to the Net Capital Rule:

1. Subtraction of Expenses Assumed by Third Parties (Rule 15c3-1(c)(2)(i)(G)):

SIPC agrees with the proposals of the Commission regarding various adjustments to the computation of net capital. Among others, these include the proposed adjustment that would require broker-dealers to treat as a liability, absent written permission from the designated examining authority, any capital contribution that is intended to be withdrawn within a year. A pending lawsuit by the Trustee in the Continental Capital Investment Services, Inc. and Continental Capital Securities, Inc. SIPA proceeding illustrates the need for such relief. In that suit, the Trustee alleges that the defendant advanced monies to the parent corporation of the brokerage debtors which in turn transferred the monies to the debtors. The debtors thereupon falsely reported compliance with the minimum net capital requirements of federal and state law. Once the false Net Capital Reports were completed, the money was re-transferred to the parent and the defendant. The false reporting scheme prevented regulatory authorities from discovering that the debtors were out of compliance and allowed the debtors to continue their fraudulent activities. The aforementioned is an example of an egregious situation. More often, the transfer of funds occurs in connection with subordinated demand notes entered into between the debtor and third parties.

2. Broker-Dealer Solvency Requirement (Rules 15c3-1(a) and 15c3-1(c)(16); 17a-11(b)(1)):

SIPC favors an amendment requiring broker-dealers to cease doing business if "insolvent" as defined under proposed Rule 15c3-1(c)(16). In such circumstances, SIPC would not object to allowing customers to liquidate securities positions under appropriate regulatory or self-regulatory supervision as part of a broker-dealer's endeavor to self-liquidate. We believe that such action would be consistent with SIPA section 78eee(a)(2) which authorizes oversight by the self-regulator of the broker's self-liquidation in order to protect the interests of customers of the broker. We note 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. Thus, insolvency or the existence of an insolvency or receivership proceeding are grounds for the commencement of a SIPA case. Indeed, the failure to comply with financial responsibility requirements or even an inability to make the computation showing compliance are grounds. 15 U.S.C. §78eee(b)(1). We also favor a requirement of immediate notification to the SEC and the designated examining authority of "insolvency."

Accounting for Third-Party Liens on Customer Securities Held at a Broker-Dealer:

The Commission solicits comment on how third-party liens against customer fully paid securities carried by a broker-dealer should be treated under the financial responsibility rules. The lien typically would arise in connection with a loan made by a third party lender to a customer and the related creation of a perfected lien on customer assets. Thus, for example, Customer borrows money from Lender in order to purchase securities. Lender has a fully perfected lien on the securities in question. The securities are in the customer's brokerage account, subject to the lien.

The Commission offers three possible alternatives for accounting for this transaction: Option 1, the broker includes the amount of the lien as a credit item in the reserve formula; Option 2, the broker moves the encumbered securities into a separate pledge account in the name of the pledgee or pledges; or Option 3, the broker records the lien on its books and records and discloses the lien and related information to the customer. The Commission observes that in the event of a SIPA liquidation, the trustee could be placed in the situation of owing the securities both to the customer and the lien-holder.

As an initial matter, the securities are in the customer's account and as such, are held by the broker for the customer. The loan obligation is between the third-party lender and the customer, and not between the customer and the broker. Therefore, the customer has no indebtedness to the broker with respect to the securities in question. Relative to the broker, the customer's net equity is the value of the securities. Under these circumstances, Option 1, which would treat the amount of the loan as a credit and therefore require the property to be segregated by the broker, would afford the customer the most protection.

Option 2 is viable, provided that it offers a good control location and does not result in a reduction in the amount of property to be segregated by the broker for its customers. Option 3 also is acceptable, although it would afford the lender less protection than Option 2.

We note that in a SIPA proceeding, under the circumstances discussed above, the customer's claim for the fully-paid securities would be allowed. However, because of the encumbrance upon them, the collateral would not be delivered in the ordinary course to the customer. In the event of a dispute between the borrower and lender as to entitlement to the securities, the trustee likely would interplead or deposit the collateral before the Bankruptcy Court, and petition the Court to require the parties to litigate the dispute of entitlement between themselves.

We have discussed above the Proposals that are of particular concern to SIPC. A number of other Proposals are made that SIPC believes to be equally sound but do not require comment. Others are outside the scope of SIPC's work and therefore, are not addressed.

SIPC would be pleased to address any questions relative to these comments. We appreciate the opportunity to express our views to the Commission.

Very truly yours,

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