SIFMA
Securities Industry and Financial Markets Association

June 15, 2007

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

Re: Release No. 34-55431, File No. S7-08-07, Amendments to Financial Responsibility Rules for Broker-Dealers

Dear Ms. Morris:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to provide the Securities and Exchange Commission (the "SEC" or "Commission") with comments on the Commission's proposed amendments (the "Proposed Amendments") to its financial responsibility rules for broker-dealers under the Securities Exchange Act of 1934 (the "Exchange Act").[2]

SIFMA commends the Commission and its staff for undertaking this review of the financial responsibility rules and for their extensive efforts in preparing the Proposed Amendments. The net capital rule (Rule 15c3-1) and the customer protection rule (Rule 15c3-3) remain vitally important to protecting broker-dealers, their customers, and the markets in which they operate. The continued efficacy of these rules, however, requires that they be periodically reviewed and updated, as the Commission is now doing, to reflect practical experience and new developments in markets, products and risk-management practices.

SIFMA welcomes and supports many of the Proposed Amendments as appropriate and timely enhancements to the Commission's financial responsibility scheme for broker-dealers. As discussed more fully below, however, in our view certain of the amendments would impose requirements whose costs are not adequately justified by their benefits, and other

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1 SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington, D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

2 Release No. 34-55431 (Mar. 9, 2007), 72 Fed. Reg. 12862 (Mar. 19, 2007) (the "Proposing Release").

amendments should be more narrowly tailored to address the specific concerns expressed by the Commission. In these cases, we have attempted to identify alternative proposals where appropriate.

We note that in many instances the issues presented by the Proposed Amendments are quite complicated and technical in nature. Accordingly, SIFMA and its Committees stand ready to discuss these comments further with the Commission staff and to assist in any other way that may be helpful in the Commission's review of the Proposed Amendments.

For convenience, our comments below are set forth in substantially the same order in which the Proposed Amendments are described in the Proposing Release.

I. Proposed Amendments to the Customer Protection Rule

A. Proprietary Accounts of Broker-Dealers

The Proposed Amendments would modify Rule 15c3-3 to require broker-dealers to treat proprietary accounts they carry for U.S. or foreign broker-dealers ("PAB accounts") much like customer accounts for purposes of the reserve formula requirements under Rule 15c3-3. A carrying broker-dealer would need to perform a separate reserve formula calculation for PAB accounts and establish a separate reserve account for PAB account-related reserve deposits.[3] In these respects, the amendments codify many requirements set forth in a 1998 no-action letter regarding proprietary accounts of introducing brokers (the "PAIB Letter"), in which the Commission staff specified conditions under which an introducing broker would not be required to take capital charges for cash or securities held in a proprietary account at another broker-dealer.[4]

While SIFMA generally supports the Commission's proposals with respect to PAB accounts, we recommend that they be modified in several important respects.[5]

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[3] Proposed amendments to paragraphs (e) – (g) of Rule 15c3-3 and Rule 15c3-3a.

[4] See Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Raymond J. Hennessy, Vice President, New York Stock Exchange, LLC ("NYSE") and Thomas Cassella, Vice President, NASD Regulation, Inc. (Nov. 10, 1998).

[5] We also request the Commission's confirmation that broker-dealers may presume that U.S. banks are "customers" under Rule 15c3-3, and not brokers or dealers for purposes of the PAB account amendments or otherwise. The Gramm-Leach-Bliley Act replaced the blanket exclusion for banks from the definitions of "broker" and "dealer" with certain conditional exclusions. It is generally expected that U.S. banks will structure their securities activities so as to qualify for these conditional exclusions or other exemptions from broker-dealer registration provided by the Commission. Since U.S. broker-dealers will not be in a position to determine whether in fact banks satisfy the requirements for these exclusions or exemptions, however, they should be permitted to presume for purposes of Rule 15c3-3 that banks whose accounts they carry are not acting as "brokers" or "dealers" and therefore are "customers."

1. Proprietary Accounts of Affiliated Foreign Broker-Dealers and Affiliated Foreign Banks

We urge the Commission to exclude from the definition of "PAB account" any proprietary account of a foreign broker-dealer or foreign bank that is affiliated with the U.S. carrying firm. Although we understand the Commission's desire to close the "gap" between Rule 15c3-3 (under which proprietary accounts of foreign broker-dealers generally are not customers) and the provisions of the Securities Investor Protection Act of 1970 ("SIPA") (under which such accounts may be treated as customers for certain purposes), in our view this objective 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.

The securities processing and settlement activities of U.S. broker-dealers are frequently integrated with their foreign affiliates to facilitate operational efficiencies. For example, foreign affiliates generally clear their U.S. securities transactions through U.S. broker-dealers, and U.S. broker-dealers clear transactions in foreign securities through their foreign affiliates. Moreover, there may be a significant volume of transactions between the accounts of the U.S. broker-dealer and its foreign affiliates on a daily basis in order to avoid fails, maximize funding efficiencies, accommodate customer trading interest, etc. Requiring these transactions to be subject to the proposed PAB account amendments would be very cumbersome and would limit the benefits of such inter-company transactions for the efficient processing and settlement of transactions in both the United States and abroad.

In addition, in many cases foreign affiliates of U.S. broker-dealers engage in transactions (e.g., swaps) with U.S. investors that U.S. broker-dealers are unable to execute on commercially competitive terms (due to U.S. capital and margin requirements), even taking into account certain recent steps to ameliorate these issues.[6] In many cases, a U.S. broker-dealer may custody the positions established by its foreign affiliates in connection with these transactions. Restrictions on how the U.S. broker-dealer is able to handle these positions of its foreign affiliates will limit the ability of the group as a whole to provide competitive services to U.S. investors.

Finally, it is important to note that Rule 15c3-1 effectively operates to limit the carrying firm's use of cash or securities held for a foreign affiliate, even if the foreign affiliate is excluded from PAB account status. In particular, Rule 15c3-1 requires that any rehypothecation of securities or lending of cash held for foreign affiliates (or any other persons) be secured by

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[6] See, e.g., Release No. 34-49830 (June 8, 2004), 69 Fed. Reg. 34428 (June 21, 2004) (adoption of alternative capital requirements for broker-dealers that are part of firms subject to consolidated supervision); Release No. 34-54918 (Dec. 12, 2006), 71 Fed. Reg. 75790 (Dec. 18, 2006) (approving portfolio margining rules).

appropriate collateral or be subject to a corresponding capital charge. In our view, these protections afforded by the net capital rule provide additional support for the conclusion that, on balance, the benefits of excluding foreign affiliates from the definition of a PAB account outweigh any potential risks to customers.[7]

2. Written Permission to Use PAB Account Securities

Proposed new paragraph (b)(5) under Rule 15c3-3 would require carrying broker-dealers to obtain written permission from PAB account owners in order to use securities carried for such accounts in the ordinary course of their business. This written permission requirement should be eliminated from the Proposed Amendments.

The PAIB Letter did not contain any such requirement, and it is not clear why the Commission proposes to adopt one now. The proposal interferes unnecessarily in the contractual arrangements between broker-dealers, who are capable of understanding the terms of standard industry custodial relationships. The cost of compliance with this requirement (which the Commission estimates to be $8,773,410)[8] therefore is not justified. Accordingly, we recommend the Commission amend proposed paragraph (b)(5) by eliminating the words after "PAB account."[9]

3. Responsibility of Introducing Firm for Violations by Clearing Firm

The proposed amendment to paragraph (c)(2)(iv)(E) of Rule 15c3-1 should be modified so as to explicitly clarify that cash and securities held in a securities account at another broker-dealer are not subject to the deduction specified in this paragraph.

The proposed amendment requires an introducing firm to take a capital charge for amounts held at another broker-dealer that fails to comply with the proposed PAB account amendments to Rule 15c3-3. Although 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],"[10] the text of the proposed amendment suggests that they in fact would have such an obligation. In practice, the

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[7] We also note that the chief rationale for the PAIB letter – i.e., the need to address the capital treatment under Rule 15c3-1 of proprietary assets carried at, and subject to rehypothecation by, another broker-dealer – does not apply in the case of foreign firms. These foreign firms are not subject to Rule 15c3-1 or SIPA, and the Commission is not responsible for limiting rehypothecation of securities or use of cash by a U.S. carrying firm in order to give effect to the capital requirements applicable to its foreign affiliate.

[8] Proposing Release at 12880.

[9] Paragraph (b)(5) would thus read: "A broker or dealer shall not be required to obtain and thereafter to maintain the physical possession or control of securities carried for a PAB account."

[10] Proposing Release at 12864.

broker-dealer whose proprietary account is being carried by another firm would not be able to determine conclusively whether the carrying firm is in compliance with these requirements. In any event, a broker-dealer should not be deemed to have violated Rule 15c3-1 merely because its carrying firm fails to perform properly requirements applicable solely to the carrying firm.

As currently drafted, the proposed amendment to paragraph (c)(2)(iv)(E) also could be read to impose on U.S. broker-dealers a new requirement (not applicable to them today) to take capital charges for all proprietary positions maintained at a foreign broker-dealer. The Proposing Release does not discuss this potential implication of the proposed amendment, and we therefore assume it was unintended. Since any misunderstanding regarding this issue could result in significant disruption and costs for U.S. broker-dealers' foreign custodial arrangements, we urge that the amendment not be adopted in its current form for this reason as well.

We also request that the Commission explicitly confirm our understanding that upon adoption of the PAB account amendments, introducing firms would not be required to obtain a written agreement from their clearing firms of the type required under the PAIB letter (since under the PAB account amendments the clearing firms are independently subject to the PAB reserve account requirement).

4. Aggregate Debit Items

The Commission should clarify that "aggregate debit items" as used in Rules 15c3-1, 15c3-1d, and 17a-11 refer only to the aggregate debit items under the customer reserve computation, not the sum of the debit items in the customer and PAB account reserve computations.

The term "aggregate debit items" is used for several purposes. For example, broker-dealers computing net capital requirements under the "alternative standard" must base such computations on "aggregate debit items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3-3a)."[11] The term is also used for alternative standard firms in determining restrictions on the withdrawal of capital,[12] limitations in connection with subordination agreements,[13] and mandatory notification requirements.[14] We understand the Commission intended that these provisions would apply only to aggregate debit items as determined under the customer reserve computation

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[11] Rule 15c3-1(a)(1)(ii).

[12] Rule 15c3-1(e)(2)(vi).

[13] Rule 15c3-1d(b)(6)(iii), (b)(7), (b)(8)(i), (b)(10)(ii)(B), (c)(2), (c)(5)(ii)(A).

[14] Rule 17a-11(c)(2).

(without reference to the PAB account reserve computation), and recommend that the Commission make this clear in the text of the relevant rules.[15]

5. Exclusion for Subordinated Accounts

The Commission should modify the PAB account amendments to specify that the account of any person that agrees to subordinate its claims to those of creditors of the carrying firm should not be treated as a PAB account. Although persons that agree to such subordination are not "customers" under Rule 15c3-3 or SIPA,[16] accounts of such persons do not appear to be excluded from being treated as PAB accounts. To implement our proposal, which would further the Commission's goal of "correcting the gap between Rule 15c3-3 and SIPA,"[17] the Commission could include an additional carve-out from the proposed definition of a "PAB account"[18] for subordinated accounts similar to that contained in the definition of a "customer."

