JPMorgan

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Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1000
Attn.: Ms. Nancy M. Morris, Secretary

Via email (rule-comments@sec.gov)

Re: File Number S7-08-07 Amendments to Financial Responsibility Rules for Broker-Dealers

Ladies and Gentlemen:

JPMorgan Chase Bank, N. A. ("JPMorgan") appreciates this opportunity to comment on the Securities and Exchange Commission's (the "Commission") proposed amendments to Rule 15c3-3 "Customer Protection – Reserves and Custody of Securities" (the "Proposal"). [1]

The Commission has proposed limitations on the amount of cash that a broker-dealer can deposit in a special reserve bank account for the exclusive benefit of customers ("Special Reserve Bank Accounts") at an unaffiliated bank in order to meet its reserve requirements to address the Commission's concerns about concentration risk at a single institution. We believe that the Commission's concerns can be better addressed through other prudential guidelines. We also believe that the proposed limitations may result in additional costs or financial detriment to broker-dealers that are not warranted in light of alternative means that exist to address the Commission's concerns. In particular, JPMorgan believes that compliance with the Proposal will impose significant operational burdens on certain broker-dealers.

Current Guidelines and Proposal

Rule 15c3-3[2] requires broker-dealers to take certain steps to protect customer assets including maintaining in a Special Reserve Bank Account cash and/or qualified securities equal to the difference between the amount of money the firm owes customers and the amount of money customers owe the firm. For the purpose of the broker-dealer meeting its reserve requirements under Rule 15c3-3, the Commission proposes to (1) exclude cash deposits at banks affiliated with the broker-dealer and (2) place limits on the amount of Rule 15c3-3 deposits a broker-dealer could maintain in a Special Reserve Bank Account at a single unaffiliated bank. Specifically, the Proposal requires a broker-dealer to exclude from the minimum reserve deposit any deposits with a single bank that exceed 50% of the broker-dealer's excess net capital or 10% of the bank's equity capital.

[1] 72 *Fed. Reg* 12862 (March 19, 2007). Please note that certain affiliates of JPMorgan intend to express their support on other sections of the proposal through industry groups. For example, the Commission has proposed to expand the definition of "qualified securities" to include money market funds described in Rule 2a-7 under the Investment Company Act of 1940 that invest only in "qualified securities." JPMorgan's support of this part of the proposal will be set forth in the Investment Company Institute's comment letter.
[2] 17 C.F.R. § 240.15c3-3.

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Potential for *Greater* Operational / Credit Risk Exposure

The Proposal is meant to address concerns that a broker-dealer could experience a loss or may not be able to access cash if the bank at which the Special Reserve Bank Account is maintained experiences financial difficulty and the broker-dealer's required reserves are concentrated in a deposit at a single bank. JPMorgan recognizes that this is an important and legitimate concern and appreciates the need to safeguard customer assets. However, we believe that the Commission's proposal does not adequately address these concerns. Even with the limitations proposed by the Commission, a broker-dealer would be exposed to credit and operational risk when making a substantial deposit at one bank. While the Proposal may require that a broker-dealer maintain deposits at more than one bank, it is not necessarily the case that credit and operational risks would be mitigated. We note, for example, that the Proposal could result in having a broker-dealer deposit significant amounts of cash with a less than adequately capitalized bank, or a bank with a low level of equity capitalization, a situation that results in more risk than one in which more than 50% of the broker-dealer's excess net capital is deposited with a well or adequately capitalized bank with a high level of equity capitalization. As indicated below, we believe that a better approach would be to take into account changes in Federal banking law that have led to increased scrutiny of the capital positions of banks.

Benefit of Due Diligence

JPMorgan notes that the limitations set forth in the Proposal are based upon the Commission Staff's advice provided to the New York Stock Exchange in 1988.[3] Since that time, Congress has enacted legislation that requires the Federal bank supervisory agencies to adopt requirements that establish regulatory capital requirements for banks. Furthermore, a system for assessing the capital adequacy of banks has been instituted and the Federal banking agencies are required to take supervisory action in the event a bank is deemed not to be adequately capitalized.[4] Banks that experience erosions in their capital levels are compelled by their Federal bank supervisors to take prompt action to correct the capital deficiency. Accordingly, the concerns which gave rise to the Commission Staff's 1988 letter and those expressed in the Proposal have been mitigated by statutes and regulations requiring prompt corrective action in the event a bank's capital position deteriorates. Moreover, JPMorgan believes that the risk that broker-dealer deposits could be inaccessible because of an institution's financial difficulty can be sufficiently and appropriately managed and reduced by requiring a broker-dealer to perform due diligence on banks holding Rule 15c3-3 deposits. Broker-dealers, like banks, are regulated entities that are required to have policies and procedures requiring them to behave in a manner consistent with safe and sound business practices. Prudent business practice requires that broker-dealers perform due diligence on a bank in which they will hold customer deposits. As a part of this investigation, broker-dealers should consider, among other factors, the credit rating or creditworthiness of the bank and whether it is either "well capitalized" or "adequately capitalized" as defined under regulations issued by the Federal bank supervisory agencies.[5] Broker-dealers also should assure that contracts between broker-dealers and banks holding Rule 15c3-3 deposits contain provisions that allow a broker-dealer to withdraw all funds from the Special Reserve Bank Account at any time and a representation by the bank that it is at least adequately capitalized and will immediately inform the broker should its status deteriorate.[6]

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[3] See NYSE Interpretation Handbook No. 88-1, February 1988.