6. Additional Comments

Proposed amendments to Rule 15c3-3(f) would require that a broker-dealer notify its bank that the PAB reserve account is held "for the benefit of brokers or dealers." The PAIB Letter, however, required the clearing broker to maintain a separate "Special Reserve Account for the Exclusive Benefit of Customers." In our view, there is no reason to require clearing brokers who have established their reserve bank accounts based on the requirements of the PAIB Letter to amend the relevant account documentation merely in order to change the name on such accounts.[19]

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[15] Our proposed clarification also would be consistent with the Commission's proposed Note 4 to the PAB account reserve computation, which states that the 1% reduction to Item 10 debit items under Note E(3) of the customer reserve computation does not apply to the PAB account reserve computation.

[16] The SIPA definition of "customer" 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 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." 78 U.S.C. 78*lll*(2)(B).

[17] Proposing Release at 12863.

[18] Proposed amendment adding paragraph (a)(16) to Rule 15c3-3.

[19] We understand, moreover, that both reserve accounts (customer and PAB) would be available for the benefit of all SIPA customers of the broker-dealer, since as noted in the Proposing Release non-broker-dealers and broker-dealers are generally treated the same under SIPA (except for purposes of closeouts and advances). See 78 U.S.C. 78*fff*-2(e) and *fff*-3(a)(5). Requiring the accounts to be named in a manner that suggests that different SIPA customers have different claims on them might therefore create confusion regarding the implications of these accounts for a SIPA liquidation.

In addition, the PAIB Letter provides that NYSE Interpretation /04 to Item 10 of Rule 15c3-3a regarding securities concentrations does not apply to the PAIB reserve computation under amended Rule 15c3-3.[20] The Commission should clarify that this interpretation also will not apply to the PAB account reserve computation.[21]

B. Banks Where Special Reserve Cash Deposits May Be Held

The Proposed Amendments would prohibit a broker-dealer from counting toward its reserve account requirements (i) any cash deposited at an affiliated bank, and (ii) any cash deposited at an unaffiliated bank to the extent such deposit exceeds 50% of the broker-dealer's excess net capital (based on its most recently filed FOCUS report) or 10% of the bank's equity capital (based on its most recent Call Report or Thrift Financial Report).[22]

1. Percentage Limitations on Cash Deposits with Banks

We recommend that the Commission reconsider or modify its proposed limitations on the amount of reserve account cash deposits that may be held at any one bank.

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[20] See NYSE Interpretation Handbook Rule 15c3-3 (Exhibit A – Item 10)/04.

[21] We recommend several additional non-substantive changes to the proposed PAB account amendments and reserve formula requirements: (i) the "a" in paragraph (e)(1) should be retained before the phrase "Special Reserve Bank Account for the Exclusive Benefit of Customers" and a closing quote should be added after that phrase; (ii) although paragraph (e)(1) defines the term "PAB Reserve Bank Account," various other paragraphs of the Proposed Amendments refer to a "PAB Special Reserve Account" – this terminology should be made consistent; (iii) the language "and PAB" in Item 13 of the reserve formula should be deleted in light of the substitution provision of Note 1; (iv) the reference to "§240.15c3-3(e)" in Item 15 of the reserve formula should be changed back to "§240.15c3-3(c)"; (v) the reference to "percentage ownership is greater than 50 percent" in Note E(6) should remain unchanged; (vi) in Note G(b), the new phrase "or futures (or options thereon) carried in a securities account pursuant to an approved SRO portfolio margining program" should be set off by commas to make clear that security futures need not be held in a portfolio margin account; (vii) in Note 1, since not all broker-dealer accounts are PAB accounts, the phrase "substituting the term 'brokers or dealers' for the term 'customers'" should be replaced with ", except that references to 'accounts', 'customer accounts' or 'customers' shall be treated as references to PAB accounts"; and (viii) the reference to commodity "exchange" in Note 6 would seem to more properly refer to a commodity clearing organization. We further note that we find Notes 6 and 10 to the PAB reserve computation somewhat confusing and suggest that the Commission clarify these provisions.

We also recommend deleting the requirement in Note 5 that commissions receivable and other receivables of another broker-dealer be "clearly identified as receivables on the books and records of the other broker or dealer." A broker-dealer generally will not know if another firm has "clearly identified" such amounts on its books and records, and in any event they would be payables on the books of the other broker-dealer.

Finally, we recommend that Note 8 be revised to refer to credits that have been or will be swept by the deposit date, that similar treatment be afforded credits swept to a bank account, and that the same interpretation be applied for credits in the customer reserve formula calculation.

[22] Proposed paragraph (e)(5) under Rule 15c3-3.

First, in our view the Commission's proposed limitations do not adequately take into account either the existing bank capital and related supervisory regime or the costs that these limitations would impose on broker-dealers. It is important to recognize that banks are subject to an extensive regulatory capital framework designed to protect against the risk of financial difficulties of a type that could threaten reserve account cash deposits. Federal and state regulators regularly examine banks, and banks must compute and report detailed financial information. This regulatory framework has been revised and refined over many decades to reflect practical experiences during periods of rapid market changes or other economic dislocations.

In addition, the Commission substantially underestimates the costs of the proposed limitations on cash deposits. First, the Commission appears to assume that only 11 broker-dealers will be subject to these limitations.[23] We are uncertain as to the basis for this assumption, since the proposed limitations would apply to a broker-dealer maintaining deposits at an affiliated bank. Second, the Commission assumes that affected broker-dealers can either open new reserve bank accounts or deposit qualified securities in lieu of cash in their existing accounts, either of which options the Commission estimates would require only 10 hours to implement.[24] In reality, however, conducting due diligence and opening new accounts, not to mention the ongoing monitoring and periodic re-evaluation of such additional accounts, would require much more time.

More importantly, there are significant costs associated with effecting the necessary changes to systems, operations, and contractual agreements that the Commission does not appear to take into account. There are also substantial additional costs associated with depositing qualified securities in a reserve account in lieu of cash – e.g., the broker-dealer must identify sufficient quantities of such securities, fund their acquisition, and assume market risk with respect to them, and may no longer have the securities readily available to meet settlement or other delivery obligations.[25]

For these reasons, we question whether there is a compelling need for the types of limitations on reserve account cash deposits that the Commission proposes to adopt.

Second, if the Commission determines nevertheless that some limits on cash deposits are necessary, in our view the current percentage tests are unduly restrictive in certain

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23 Proposing Release at 12881.

24 Id.

25 Indeed, many broker-dealers must actively manage the securities held in a reserve account in order to minimize settlement failures and optimize operational efficiencies. Intra-day substitutions of securities for these purposes are discussed further in Part I.B.3 below.

instances and should be modified.[26] For example, these 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 cash deposits and the overall size or equity capital of the bank.[27]

In addition, we suggest that the Commission consider higher percentage limits for cash deposits held at very large, money center banks. At some level of size, scale and financial stability, a bank should be presumed to be adequately supervised and sufficiently safe for a more significant amount of reserve account cash deposits by a broker-dealer. Higher percentage tests for sufficiently large banks also would strike a better balance between the Commission's concerns regarding the safety of cash deposits, on the one hand, and the substantial costs imposed on broker-dealers, on the other, by overly restrictive deposit limitations. Appropriate standards for defining banks eligible for this treatment might include a minimum equity capital requirement and designation as "well capitalized" for regulatory capital purposes.[28]

2. Affiliated Banks

We urge that the Commission not adopt a complete prohibition on recognizing cash deposits at affiliated banks for reserve account purposes. Affiliated banks are subject to the same financial regulation applicable to unaffiliated banks. We therefore recommend that affiliated banks be treated the same as unaffiliated banks for these purposes.[29]

3. Substitutions of Cash for Qualified Securities

If the Commission adopts any limitations on the amount of cash deposits that may be held at a bank, we urge the Commission to clarify that such limitations would not apply to cash that is substituted for qualified securities on an intra-day basis.

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[26] In addition, broker-dealers should be afforded an adequate grace period to restructure their reserve accounts if a bank's status changes, or the broker-dealer's excess net capital changes, such that cash deposits are no longer eligible for reserve account purposes.

[27] At a minimum, it would seem appropriate that firms be permitted to maintain reserve account deposits of up to $100,000 at any bank, given the federal insurance protection available for such deposits.

[28] "Well capitalized" banks must have: (i) a total risk-based capital ratio of 10.0% or greater; (ii) a Tier 1 risk-based capital ratio of 6.0% or greater; and (iii) a leverage ratio of 5.0% or greater. See 12 CFR 6.4 (Office of the Comptroller of the Currency); 12 CFR 208.43 (Board of Governors of the Federal Reserve System ("Federal Reserve Board")); 12 CFR 325.103 (Federal Deposit Insurance Corporation ("FDIC")); 12 CFR 565.4 (Office of Thrift Supervision).

[29] In any event, affiliated banks should not be subject to any greater limitations than currently apply by interpretation. See NYSE Interpretation Handbook Rule 15c3-3(e)(3)/051.

The Proposed Amendments would not limit deposits of qualified securities at any bank, since banks agree not to re-lend or hypothecate such securities. In order to effectively manage and optimize their settlement obligations throughout the day, however, some broker-dealers regularly substitute cash for some or all qualified securities in the reserve account, so that those securities are available to make deliveries during the day, and then return qualified securities to the reserve account by the end of the day. If the Commission limits the amount of cash deposits that may be held at a bank, a question may arise as to whether such limits apply to cash held in a reserve account on an intra-day basis as a result of these substitution procedures.

Cash that is substituted for qualified securities on an intra-day basis should not be subject to any deposit restrictions adopted by the Commission. These intra-day substitutions provide essential operational efficiencies for broker-dealers that help reduce settlement failures. Although broker-dealers could substitute securities for securities on an intra-day basis, this is much more difficult to implement as an operational matter than an exchange of cash vs. securities, and in any event does not provide the broker-dealer with efficient access to all securities that may be necessary to meet delivery needs. Broker-dealers would effectively be required to manage different pools of securities across multiple bank accounts, an approach that in our view is not viable.

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

The Proposed Amendments would expand the definition of "qualified securities" eligible to meet reserve account requirements to include money market funds (as described in Rule 2a-7 of the Investment Company Act of 1940 ("Rule 2a-7")) that: (i) invest only in securities issued or guaranteed by the United States as to principal and interest; (ii) are not affiliated with the broker-dealer; (iii) agree to redeem fund shares in cash no later than the business day following a redemption request by a shareholder; and (iv) have net assets equal to at least 10 times the value of the shares held by the broker-dealer for purposes of its reserve account requirements.[30]

SIFMA supports the proposed expansion of the definition of "qualified securities" to include money market funds, subject to the following comments.[31]

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[30] Proposed amendment to paragraph (a)(6) of Rule 15c3-3. As "qualified securities," money market fund shares would need to be held in the broker-dealer's reserve account at a bank. It may be appropriate for the Commission to consider permitting broker-dealers to hold fund shares outside of a bank account (subject to similar requirements limiting liens on such shares).

[31] In addition to the comments below, we recommend broker-dealers be afforded a grace period to restructure their reserve account arrangements if the value of the shares they hold in a fund were to exceed 10% of the fund's net assets – e.g., due to withdrawals from the fund by other investors.

1. Highly Rated Money Market Funds

We recommend that the Commission include as "qualified securities" funds that have received the highest money market fund rating from a nationally recognized statistical rating organization ("NRSRO"). Money market funds are subject to stringent portfolio quality, maturity, and diversification requirements under Rule 2a-7, and NRSROs impose additional restrictions on top-rated funds.[32] For example, to receive a top NRSRO rating, a money market fund must maintain a maturity that affords risk protections comparable to Treasury-only funds. In light of these requirements, the excellent safety record of money market funds, and their broad acceptance as cash equivalents for various purposes, we urge that the Commission permit top-rated funds to be included as "qualified securities."[33]

2. Affiliated Money Market Funds

We recommend that the Commission eliminate the proposed requirement that a money market fund not be "affiliated" with the broker-dealer holding shares in such a fund for reserve account purposes. The diversification requirements of Rule 2a-7 are intended to ensure that a money market fund is readily able to satisfy redemption requests promptly even under adverse circumstances. In addition, a money market fund cannot hold securities issued by its adviser or affiliates of its adviser.[34] On top of these restrictions applicable to all money market funds, the Commission is imposing additional limitations for "qualified security" status – e.g., a requirement that the funds be of the highest credit quality, and a limitation on the percentage of the fund that a broker-dealer may own for these purposes. Collectively, these restrictions provide adequate comfort that money market funds, including affiliated funds, will have sufficient liquidity to satisfy any redemption requests.

3. Next-Day Redemption Requirement

In order for its shares to be "qualified securities" under the Proposed Amendments, a money market fund must agree "to redeem fund shares in cash no later than the business day following a redemption request by a shareholder." Although many money market

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[32] See also discussion infra Part V.G.

[33] If this recommendation is not adopted, we propose that the Commission at a minimum include as qualified securities money market funds 95% of which are composed of U.S. Treasury securities. We note that this approach would be consistent with the Regulation T definition of an "exempted securities mutual fund" as any security issued by a registered investment company that has "at least 95 percent of its assets continuously invested in exempted securities." 12 CFR 220.2. The 100% requirement may inadvertently exclude money market funds that are primarily "Treasury-only" but in fact maintain relatively small investments in other securities. Regardless of the percentage test adopted, the Commission should clarify that any cash held by a fund is excluded from this test.

[34] Investment Company Act Rule 12d3-1.

funds appear to offer next-day redemption, they may reserve the right to redeem shares in up to 7 days.[35] We are concerned that such funds might not be "qualified securities" under the Commission's proposed definition, and that it would be impractical to require a broker-dealer to contract separately with a fund to receive next-day redemption (even assuming a fund would undertake such an obligation). An alternative and more flexible approach would be to require that the fund agree to redeem shares "promptly upon request" – where it is understood that this will permit redemption to occur in any event within 7 days.[36]

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

The Proposed Amendments would add a new paragraph (d)(4) to Rule 15c3-3 requiring a broker-dealer with a possession or control deficit in a security included on its books and records as a proprietary short position or a short position for another person for more than 10 business days (or more than 30 calendar days if the broker-dealer is a market maker in the securities) to take prompt steps to obtain physical possession or control of such securities.[37] Currently, there is no requirement to take such steps when a customer's fully paid or excess margin long position allocates to a short position; instead, the broker-dealer includes the value of the security as a credit in the reserve formula. In proposing this amendment, the Commission expressed concern that under the current approach a broker-dealer may "monetize the customer's security … contrary to the customer protection goals of Rule 15c3-3, which seeks to ensure that broker-dealers do not use customer assets for proprietary purposes."[38]

We do not support the proposed amendment. We disagree in particular with the suggestion that under the current rule a broker-dealer may freely "monetize" customer securities (in the sense of converting such securities into cash that the broker-dealer may use in its own business), since as the Commission notes the broker-dealer must put a credit item in the reserve formula for the security. In addition, we are concerned about the disruptive impact the Commission's proposal may have for bona fide short selling activities, particularly by market makers.

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35 See Investment Company Act § 22(e).

36 This approach would be similar to the standard the Commission adopted or approved in authorizing money market funds to be used to satisfy margin requirements for security futures or in connection with a portfolio margin account. See, e.g., Exchange Act Rule 404(b)(2)(iii); NYSE Rule 431(g)(7)(D)(3); National Association of Securities Dealers, Inc. ("NASD") Rule 2520(g)(7)(D)(iii).

37 We understand that broker-dealers could obtain such possession or control by borrowing, buying-in, or otherwise obtaining the necessary securities. In other words, the differences in the language at the end of proposed paragraph (d)(4) and the language at the end of current paragraphs (d)(2) and (d)(3) should not be read to suggest that broker-dealers have different options available to them under these paragraphs for obtaining possession or control of the relevant securities.

38 Proposing Release at 12865.

1. Potential Impact on Bona Fide Short Positions

Proposed paragraph (d)(4) may increase the cost, or result in the close-out, of proprietary or customer short positions that were established and maintained in accordance with all applicable short sale regulations and that could be important to the investment or hedging strategies of the broker-dealer or its customers.[39]

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

The Commission's proposal therefore will impose an additional burden on short sales, which have been recognized as important contributors to liquidity and pricing efficiency.[40] In addition, there is some risk that a customer could use this amendment to facilitate market manipulation (by paying off debit balances, or moving a margin account to another broker-dealer, and forcing buy-ins of short positions). We note, moreover, that the terms of the proposal could be viewed as interfering with the carefully crafted short sale and buy-in requirements of Regulation SHO. We are skeptical that any minimal potential benefits of the proposed amendment are sufficient to outweigh these concerns, particularly since customers who have fully paid or excess margin securities with a broker-dealer that allocate to a short position are already protected in this instance by the related credit to the reserve formula.

At the very least, if the Commission does adopt the proposed amendment, it should exempt short sales by market makers from paragraph (d)(4), since their ability to engage in bona fide short selling activities – free from any risk of having their short positions closed out without notice and without fault on their part – is important to market liquidity.

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[39] We have assumed that the close-out requirement under proposed paragraph (d)(4) would apply to customer short positions. If this is not correct, the Commission should clarify this point in any adopting release. Even in this case, however, the concerns expressed herein would still be relevant to paragraph (d)(4) as applied to non-customers.

[40] Release No. 34-50103 (Jul. 28, 2004), 69 Fed. Reg. 48008, 48009 n.6 (Aug. 6, 2004).

2. Timing Issues

If proposed paragraph (d)(4) is adopted, the 10- and 30-day grace periods should begin to run from the date the possession or control deficit is identified, rather than the date the short sale was executed. This would allow time for the broker-dealer to take orderly steps to borrow the relevant securities, and would decrease the likelihood that bona fide short positions must be closed out or that customers could use the retirement of margin debt to promote a short squeeze.

As proposed, paragraph (d)(4) would require a broker-dealer to take prompt steps to obtain physical possession or control of securities no later than the business day after the determination that a possession or control deficit exists. Affected short positions must have been on the broker-dealer's books for 10 business days (or 30 calendar days if the broker-dealer is a market maker). This time period, however, could have run prior to the time the possession and control deficit arose.[41]

In addition, in order to ensure consistency and facilitate implementation, SIFMA recommends that the grace periods for all broker-dealers be harmonized at 30 calendar days, rather than varying based on whether a broker-dealer is a market maker in the relevant security.

3. Syndicate Short Positions

If proposed paragraph (d)(4) is adopted, it should be modified to explicitly exclude an underwriter's short position created in connection with a distribution of securities until after the later of the completion of such underwriter's participation in the distribution (as defined in Rule 100 of Regulation M) or the delivery date for securities acquired in the exercise of any overallotment option (or "green shoe"). 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). In addition, where an underwriter sells short to a customer in anticipation of obtaining the securities through the exercise of an overallotment option (if not through secondary market purchases), paragraph (d)(4) should not

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[41] In this respect, proposed paragraph (d)(4) parallels existing paragraphs (d)(2) and (d)(3), which also require prompt steps be taken to obtain securities that have not been received for a period that could have run out before a segregation deficit even arose. There is, however, a fundamental difference between the provisions: the short sales covered by proposed paragraph (d)(4) would have been effected and settled in compliance with all regulatory and contractual requirements, while the situations described in existing paragraphs (d)(2) and (d)(3) involve the ongoing failure of a party to deliver securities when due. Such failure to deliver for a lengthy period justifies taking immediate steps to obtain physical possession or control of the relevant security. In the case of legitimate short sales, however, there is no similar justification for taking immediate steps to close out the transaction.

require the premature exercise of the overallotment option or the use of secondary market purchases instead of the overallotment option.[42]

E. Treatment of Free Credit Balances[43]

The Commission is proposing to add a new paragraph (j) to Rule 15c3-3 that would generally prohibit a broker-dealer from transferring customers' free credit balances except under certain circumstances. Among other provisions, this new paragraph would establish consent, notification and disclosure requirements for "sweep" arrangements under which free credit balances are automatically invested in a "money market mutual fund product" or an "interest-bearing account product at a bank" without a specific order or authorization from the customer for each such transfer.

In general, SIFMA agrees with the fundamental principles embodied in the proposal – 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.[44] We also agree with the premise that changes in the investment or product into which customer free credit balances are swept should be conditional on appropriate disclosure to the customer.

SIFMA has set forth below certain proposed modifications to paragraph (j). In addition, we request that the Commission work with the self-regulatory organizations ("SROs") to rescind or modify SRO rules that would be duplicative or inconsistent with the requirements of paragraph (j) as adopted.

1. Ability of Broker-Dealers to Use Free Credit Balances

Proposed paragraph (j)(2) would prohibit a broker-dealer from converting, investing, or transferring customer free credit balances except under certain conditions. We understand this provision was intended to prevent a broker-dealer from causing an obligation it has to return cash to a customer to be transformed into an obligation of another entity to the customer (such as a bank or money market fund) without the customer's consent. The proposed language could be construed much more broadly, however, to prohibit a broker-dealer from using, investing, or transferring cash deposits that are not swept to other investments or products

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[42] SIFMA notes that, because Section 11(d)(1) of the Exchange Act prohibits broker-dealers participating in the distribution of new issues from extending credit on those securities, securities sold in distributions by participating underwriters are more likely to be fully paid and therefore subject to a possession or control requirement that would trigger these concerns.

[43] The comments in this Part I.E were prepared primarily by an ad hoc SIFMA working group on sweeps.

[44] In SIFMA's view, moreover, customer consent should be permitted to take a number of different forms, as in other securities transactions, including oral instructions, written authorization, various forms of transaction instruments (e.g., check or debit card) and the terms of any customer agreement.

(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. We suggest the language of paragraph (j)(2) be revised to reflect this intent more accurately – e.g., 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 or investing it in another instrument on behalf of the customer, except as permitted under paragraph (j)(2).

2. Types of Sweep Investments and Products

Proposed paragraphs (j)(2)(ii) and (iii) would permit the transfer of customer free credit balances to either a money market fund or a bank deposit account, but not into other investments or products.