[4] See 12 U.S.C. § 1831o; 12 C.F.R. Part 6; Part 208, Subpart D; Part 303, Subpart K.

[5] 12 C.F.R. §§ 6.4(b)(1), (2) (Comptroller of the Currency); 208.43(b)(1),(2) (Federal Reserve Board); 325.103(b)(1),(2) (Federal Deposit Insurance Corporation).

[6] Naturally, a broker-dealer would be expected to have back-up arrangements with another bank in the event it withdraws all its funds from one bank and needs to re-deposit them with another.

JPMorgan also notes that broker-dealers should perform due diligence on operational capabilities and controls in considering where to place substantial cash deposits. A bank that offers state of the art, real-time online reporting, and robust resiliency and disaster recovery should be favored over those with more limited operational strengths. As an example, even after September 11, JPMorgan was able to continue, without interruption to process cash payments, securities transactions and administer cash and securities accounts.

UK FSA Approach

In fact, there are approaches that are similar to our views under other regulatory schemes analogous to the Commission's. For example, in the United Kingdom, the Financial Services Authority ("FSA") requires that a firm in selecting a bank to hold customer deposits owes a duty of care to a client when it decides where to place client money (FSA CASS Manual 4.3.41). Rather than imposing strict guidelines, the FSA requires a firm to undertake due diligence when opening a client bank account and to consider a number of factors in making a decision as to an appropriate bank 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 that this information is available, the level of risk in the investment and loan activities undertaken by the bank and its affiliated companies."

While the FSA requires firms to consider diversifying placements of client money where the amounts are of a sufficient size to warrant diversification, the FSA does not impose a strict requirement on the size of a deposit with any one institution. Rather, the FSA requires a firm to perform due diligence on the bank and act accordingly. Given the credit and operational risks that could result in simply applying a numerical approach in determining the size of the cash held at a particular bank, we believe that an approach based upon the FSA's approach is both reasonable and prudent. Certain of the factors the FSA requires firms to consider in performing their due diligence appear to address the same concerns as the Proposal. For example, investigating the bank's overall capital and/or total Tier 1 Capital and the amount of client money placed as a percentage of the bank's equity capital helps to ensure that a bank does not accept deposits that are large relative to the size of the bank.

Recommended Approach

JPMorgan believes that requiring broker-dealers to perform due diligence on banks holding Rule 15c3-3 deposits, that banks holding such deposits be "adequately" or "well capitalized" and the protective contractual provisions discussed above provide safeguards that will better achieve the Commission's objective without imposing artificial, somewhat arbitrary constraints on broker-dealers, which constraints do not entirely address the Commission's concerns. As a result, JPMorgan recommends that the Commission adopt a rule providing that broker-dealers (1) may maintain customer deposits subject to Rule 15c3-3 only in unaffiliated banks that are well or adequately capitalized, (2) must investigate their overall exposure to the banks and carefully determine that it is appropriate to maintain customer deposits at such banks and (3) require certain contractual provisions between the broker-dealer and the bank.

Potential Operational Risks / Burdens from Current Proposal

Permitting broker-dealers to maintain deposits at a single unaffiliated bank, when it is determined by the broker-dealer to be prudent to do so, provides the broker-dealer with a liquid and administratively efficient means to manage its Rule 15c3-3 deposits. It also allows the broker-dealer to obtain the most competitive return on its deposit, while meeting prudential safety and soundness considerations. JPMorgan 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. JPMorgan estimates that at any one time, approximately 10 to 15% of its broker-dealer customers could be impacted by the proposed rule change and many of these customers would be required to open accounts at multiple institutions. To the extent that a broker-dealer elects to maintain all its Rule 15c3-3 deposits in cash it will need to devote resources to engage in ongoing due diligence on a number of banks, reconcile account statements, maintain balances, send wires from various accounts, etc. The broker-dealer will transition from a liquid and flexible system where they can easily move deposits in accordance with the reserve requirement to a situation requiring additional resources, oversight, management and reconciliation in order to effectively manage cash in accounts at multiple institutions. Moreover, the broker-dealer may not be able to leverage volume to obtain the best rate on its deposits.

If a broker-dealer elects to use qualified securities as opposed to cash to meet all or part of its reserve requirement, then the broker-dealer will likely have a significant amount of additional operational and transactional costs. While 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 smaller broker-dealers may be required to hire additional staff to manage and maintain a securities portfolio. 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. In addition, securities pose additional operational risks such as failures to settle in a given market. JPMorgan believes that the upfront and ongoing cost to each broker-dealer is far higher than the one-time fee of $2,630 the Commission estimates in the Proposal.

Conclusion

While JPMorgan supports the aims of the section of the Proposal that is the subject of this letter, it believes that permitting broker-dealers to maintain Rule 15c3-3 deposits at a single bank subject to the conditions recommended in this letter provides broker-dealers a flexible, cost-efficient management approach to Rule 15c3-3 deposits. JPMorgan believes that the risks of having such deposits concentrated at a single bank are mitigated by requiring that: (1) broker-dealers perform ongoing due diligence on banks holding Rule 15c3-3 deposits, (2) the bank be “well capitalized” or “adequately capitalized” as defined under regulations of the Federal bank supervisory agencies with robust operational capabilities and controls, and (3) certain contractual provisions exist between the broker-dealer and the bank.

Again, JPMorgan appreciates the opportunity to comment on this subject and would be pleased to discuss any of the points raised in this letter in more detail. Should you have any questions, please contact Diane Eshleman at 212-552-0900.