The Commission should not limit the types of investments or products into which a customer can direct a broker-dealer to sweep free credit balances. Clearly, the broker-dealer should comply with applicable disclosure requirements in offering any investment or product as part of a sweep arrangement. Assuming such compliance, however, Rule 15c3-3 should not stifle innovation by limiting the ability of broker-dealers and their customers to identify new or different sweep investments or products. We therefore recommend that the proposed rule be modified to refer to "investments or products, including but not limited to" money market funds or bank deposit accounts.

In addition, a broker-dealer should be permitted to transfer customer balances from one sweep product to another – i.e., to effect a "bulk transfer" between sweep products – if appropriate notice and disclosures have been given to the customer. Although paragraphs (j)(2)(ii)(D) and (iii)(C) appear intended to permit such bulk transfers, other language in paragraphs (j)(2)(ii) and (j)(2)(iii) could be read to suggest that the only permitted transfers under these paragraphs are those in which "free credit balances" are moved into money market funds or bank deposit accounts (rather than between such funds and accounts). We recommend that paragraphs (j)(2)(ii) and (j)(2)(iii) be revised to clarify that they cover transfers of "free credit balances and customer investments in money market mutual funds, bank account products and other similar investment products" to any other investment product, including money market mutual funds, bank account products or other investment products.

3. Terms and Conditions of Sweep Arrangements

Proposed paragraph (j)(2)(ii)(A) would permit a broker-dealer to sweep the free credit balances of customers whose accounts are opened after the effective date of the Proposed Amendments into a money market fund or deposit account without specific authorization for each transfer if the customer has "previously affirmatively consented to such treatment of the free credit balances" after being notified of (i) the different "general types" of money market funds and deposit account products made available by the broker-dealer and (ii) the "applicable terms and conditions that will apply if the [broker-dealer] changes the product or type of product …."

SIFMA agrees that broker-dealers should be required to obtain a customer's consent to a sweep arrangement, and that such consent should be based on adequate disclosure of the options, if any, made available to the customer by the broker-dealer. It is unclear, however, what the Commission intends by requiring disclosure of the "applicable terms and conditions that will apply if the broker-dealer changes the product or type of product …." This provision 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. In addition, under paragraph (j)(2)(ii)(D), a broker-dealer is already required to describe any changes it makes contemporaneously with such changes. Given this type of notice, there is no need for the type of generalized (and therefore less effective) disclosure that would be required by paragraph (j)(2)(ii)(A).

In addition, in response to the Commission's request for comment as to the cost burdens that would result if the requirement in paragraph (j)(2)(ii)(A) to obtain a new customer's prior agreement were to be applied to existing customers, we believe such costs would be substantial. Broker-dealers would be required to amend their agreements with all existing sweep customers, an enormous undertaking that would require significant resources and time. We therefore support the Commission's proposal to treat new and existing customers differently in this respect.

4. SRO Disclosures and Notices Regarding Sweep Arrangements

Proposed paragraphs (j)(2)(ii)(B) and (iii)(A) would require a broker-dealer to provide customers "on an ongoing basis" with all disclosures and notices required by the applicable SROs. There currently are no SRO requirements that broker-dealers make disclosures concerning sweep arrangements on an ongoing basis.[45] We therefore request that the Commission clarify or eliminate this requirement.

5. Withdrawal of Cash from Sweep Arrangements

Proposed paragraphs (j)(2)(ii)(C) and (iii)(B) would require a broker-dealer to inform customers in quarterly account statements that they can withdraw funds in their sweep investment or product and have the funds held as free credit balances.

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[45] In February 2005, the NYSE issued Information Memo 05-11, addressing the use of "prior or negative consent" by member firms to adopt or amend a "sweep plan" and requiring customer disclosures with respect to deposit account sweep arrangements concerning the "terms and conditions, risks and features of the programs, conflicts of interest, current interest rates, the manner by which future interest rates will be determined, as well as the nature and extent of [Securities Investor Protection Corporation ("SIPC")] or FDIC insurance available." To avoid duplicative or inconsistent regulation, we request the Commission work with the NYSE to amend this guidance as appropriate if paragraph (j) is adopted.

We note that the language of these paragraphs requires notice that a sweep investment or product can be liquidated on a customer's "demand." Typically, under the disclosed terms of a money market fund or bank deposit account, the fund or bank may take up to 7 days to pay requests for withdrawals. In our view, therefore, it may not be appropriate to use the term "on demand" in connection with these products.

In addition, we are concerned that the proposed disclosure requirement incorrectly suggests that customers always have the option of holding their funds as a free credit balance at a broker-dealer. In fact, the account documentation for certain clients may not contemplate this option, and some firms may not have the necessary systems or procedures in place to permit every customer to automatically elect to hold free credit balances in lieu of using a sweep arrangement. More generally, we question whether the proposed disclosure is necessary as part of a quarterly statement – particularly since it may imply that sweep investments or products are in some way inferior to free credit balances, when in fact they are intended to offer more favorable returns to customers. If the quarterly disclosure requirement is adopted, however, we urge that it be modified so as not to suggest that upon liquidation of a sweep investment or product, the customer's funds may automatically be held as a free credit balance.

6. Termination of Sweep Arrangements

Proposed paragraphs (j)(2)(ii)(D) and (iii)(C) require 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." 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. In fact, the broker-dealer may elect not to continue offering the prior sweep options, and not to offer another sweep product.[46] The customer could then transfer its free credit balances to another money market fund, bank deposit, or other investment or product of its choosing offered by the broker-dealer. We recommend that the proposed paragraphs be amended to read:

> The notice must describe the new money market fund, bank deposit type [or other investment or product], or terms and conditions and the options available to the customer if the customer does not accept the new money market fund, bank deposit type [, other investment or product,] or terms and conditions.

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[46] Broker-dealers are not required to offer sweep investments or products.

7. Negative Response Letters Under NASD Rules

NASD Rule 2510(d)(2) permits the use of "negative response letters" to effectuate a bulk exchange between one money market fund and another such fund, irrespective of any yield difference between the funds, in connection with a change in sweep investments. NASD Rule 2510(d)(2) does not specifically address bulk transfers among different products, such as a bulk transfer from a money market fund to a bank deposit account or between products other than funds.[47]

In light of the provisions of paragraphs (j)(2)(ii) and (iii) permitting a bulk transfer of funds from one investment or product to another and providing a procedure for implementing those transfers, SIFMA requests that in connection with the adoption of paragraph (j) the Commission work with the NASD to amend and conform Rule 2510(d)(2).

8. Authorization for Non-Sweep Transfers of Free Credit Balances

Paragraph (j)(2)(i) prohibits a broker-dealer from transferring free credit balances without "a specific order, authorization, or draft from the customer" if the transfer is not covered by paragraphs (j)(2)(ii) or (iii). According to the Proposing Release, this paragraph "is not addressing free credit balance sweeps …, but rather the use of customer free credit balances for other purposes …."[48]

We recommend that 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 of a customer to another account, entity or product. Customers may prefer, for example, that free credit balances be regularly transferred to a linked account in their name at another broker-dealer or bank that is not a part of a "sweep arrangement." 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 identical.

F. Importation of Rule 15c3-2

The Proposed Amendments would rescind Rule 15c3-2, which prohibits a broker-dealer from using any customer's free credit balances in connection with the operation of its business unless the broker-dealer makes certain periodic disclosures to its customers regarding the amounts due to them and certain related matters. Similar disclosure requirements would be

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[47] See, e.g., Letter from Sarah J. Williams, Assistant General Counsel, NASD, to the Metropolitan Life Insurance Company (Feb. 3, 2003).

[48] Proposing Release at 12866.

added, however, to new paragraph (j)(1) of Rule 15c3-3. SIFMA has no objection to the elimination of Rule 15c3-2.[49]

We have several comments regarding proposed paragraph (j)(1). First, the requirement to disclose that free credit balances are payable "on demand" should be amended to address circumstances in which payment cannot be made on demand. For example, if a customer has an obligation to the broker-dealer, or if a lien exists on an account, the broker-dealer may refuse to permit the cash withdrawal until the relevant obligation is satisfied.

Second, the proposed revisions to the definition of "free credit balances" intended to protect the SIPA status of portfolio margining customers (discussed in Part II below) create some ambiguity as to what must be disclosed under paragraph (j)(1). Under the new definition, some amount of a customer's "free credit balance" may no longer be payable to the customer on request – e.g., cash held as margin deposits for futures, subject to a lien – and should not be described to the customer as a free cash deposit available for withdrawal. In addition, it is unclear how a broker-dealer could satisfy the requirement to disclose the amount of the customer's free credit balance when that amount depends in part on other unknown variables – e.g., the market value of future options on a SIPA "filing date."

We believe it would be appropriate to eliminate the disclosure requirement in paragraph (j)(1), since broker-dealers generally send customers statements of account that provide them with the relevant information. Alternatively, the Commission could (i) bifurcate the definition for free credit balances into credit balances for purposes of the paragraph (j)(1) disclosure requirement, and credit balances for purposes of reserve account requirements and SIPA, and (ii) replace the statement that funds are payable on demand with language clarifying that the amount of the customer's cash balances, net of any amounts owed to the broker-dealer or subject to a lien, are payable promptly upon request.

As a more general matter, we urge 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 (to be completed by the morning of the second following business day). This would help protect broker-dealers from liquidity issues if a customer with a material credit balance seeks to withdraw a significant amount at once.

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[49] Rule 15c3-3(j)(1) adds the reference to accepting (rather than simply using) a free credit balance, which appears to broaden the proposal beyond the current scope of Rule 15c3-2 in a manner that is unnecessary. SIFMA would recommend language along the following lines: "No broker or dealer may use any free credit balance carried for the account of any customer…"

G. Aggregate Debit Items Charge

The Commission proposes to treat broker-dealers using the "alternative standard" "on a par" with firms using the "basic method" with respect to required reductions to their debit balances. Currently, firms subject to the "basic method" of computing net capital requirements are required to reduce by 1% the debits in Item 10 of the reserve formula (i.e., debit balances in customers' cash and margin accounts).[50] Firms using the "alternative standard" of computing net capital requirements, in contrast, must reduce aggregate debit items by 3%.[51] Since debits offset credits under the reserve formula, these reductions in debits effectively increase the amounts that broker-dealers must maintain in their reserve accounts, and this increase is greater for "alternative standard" firms than for "basic method" firms.

SIFMA supports the SEC's proposal to eliminate the current requirement that "alternative standard" firms reduce aggregate debit items by 3%,[52] which "would make alternative standard firms subject to the 1% reduction in debit items as required in Note E(3) of Rule 15c3-3a" – i.e., the same 1% reduction as currently applies to "basic method" firms.[53] As noted in the Proposing Release, the higher charge applicable to "alternative standard" firms was initially intended to provide an additional "cushion" in their reserve accounts to protect against risk.[54] In the decades since these requirements were adopted, however, the amount of debits carried by broker-dealers has increased substantially, resulting in much larger "cushions" than originally intended. In addition, this increase in debits has not resulted in a proportionate increase in risk for these firms, since there is a diversification of risk inherent across debits for different customers. Conforming the reduction in debits for "alternative standard" firms to that required for "basic method" firms is therefore an appropriate modification that will continue to provide a prudential "cushion" in the reserve formula calculations of all firms.

H. "Proprietary Accounts" Under the Commodity Exchange Act

The Proposed Amendments would clarify the treatment of funds carried in "proprietary accounts" (as that term is defined under the Commodity Exchange Act ("CEA")) by broker-dealers that are also registered under the CEA as futures commission merchants ("FCMs"). Currently, the definition of "free credit balances" under Rule 15c3-3 excludes funds carried in commodity accounts that are segregated in accordance with the CEA. Since the CEA segregation requirements do not apply to "proprietary accounts," however, funds carried in such

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50 Rule 15c3-3a, Note E(3).

51 Rule 15c3-1(a)(1)(ii)(A).

52 Proposed amendment to paragraph (a)(1)(ii)(A) of Rule 15c3-1.

53 Proposing Release at 12868.

54 Proposing Release at 12867-68.

accounts could be viewed as ineligible for the exclusion from the definition of "free credit balances." The Commission therefore proposes to amend the definition of "free credit balances" to explicitly exclude funds carried in a "proprietary account."[55]

SIFMA supports this proposed amendment. Since the funds in such "proprietary accounts" relate to commodities transactions, they may not be treated as customer property in a SIPA proceeding and are not the type of asset that the reserve requirements of Rule 15c3-3 were intended to protect. We recommend that the proposed amendment be modified, however, to clarify that the relevant definition of "proprietary account" for these purposes is that contained in 17 CFR 1.3(y), since there are other definitions of "proprietary account" under other CEA regulations.[56] The proposed modification would also be consistent with the reference to "proprietary accounts" in the definition of "customer" under Rule 15c3-3.

I. Amended Definitions of "Fully-Paid Securities" and "Margin Securities"

Although the Proposing Release makes clear that the proposed modifications to the definitions of "fully paid securities" and "margin securities" were not intended to have any substantive effect, we are concerned they would, in a way that could adversely impact broker-dealers.

Currently, "fully paid securities" are generally carried in a cash account (with certain exceptions). Under the proposed definitions, any security in any account – including a margin account – could be a "fully paid security" (and subject to possession or control requirements) if it has been paid for in full. This 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). In our view, "fully paid securities" should only include securities in a cash account that have been paid for in full. Any securities in a margin or other non-cash account should be "margin securities" or "excess margin securities," depending on the customer's margin balance in such account.[57]

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55 Proposed amendment to paragraph (a)(8) of Rule 15c3-3.

56 See, e.g., 17 CFR 1.17(b)(3).

57 The current and proposed definitions of "margin securities" are also potentially confusing in that they define "margin account" for purposes of the rule in a way that potentially includes "cash accounts," although this result does not appear to have been intended (since in other parts of the Rule cash and margin accounts are referred to separately).

II. Proposed Amendments Regarding Holding Futures Positions in a Securities Portfolio Margin Account

The Proposed Amendments include two changes intended to address the status of futures positions held in a securities portfolio margin account in the event of a SIPA liquidation. First, the definition of "free credit balances" under Rule 15c3-3 would be amended to include funds in a portfolio margin account relating to futures and futures options positions and the market value of futures options as of the filing date in a SIPA proceeding.[58] This amendment is intended to make claims related to these positions claims for "cash" included in the customer's net equity claim under SIPA.[59] Since they are "credit balances," these amounts would also need to be included as credits in the firm's reserve formula. Second, Item 14 of the reserve formula would be amended to include deposits by the firm at clearing organizations related to futures and options thereon carried in a portfolio margin account as debit items.[60] This amendment is

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[58] "The term *free credit balances* also shall include such liabilities 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 ('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. 78*lll*(7)) of any long options on futures contracts." Proposed amendment to paragraph (a)(8) of Rule 15c3-3.

As a technical comment, we note that the phrase "such liabilities" could be interpreted to refer back to the types of liabilities addressed in the prior sentence, which include only funds subject to immediate cash payment (among other limitations). To address this issue and certain other technical comments, we propose that this sentence be revised as follows: "The term *free credit balances* also shall include (i) 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 ('SRO portfolio margining rule'), including variation margin or initial margin marks to market, and proceeds resulting from or margin paid or released in connection with closing out, settling or exercising futures contracts and options thereon, and (ii) 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. 78*lll*(7)) of any long options on futures contracts." In addition, in anticipation of including non-equity products in portfolio margin accounts, this language should be expanded to cover commodity options that may hedge such non-equity products.

[59] Under a SIPA proceeding, each customer shares in customer property pro rata according to the customer's "net equity" at the time of filing. 15 U.S.C. 78*fff*-2(c)(1)(B). The net equity of each customer consists of "the dollar amount of the [customer's account(s)] determined by calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated … on the filing date [the customer's] securities positions" minus amounts owed by the customer to the debtor. 78 U.S.C. 78*lll*(14).

[60] Specifically, broker-dealers would be required to include as debit items "[m]argin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78*q*–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. 7*a*–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…."

intended to permit such deposits to be considered "customer property" in a broker-dealer liquidation.[61]

SIFMA has consistently supported the development and expansion of an effective regime for portfolio margining,[62] and therefore also supports this effort by the Commission to provide greater legal certainty regarding the SIPA treatment of futures positions in a portfolio margin account. We believe that, assuming the Commission's intended interpretation of terms used in SIPA is respected in a SIPA liquidation proceeding, the amendments would provide protection to portfolio margin customers that have futures positions. We note that, in our view, protection of such customers also could be achieved (in terms of assuring there are adequate assets to cover obligations to such customers) through an appropriate combination of the calculations required under Rule 15c3-3 reserve requirements and the Commodity Futures Trading Commission ("CFTC") segregation requirements.[63]

Although we believe adequate financial protection could be provided to customers in the manner described above, we urge the Commission to consider ways to achieve greater legal certainty that its intended approach will be respected in a SIPA proceeding. We are particularly concerned by the apparent disagreement between the Commission and SIPC (as indicated by SIPC's comment letter on the Proposed Amendments) regarding the implications of the Commission's amendments.[64]

Greater legal certainty could be achieved through an amendment to SIPA, which we encourage the Commission to continue to pursue. Short of that, the Commission might consider one or more alternative approaches. For example, the Commission may be able to exercise its general exemptive authority under Section 36(a) of the Exchange Act to achieve at

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61 The definition of "customer property" under SIPA 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…." 15 U.S.C. 78*lll*(4)(B).

62 See Letter from James Barry, Ad Hoc Portfolio Margining Committee, John Vitha, Chair, Derivatives Product Committee, and Christopher Nagy, Chair, Options Committee, Securities Industry Association ("SIA"), to Nancy M. Morris, Secretary, SEC (May 16, 2006); Letter from Gerard J. Quinn, Vice President & Associate General Counsel, SIA, to Nancy M. Morris, Secretary, SEC (Feb. 13, 2006); Letter from Barbara Wierzynski, Executive Vice President & General Counsel, Futures Industry Association, and Ira D. Hammerman, Senior Vice President & General Counsel, SIA, to Jonathan G. Katz, Secretary, SEC (Mar. 4, 2005).

63 See supra Part I.F for a discussion of separate issues created by the proposed amendments to the definition of "free credit balances."

64 See Letter from Josephine Wang, General Counsel, SIPC, to Nancy M. Morris, Secretary, SEC (May 17, 2007) (the "SIPC Comment Letter").

least some of its intended aims.[65] The exercise by SIPC of its authority to define terms not otherwise defined in SIPA (such as "cash" or other terms) might also provide some additional clarity. At a minimum, it would be helpful (in terms of encouraging judicial deference to the Commission's views) for the Commission to articulate in greater detail the analysis supporting its legal interpretation of the Proposed Amendments as they relate to the SIPA treatment of futures and options thereon in a portfolio margin account, and to obtain SIPC's written concurrence in this analysis.

In addition, implementation of portfolio margining requires the resolution of certain CFTC-related regulatory issues. Broker-dealers and their customers are still effectively prohibited from including futures positions in a portfolio margin account by the segregation requirements of the CFTC.[66] Consideration also must be given to the implications for customers of broker-dealers that are FCMs of the interplay between SIPA and the insolvency provisions of Part 190 of the CFTC's regulations. We therefore urge the Commission to work with the CFTC to address these issues as promptly as possible in order to facilitate portfolio margining of related positions that include futures.[67]

III. Proposed Amendments with Respect to Securities Lending and Borrowing and Repurchase / Reverse Repurchase Transactions

A. Principal vs. Agency Capacity of Broker-Dealers

Under the Commission's proposed modifications to Rule 15c3-1(c)(2)(iv)(B), a broker-dealer that "participates in a loan of securities by one party to another party shall be deemed a principal" for purposes of applying net capital charges in connection with such loan, unless (i) "the broker-dealer has fully disclosed the identity of each party to the other," and (ii)

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65 The Commission exercised its Section 36(a) authority when it exempted over-the-counter derivatives dealers from SIPA. See Rule 36a1-2; Release No. 34-40594 (Oct. 23, 1998), 63 Fed. Reg. 59362, 58366 n.31 (Nov. 3, 1998).

66 In particular, Section 4d(a)(2) of the CEA and Rule 1.20 thereunder require an FCM to segregate customer assets entirely from the FCM's own assets or assets of non-customers. In contrast, Rule 15c3-3 imposes a "net" segregation requirement under which a broker-dealer must segregate only a certain portion of customer funds and securities (depending on the amounts customers owe to the broker-dealer). Including futures in a portfolio margin account, which is a securities account in which assets are not subject to segregation in aggregate, may conflict with the segregation provisions of the CEA. Accordingly, relief from the CFTC's segregation requirements would appear to be necessary to permit futures to be held in the portfolio margin account.

67 Proper implementation of portfolio margining will also require attention to cross-margining at the clearinghouse level. If a firm is not able to cross-margin positions in its clearinghouse accounts (i.e., if it is not eligible to receive the same beneficial cross-margining that it offers to its customers), the firm may in effect be required to post more margin to the clearinghouses than it receives from its customers. Such a result would impose an economic cost that may undermine the benefits of cross-margining.

"each party has expressly agreed in writing that the obligations of the [broker-dealer] shall 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 shall not include a right of setoff against obligations, if any, of the [broker-dealer]." The Commission suggests that this amendment is necessary to avoid "[u]ncertainty as to whether broker-dealers are acting as principal or agent in a securities loan transaction," an issue that it notes was raised in litigation related to the bankruptcy of MJK Clearing.[68]

SIFMA recommends that the Commission not adopt this proposal. In our view, the proposal is unnecessary in view of existing standardized documentation for securities lending transactions, is overly broad in its scope, and would impose significant burdens on broker-dealers participating in the securities lending markets. In Part III.A.4 below, we have suggested potential modifications to the proposal, if it is to be adopted, that would address some of these concerns.

1. Standardized Master Agreements Already Address this Issue

Standardized master securities lending agreements ("MSLAs") that are, as noted by the Commission, widely used in the industry already clearly address the status of the parties thereto as principals or agents.[69] In particular, these MSLAs state that each party is acting as principal unless a separate "agency" annex is executed ("Agency Annex").[70] It is clear, therefore, that a party entering into an MSLA should treat the other party executing such contract (or its principal, if an Agency Annex is used) – rather than any third party involved in the transaction – as its counterparty and "credit" risk. While it is true that in MJK Clearing-related litigation certain conduit lenders that had entered into MSLAs claimed they were acting as agents rather than principals (and therefore were not liable for performance of the resulting securities lending transactions), this claim was rejected in reported court decisions based on the plain wording of the relevant MSLA and the parties' agreement therein that each was acting as principal.[71]

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68 Proposing Release at 12870.

69 See SIFMA 1993 MSLA §§ 9.4 (borrower and lender represent that they are acting for their own accounts), 10.2 (principal capacity of borrower), and 10.3 (principal capacity of lender). See also SIFMA 2000 MSLA §§ 10.3 (borrower and lender represent that they are acting for their own accounts) and 11.1 (principal capacity of both parties).

70 1993 MSLA Annex I; 2000 MSLA Annex I.

71 See Nomura Sec. Int'l, Inc. v. E*Trade Sec., Inc., 280 F. Supp.2d 184, 195 (S.D.N.Y. 2003) (the relevant [1993] MSLA "explicitly provides that each party acts as a principal in all transactions, unless expressly stated otherwise in a specified written form (Annex I). ([1993] MSLA § 9.4.)").

In light of this contractual framework, the Commission's proposal is unnecessary because it merely attempts to clarify what is already clear (and has been confirmed by judicial precedent). A broker-dealer involved as a service provider or in a similar capacity in a securities lending transaction between two parties to an MSLA is not at any meaningful risk of inadvertently becoming liable to perform that transaction as principal, since the borrower and lender have executed the MSLA, are known to each other, and have agreed that they are acting as principals. Indeed, the Commission's proposal could be viewed as creating uncertainty by suggesting that, absent a special agreement, a party other than the signatories to the MSLA (such as a broker-dealer acting as a service provider) could be liable for performance of transactions entered into under that MSLA.

2. The Scope of the Amendment is Broad and Vague

Even aside from the points noted above, the proposed amendment is both broad and vague in its scope. The Proposing Release states the amendment would address broker-dealers that provide "securities lending and borrowing settlement services."[72] The text of the proposal, however, states that it would apply to any broker-dealer that "participates in a loan of securities" – apparently without regard to the nature or extent of that participation. The amendment could therefore impact broker-dealers in situations having nothing to do with the conduit lending arrangements that were at issue in the MJK Clearing cases. For example, would a broker-dealer that executes a customer short sale and "locates" securities available for borrowing be viewed as "participating" in the securities loan and required to take net capital charges as a principal, even if it is not a party to the securities lending agreement? Could a prime broker that handles settlement of a customer's short sale by taking delivery of securities borrowed by the customer from another broker-dealer be viewed as acting as principal in that transaction for capital purposes? Would a broker-dealer that merely provides administrative services be viewed as a principal to a securities loan, and if so, would it be acting as "borrower" or "lender" for purposes of applicable capital charges?

3. The Amendment Would Impose Extensive Burdens on Broker-Dealers

The Commission correctly notes that MSLAs already include provisions for agent lenders to disclose their principals and for principals to agree not to hold the agent liable for a counterparty default.[73] The Commission goes on, however, to conclude on that basis that "the standard agreement used by the vast majority of broker-dealers should contain the representations and disclosures required by the proposed amendment," that the amendment

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[72] Proposing Release at 12870.

[73] See Proposing Release at note 68 and accompanying text; 12884.

"would be codifying industry practice," and that only nine broker-dealers would need to modify their standard agreements to include the required language.[74]

This cost analysis in the Proposing Release substantially underestimates the burden this amendment, as drafted, would place on broker-dealers. The Agency Annex to the MSLA provides a mechanism by which parties entering into the MSLA can disclose that they are acting in an agency capacity on behalf of a principal. It does not provide a means for broker-dealers that do not borrow or lend securities, but instead provide ancillary services to such borrowers or lenders (in a manner that could cause them to be viewed as "participating" in the transaction), to clarify that they are not liable as principals. If the proposed amendment is adopted, every broker-dealer that participates in a securities lending transaction other than as the borrower or lender (or the executing agent for the borrower or the lender) would need to embark on the enormous task of putting in place new written agreements (other than an MSLA and Agency Annex) with each of the parties to the transaction. This would cause significant disruption and impose substantial burdens on the industry that, for the reasons noted above, are unnecessary given the contractual clarity under current MSLAs.

4. Potential Alternative Approach

We recognize that there may be unique circumstances in which a broker-dealer enters into a securities lending transaction on behalf of an undisclosed principal, and therefore has liability for performing that transaction under general principles of agency law. As a practical matter, we believe these circumstances are relatively unusual, and in any event when an MSLA is used it clarifies that the broker-dealer is liable as a principal unless the parties have executed an Agency Annex. In our view, therefore, the proposed amendment is not necessary to address this situation.[75]

If, however, the Commission desires to address the "agent for an undisclosed principal" issue by specifically mandating the type of language already used in MSLAs, it should modify its proposal so that it applies only to a broker-dealer executing a securities lending agreement as agent on behalf of a principal (rather than to any broker-dealer that "participates" in a securities lending transaction). As so modified, the amendment would focus more precisely on the issue presented in the MJK Clearing litigation, and a broker-dealer's documentation obligations under it could be met by using the Agency Annex (as contemplated by the Commission in the Proposing Release). In addition, the amendment should be modified so as

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[74] Proposing Release at 12884.

[75] We also note that a broker-dealer acting as agent for an undisclosed principal can be liable for performance of transactions other than securities loans. It is therefore arguably inappropriate to explicitly address this issue solely in the context of securities lending transactions.

not to require pre-trade disclosure of the identity of the principal, since even under the Agency Annex such disclosure can be made on the next business day.[76]

B. Notification of Securities Borrowing and Lending Activity

The Proposed Amendments would require a broker-dealer to notify the Commission whenever either (i) the total amount of money payable against all securities loaned or subject to a repurchase agreement ("repo") or (ii) the total contract value of all securities borrowed or subject to a reverse repurchase agreement ("reverse repo") exceeds 2,500% of tentative net capital.[77] Transactions in U.S. government securities would be excluded from these calculations, and a broker-dealer would not be required to provide such notification if it submitted to its designated examining authority ("DEA") "a monthly report of its securities lending and borrowing and repurchase and reverse repurchase activity."

We do not object to a requirement that broker-dealers provide the Commission or their DEAs with additional information regarding their securities lending and repo activities involving non-U.S. government securities.[78] We recommend, however, that this information be provided by all broker-dealers through reporting of position sizes at month-end on FOCUS reports, rather than through a separate notification procedure. Month-end reports regarding such activities would provide the Commission and DEAs with up-to-date data sufficient to identify promptly any potential concerns regarding excessive leverage or other risks, and adequate opportunity to respond quickly to events that could adversely affect customers.

IV. Proposed Amendments Regarding Documentation of Risk Management Procedures

The Proposed Amendments would modify Rule 17a-3 to require certain large broker-dealers to make and keep current records "documenting any internal risk management controls established and maintained by [the broker-dealer] to assist it in analyzing and managing the risks associated with its business activities." This documentation requirement would only apply to broker-dealers that have more than (i) $1,000,000 in aggregate credit items under their reserve formula calculation, or (ii) $20,000,000 in capital (including debt subordinated in accordance with Rule 15c3-1d).[79]

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[76] In addition, under the new agency lending disclosure initiative, identification of principals generally does not occur until the business day after the transaction is executed.

[77] Proposed amendment adding new paragraph (c)(5) to Rule 17a-11.

[78] We request that the Commission confirm our understanding that the proposed notification or reporting requirements would cover principal transactions only (not agency transactions).

[79] Proposed amendment adding new paragraph (a)(23) to Rule 17a-3.

The Commission notes, and we agree, that a "well-documented system of internal controls designed to manage material risk exposures enables a broker-dealer's management to identify, analyze, and manage the risks inherent in the firm's business activities with a view to preventing significant losses."[80] As the Commission also notes, most broker-dealers already have "well-documented procedures and controls for managing risks."[81]

We understand that the proposed amendment does not impose any requirements beyond those applicable under Rule 15c3-4. Accordingly, we urge 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 – e.g., as a result of undertakings by its holding company.[82]

We also recommend several additional modifications to the Commission's proposal.[83] First, we strongly recommend that the documentation requirement be limited to internal controls that address market, credit and liquidity risk. As currently drafted, the proposal does not limit the types of risk controls that must be documented – in fact, the Proposing Release highlights a wide range of different risks that may be subject to internal controls of some sort. Virtually every aspect of a broker-dealer's business incurs risk, and every procedure could be deemed a "risk management control" procedure under such a broad definition. If adopted as proposed, broker-dealers would face uncertainty as to the scope of the requirement, and the Commission would likely find considerable variance in approaches across the industry. Market, credit and liquidity risks have more commonly understood meanings, and the absence of documentation regarding controls for these risks should be of greater regulatory interest. We believe limiting the scope of the proposal to controls addressing these risks would "reinforce the practice"[84] of documenting internal controls.

In addition, the documentation requirement should be clarified in several respects. The text of the amendment should incorporate the concept, as articulated in the Proposing Release, that a firm's internal controls are not required to contain any minimum elements. The Commission also should clarify that firms are permitted to document their policies at a reasonably high level of detail in light of the nature of the activities addressed and the firm's overall business. In practice, it is impossible to reduce effectively to writing the minutiae of every step that must be taken as part of a robust internal control procedure – particularly with

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80 Proposing Release at 12870.

81 Proposing Release at 12871.

82 See Rule 15c3-1e(a)(1)(viii)(C).

83 In addition to the comments above, if some version of Rule 17a-3(a)(23) is adopted, the Commission should clarify the reference to "capital" in (a)(23)(i). For example, does this refer to "net capital," "tentative net capital" or some other amount?

84 Proposing Release at 12871.

respect to procedures for "analyzing" and "managing" different types of risk, as to which firms routinely rely on experienced risk management professionals to exercise judgment in appropriate circumstances. Although we think this recommendation is likely consistent with the Commission's intent, we are concerned that unless it is adopted firms' good faith efforts to comply with the documentation requirements potentially will be subject to unwarranted second-guessing in the examination context.

We further recommend the Proposed Amendments clarify that for broker-dealers that are part of larger institutions that establish internal controls applicable to multiple entities, the new documentation requirement may be satisfied by written policies prepared for any group of entities that includes the broker-dealer (i.e., they need not be prepared exclusively for the broker-dealer).

Finally, we recommend that the proposed documentation requirement be modified so as not to require a broker-dealer to maintain outdated versions of its internal controls. From a risk management perspective, it is important that the firm's current controls are documented. Requiring a firm to retain older versions of such controls reflecting every change that is made over time creates unnecessary operational burdens and may effectively disincentivize the firm from making frequent minor changes to its written controls as conditions warrant.

V. Proposed Amendments to the Net Capital Rule

A. Requirement to Subtract from Net Worth Certain Liabilities or Expenses Assumed by Third Parties

The Proposed Amendments would require a broker-dealer to take a capital charge for any liability or expense relating to the business of the broker-dealer for which a third party has assumed 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.[85] The proposal would incorporate into Rule 15c3-1 certain features of a 2003 interpretive letter on expense sharing arrangements.[86]

In our view, the concerns underlying this proposal relate exclusively to smaller broker-dealers that may implement such expense payment arrangements to accommodate their business models and limited operational infrastructure. For example, smaller firms required to register as broker-dealers due to very limited securities trading activities may use these arrangements because they do not have independent accounting and expense payment systems.

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[85] Proposed amendment adding new paragraph (c)(2)(i)(F) to Rule 15c3-1.

[86] See Letter from Michael A. Macchiaroli, Associate Director, SEC, to Elaine Michitsch, NYSE, and Susan DeMando, NASD (July 11, 2003).

In general, SIFMA agrees with the principle that such broker-dealers should not be permitted to transfer liabilities to third parties without restriction and to the detriment of their creditors and customers. At the same time, we believe there are circumstances in which third parties may appropriately assume an expense related to a broker-dealer's business, and when properly implemented these arrangements do not "misrepresent the firm's actual financial condition" or "deceive the firm's customers."[87]

We suggest that the Commission provide a non-exclusive list of criteria that a broker-dealer may take into account in determining whether a third party has "adequate resources independent of the broker-dealer" to pay a liability or expense, including potentially relevant factors beyond those referred to in the Proposing Release. We also request that the Commission clarify that the reference to expenses "relating to the business of the broker-dealer" means expenses "incurred by the broker-dealer in its business" – since affiliates or other third parties may frequently incur expenses that could be "related to" the broker-dealer's business but that are properly attributable to the affiliate or third party as part of its own business.

Finally, we note that not all requirements under the 2003 interpretive letter are incorporated into the Proposed Amendments. For example, the Proposed Amendments do not refer to written agreements from a vendor or other party stating that the broker-dealer is not liable for the relevant expense. It would be helpful if the Commission would clarify in the Proposed Amendments or any adopting release that the requirements of the 2003 letter would no longer be relevant once the Proposed Amendments are effective.

B. Requirement to Subtract from Net Worth Non-Permanent Capital Contributions

The Proposed Amendments would also require a broker-dealer to take a capital charge for any contribution of capital (i) under an agreement that provides the investor with the option to withdraw the capital, or (ii) that is intended to be withdrawn within a period of one year unless the withdrawal has been approved in writing by the firm's DEA. In addition, any withdrawal of capital made within one year would be presumed subject to this capital charge.[88]

In our view, these Proposed Amendments, as well as the 2000 interpretive letter that they codify,[89] raise a number of important policy issues that are relevant primarily for smaller-sized firms and would best be addressed through a separate dialogue involving the Commission staff, the SROs, and such firms, in which the various fact patterns and relevant

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87 Proposing Release at 12871.

88 Proposed amendment adding new paragraph (c)(2)(i)(G) to Rule 15c3-1.

89 See Letter from Michael A. Macchiaroli, Associate Director, SEC, to Raymond J. Hennessy, NYSE, and Susan DeMando, NASD (Feb. 23, 2000).

policy concerns can be discussed in greater depth. SIFMA stands ready to help facilitate this dialogue as appropriate.

We note by way of background for such dialogue that we agree it is important to the efficacy of the Commission's net capital requirements that contributions of capital not be subject to withdrawal at will. Overly restrictive limitations on withdrawals of capital, however, will have the effect, in some instances, of preventing capital in excess of regulatory minimums from being contributed to a broker-dealer in the first place – with the incongruous result that the broker-dealer may be deprived of capital that otherwise could address specific funding needs arising from time to time, or that could reduce the risk the firm poses to customers and creditors.

We are particularly concerned about a rule under which withdrawals of capital within one year for fully legitimate reasons presumptively results in that amount of capital being deemed never to have been contributed to the broker-dealer – leading to potential hindsight deficiencies or the need to revise FOCUS reports even if the withdrawal does not create a capital deficiency. One possible approach would be to create an exception for certain de minimis withdrawals of capital (similar to the safe harbor the Commission provides from its notice requirements for certain withdrawals), and for dividends or distributions related to current or prior period earnings.[90]

C. Requirement to Deduct the Amount a Fidelity Bond Deductible Exceeds SRO Limits

Under the Proposed Amendments, a broker-dealer subject to an SRO fidelity bond requirement would be required to take a capital charge to the extent that the deductible on any such fidelity bond exceeds the maximum deductible permitted by the broker-dealer's DEA.[91]

SIFMA supports this proposed amendment, which in effect closes the current "gap" between Rule 15c3-1 and SRO rules that generally require a broker-dealer to take a capital charge for any excess fidelity bond deductible when computing its net capital under Rule 15c3-1. In our view, a capital charge under Rule 15c3-1 for excess deductibles is appropriate in light of the protections that fidelity bonds are intended to provide. It is also appropriate, in our view, that this charge be reflected in a firm's net capital computation.[92]

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[90] See Rule 15c3-1(e)(1)(iii)(B).

[91] Proposed amendment adding new paragraph (c)(2)(xiv) to Rule 15c3-1.

[92] If the proposed fidelity bond amendment is adopted, we ask the Commission to work with the SROs to eliminate any rules that are duplicative with these amendments.

D. Broker-Dealer Solvency Requirement

The Proposed Amendments would modify Rule 15c3-1 by defining circumstances in which a broker-dealer would be deemed "insolvent,"[93] providing that an "insolvent" broker-dealer is not in compliance with Rule 15c3-1 (with the consequence that it must cease its securities business activities), [94] and requiring such a broker-dealer to provide immediate notice to the Commission, the firm's DEA and, if applicable, the CFTC.[95]

SIFMA supports the Commission's objective of protecting customers, markets, and clearance and settlement systems from insolvent broker-dealers. We are concerned, however, about the possible unintended consequences of the proposal to make solvency a requirement for compliance with Rule 15c3-1. We therefore suggest the Commission adopt only the proposed notice requirement and that the proposed definition of "insolvency" be modified as described below.[96]

1. Potential Unintended Consequences of Solvency Requirement

In the Proposing Release, the Commission noted that:

> By making solvency a requirement of Rule 15c3–1, a broker-dealer that is insolvent would have to cease conducting business because section 15(c)(3) of the Exchange Act 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).[97]

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93 Proposed new paragraph (c)(16) of Rule 15c3-1 would provide that a broker-dealer is "insolvent" if it: (i) is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate such broker-dealer or its property whether commenced voluntarily or involuntarily or is applying for the appointment or election of a receiver, trustee, or liquidator or similar official for such broker-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 Rule 15c3-1.

94 Proposed amendment to paragraph (a) of Rule 15c3-1.

95 Proposed amendment to paragraph (b)(1) of Rule 17a-11.

96 As a purely technical comment, we note that the reference to "broker-dealer" in proposed paragraph (c)(16) of Rule 15c3-1 should be changed to "broker or dealer" to be generally consistent with the rest of the Rule.

97 Proposing Release at 12872-73.

While the Commission's goal of "removing risks associated with having a financially unstable firm continue to operate" is laudable,[98] we are concerned that such a firm should not be prevented from executing hedging or liquidating transactions intended to reduce the risk the firm poses to the financial markets and its customers. Indeed, such limitations could inadvertently frustrate the Commission's objective of reducing the adverse impact of an insolvency event.[99]

We note that SIPC is already empowered to apply for a protective decree and the appointment of a trustee for an insolvent firm[100] and is therefore already able to protect customers and markets against such firms. Accordingly, while we would support amending Rule 15c3-1 to require that an insolvent firm provide immediate notice of that status to regulators – since this approach builds logically on the current SIPA liquidation regime – we recommend that the Commission not affirmatively prohibit a firm from effecting risk-reducing transactions.

2. Involuntary Proceedings

As proposed, the definition of "insolvency" would not distinguish between voluntary and involuntary insolvency proceedings. Involuntary insolvency proceedings do not necessarily indicate that the broker-dealer is insolvent. Such proceedings can be frivolous, malicious or otherwise lacking in merit. For this reason, industry standard contract forms generally provide a grace period for a party to such a proceeding to obtain a stay or dismissal of it before an event of default is deemed to occur.[101] We do not believe the filing of an involuntary insolvency proceeding against a broker-dealer should automatically prevent a firm from continuing its securities business. On the other hand, since involuntary insolvency proceedings may be meritorious, we believe it would be appropriate for a broker-dealer to immediately report to its applicable regulators the filing of any such proceeding against it.

3. Incorporation of Bankruptcy Code Insolvency Definition

The proposed definition of "insolvency" incorporates the definition of "insolvent" from Section 101 of the Bankruptcy Code. If the proposed amendment were limited to a reporting requirement, reference to this Bankruptcy Code definition might be appropriate, since a firm being "insolvent" as defined in the Bankruptcy Code is a basis on which SIPC is entitled to

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98 Proposing Release at 12886.

99 Such limitations would also be at odds with Section 78*eee*(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 to the direction of an SRO.

100 See 15 U.S.C. 78*eee*(a).

101 For example, this grace period is 15 days in the SIFMA MSLA, Master Repurchase Agreement and the 2002 ISDA Master Agreement.

obtain a protective decree.[102] For purposes of determining whether a broker-dealer should be permitted to continue operating its business, however, the amount of its net capital is a much more appropriate standard.[103] The Bankruptcy Code generally defines an entity to be "insolvent" if the sum of its debts is greater than all of its property, at a fair value. A broker-dealer could be insolvent under the Bankruptcy Code definition but still in net capital compliance if, for instance, it received significant capital in the form of debt subordinated to the claims of creditors pursuant to a satisfactory subordination agreement. Such subordinated debt would be debt for purposes of the Bankruptcy Code definition of "insolvent" but is added back to the firm's net worth in determining its net capital. We do not believe that such a firm should be deemed in violation of Rule 15c3-1 and therefore unable to conduct a securities business since subordinated debt, like the firm's equity capital, serves to protect customers and market counterparties.[104]

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

Rule 15c3-1(e)(3) currently permits the Commission to issue an order restricting for up to 20 business days any withdrawals of capital from a broker-dealer or any advances or loans to stockholders, affiliates or insiders, if the Commission determines that such activities may have certain adverse effects on the broker-dealer's financial integrity or its customers or creditors.[105] Such Commission orders, however, may only restrict withdrawals, advances or loans that during a 30 calendar day period exceed 30% of the broker-dealer's excess net capital. The Proposed Amendments would eliminate this 30 calendar day / 30% limit, thereby permitting the Commission in appropriate circumstances to restrict all withdrawals, advances or loans. SIFMA recommends that these proposals be modified in certain technical respects.

First, it should be clear that the Commission may issue orders imposing partial or conditional restrictions on withdrawals, advances and loans (rather than only complete restrictions), since in many instances it may be appropriate to permit a broker-dealer to continue to engage in certain types of activities that do not impose undue risk for the firm. Flexibility to permit certain types of withdrawals, advances or loans is particularly important in light of

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102 15 U.S.C. 78*eee*(b)(1).

103 In addition to being the more appropriate criterion, net capital also avoids many of the difficult valuation questions implicit in the Bankruptcy Code definition of insolvency by excluding from net capital a variety of assets not readily convertible into cash.

104 We also note that in clause (iii) of the Commission's proposed definition of "insolvency," it is unclear whether the admission is required with respect to both (a) insolvency within the meaning of the Bankruptcy Code and (b) the inability to meet debts as they mature, or only to the latter.

105 In order to issue such an order, the Commission must conclude that the withdrawal, advance or loan may be detrimental to the financial integrity of the broker-dealer, or unduly jeopardize the broker-dealer's ability to repay its customer claims or other liabilities in a manner that may have a significant impact on markets, customers or creditors. Rule 15c3-1(e)(3)(i)(B).

paragraph (e)(4)(iv), which generally provides that "any transaction" between a broker-dealer and an insider or affiliate that results in a reduction of net capital is deemed to be an advance or loan of capital.

Second, we urge the Commission to consider explicitly permitting certain types of withdrawals, advances or loans even after the issuance of a temporary restrictive order. We note in particular that paragraphs (e)(4)(ii) and (iii) contemplate certain types of withdrawals, advances or loans in the ordinary course that would not be restricted by other provisions of paragraph (e). It is not clear why these types of activities should not also be automatically exempted from a temporary order issued by the Commission.

Third, the text of paragraph (e)(3)(ii) should be modified to clarify that a broker-dealer may request and receive a hearing on an order temporarily restricting any advances or loans by a broker-dealer – not merely on an order restricting withdrawals by a broker-dealer, as may be suggested by the current language.

Finally, we note that although the Proposed Amendments add the term "member" to paragraph (e)(3)(i) – presumably in recognition of the substantial number of firms now organized as "limited liability companies" whose owners may be referred to as "members" – there are a number of other provisions in paragraph (e) and elsewhere in the Rule that do not specifically refer to "members." For the sake of consistency these other provisions of the Rule should also be modified accordingly.[106]

F. Adjusted Net Capital Requirement: Appendix A of Rule 15c3-1

The Proposed Amendments would adopt permanently paragraph (b)(1)(iv) of Appendix A to Rule 15c3-1, which was initially adopted on a temporary basis in 1997. This paragraph specifies a lower range of pricing parameters for the computation of theoretical gains and losses by a firm carrying the accounts of option specialists or market makers that contain certain positions in major market foreign currencies and high capitalization and non-high capitalization diversified indices. In effect, paragraph (b)(1)(iv) reduces the capital charges the carrying firm must apply in respect of such accounts.

SIFMA supports the Commission's proposal to make paragraph (b)(1)(iv) permanent.[107] We agree with the Commission that despite "periods of significant volatility in the securities markets, … 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 … result

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[106] We note that specific references to "members" should eventually be included in other Commission financial responsibility rules.

[107] As technical comments, we note that the "and" after proposed paragraph 15c3-1a(b)(1)(iv)(A) should be deleted and the period after proposed paragraph (b)(1)(iv)(B) should be replaced by "; and".

in excessive leverage."[108] In our view, other revisions to the capital requirements for option market makers may also merit the Commission's consideration. In particular, we understand that as a result of option market makers hedging much of their market exposure, the minimum capital requirement per option contract ($25) has for at least several years been the primary determinant of option market makers' capital requirements. This minimum, set at the time of the adoption of the current capital requirements applicable to option market makers, was intended to include an allowance for the liquidation of a market maker's trading book. With the development of electronic trading platforms and other advancements in trading technologies, we believe the Commission should re-visit the assumptions underlying the original minimum capital requirement and consider lowering that minimum to a level more in line with currently available trading technologies.

G. Adjusted Net Capital Requirement: Money Market Funds

The Proposed Amendments would reduce the capital charge for money market funds (as defined in Investment Company Act Rule 2a-7) from 2% to 1%.[109] SIFMA agrees that the 2% charge should be lowered, particularly in light of the enhanced protections against risk that have been imposed by the Commission on such funds since the 2% charge was initially established. For the reasons discussed below, we recommend that the appropriate capital charge for money market funds should be no higher than 0.625% (5/8^{ths} of 1%).

Money market funds are subject to a range of restrictions imposed by the Commission to limit their risk. The Commission has stated that investors generally treat the shares of these funds as cash, so "the credit risks to which holders of money market shares are exposed should be minimized to the lowest level practicable."[110] Accordingly, Rule 2a-7 permits a money market fund to purchase only securities that (i) are U.S. dollar denominated, (ii) are determined to present minimal credit risk, and (iii) qualify as "eligible securities" – including a requirement that they have a maturity of 397 calendar days or less.[111] In addition, a money market fund is subject to significant diversification requirements, including restrictions on investing more than 5% of its total assets in the securities of any one issuer (excepting U.S. government securities).[112] Money market funds must also limit their dollar-weighted average portfolio maturity to 90 days or less. Many money market funds maintain even shorter average

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108 Proposing Release at 12874.

109 Proposed amendment to paragraph (c)(2)(vi)(D)(*1*) of Rule 15c3-1.

110 Release No. IC-18005 (Feb. 20,1991), 56 Fed. Reg. 8113, 8118 (Feb. 27, 1991).

111 Rule 2a-7(c)(3)(i); Rule 2a-7(a)(10). "Eligible securities" must also either have received one of the two highest short-term ratings from the requisite NRSRO or, if the security is unrated, have been determined to be of comparable quality by the fund's board (or its delegate).

112 Rule 2a-7(c)(4).

maturities, consistent with their objective of maintaining "a stable net asset value per share or price per share."[113]

Since many of these diversification and related requirements were adopted after the Commission established a 2% haircut on money market funds, in our view it is appropriate to lower that haircut in recognition of this enhanced regulatory regime. It is not clear to us, however, how the Commission selected a 1% charge. Rule 15c3-1 already imposes lower charges on other instruments that would appear to present greater risk. For example, a broker-dealer must apply a capital charge of 1/8th of 1% to commercial paper rated in the top three ratings categories by an NRSRO that has at least 30 days but less than 91 days to maturity.[114] Certain municipal securities with similar maturities also require a capital charge of 1/8th of 1%.[115]

This disparity of net capital treatment appears inappropriate, since money market funds – with regulated portfolio quality, diversity, and maturity – do not present any greater risk to broker-dealers than the instruments subject to a 1/8th of 1% charge. Indeed, money market funds are now generally considered a stable, safe investment by financial regulators in a variety of contexts. Since such funds diversify and reduce the risks of the short-term instruments they invest in, they should receive at least comparable net capital treatment.

In our view, an appropriate maximum capital charge for money market funds would be 0.625%, or 5/8^{ths} of 1%. This charge reflects a combination of (i) a charge of 1/8th of 1% based on the current charges for shorter-term commercial paper and municipal securities, and (ii) an additional charge of .50% to account for any minimal risk associated with the nature or operation of mutual funds, such as potential deviations between the price per share and the assets of the fund or potential market movements that may occur in respect of the fund's short-term instruments as they are being liquidated.[116]

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113 Rule 2a-7(c)(2).

114 Rule 15c3-1(c)(2)(vi)(E)(*2*).

115 15c3-1(c)(2)(vi)(B)(*1*)(*ii*). Among other requirements, the municipal security must have a scheduled maturity at date of issue of 731 days or less and be issued at par value and pay interest at maturity or be issued at a discount.

116 Money market funds may value certain portfolio securities using the "amortized cost method" or "penny-rounding method." Rule 2a-7(c). Funds must take prompt action if the price per share deviates by more than 0.5%. Rule 2a-7(c)(7)(ii)(B) & (c)(8). We note that our proposed standard is conservative since (i) money market funds generally specify smaller deviations than the 0.5% regulatory standard and (ii) the 1/8th of 1% additional charge would already account for some of the risk that the value of a fund would deviate from its stated share price.

VI. Responses to Requests for Comment on Additional Matters

A. Early Warning Levels

The Commission has established certain "early warning" notification requirements under Rule 17a-11 intended to provide it with advance notice that a broker-dealer may be experiencing financial difficulties. Broker-dealers that are subject to the "alternative standard" (i.e., a requirement to maintain net capital equal to 2% of aggregate debit items) must provide this early warning notice to the Commission if their net capital falls below 5% of aggregate debit items.[117]

A number of years ago, SIFMA's Capital Committee proposed modifying the Commission's early warning levels for very large "alternative standard" firms with more than $10 billion in debits.[118] The Committee argued that since the current early warning levels were adopted, there have been significant increases in customer debit items, particularly as a result of debit balances in customers' margin accounts ("Margin Debits") and securities borrowed to effectuate short sales by customers ("Securities Borrowed"),[119] reflecting in part the expanded use of hedging techniques to protect portfolio values by institutions and high net worth individuals.

The Committee also argued that as a broker-dealer's debits grow, its risk is diversified across more counterparties, business lines and products. Margin Debits and Securities Borrowed have historically had low levels of credit loss over a wide range of market conditions, and to the Committee's knowledge no broker-dealer had experienced a significant credit loss related to such assets, whether in absolute terms or in relation to earnings or capital. The Committee further noted that sound regulatory and business practices had made Margin Debits and Securities Borrowed relatively low-risk assets, particularly in view of the adequacy of SRO and house maintenance margin requirements, daily marking-to-market of securities borrowings and other credit transactions, and enhanced systems for making and collecting margin calls.

In the time that has elapsed since the Capital Committee originally made this proposal, the rationale for modifying the early warning provisions has only become stronger as the amount of debit items at large broker-dealers has continued to increase. There has also been a significant evolution in regulatory oversight, as regulators have focused more on (and have

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117 Rule 17a-11(c)(2).

118 In particular, the Committee proposed that the notice be required if net capital falls below the sum of (i) 5% of the first $10 billion in debits, (ii) 4% of the next $5 billion, (iii) 3% of the next $5 billion, and (iv) 2.5% of all remaining debits.

119 Items 10 and 11, respectively, of the reserve formula set forth in Rule 15c3-3a.

required firms to implement) effective risk management practices. At the same time, the continued growth of debit items has meant that many broker-dealers must maintain ever larger pools of excess net capital (i.e., capital above their minimum requirement of 2%) in order to remain above the 5% threshold and avoid any adverse perception in the market regarding their creditworthiness that an early warning notice might create. Such broker-dealers are effectively required to lock up enormous additional amounts of capital rather than employ it usefully in their business, an especially acute burden for broker-dealers most active in customer financing businesses.

In light of the foregoing, SIFMA recommends that the early warning percentages be revised to be the sum of:

- 5% of aggregate debit items up to $10 billion;
- 4% of aggregate debit items between $10 billion and $15 billion;
- 3% of aggregate debit items between $15 billion and $20 billion;
- 2% of aggregate debit items between $20 billion and $25 billion; and
- 1% of aggregate debit items in excess of $25 billion.

Under this approach, the notification requirement would equal the minimum capital requirement when a firm has aggregate debit items of $70 billion (and thus a capital requirement of $1.4 billion). We would propose that for firms at or above this level of capital, the notification requirement would equal the minimum capital requirement.

In our view, this scale would more accurately reflect the risks associated with the customer debits held by large broker-dealers while still providing early warnings to the Commission of a reduction in such broker-dealers' excess net capital. We note that even with these lowered percentages, a broker-dealer with $25 billion in aggregate debit items would be required to provide notification if its net capital fell to $950 million.

Other early warning rules establish percentage thresholds similar to Rule 17a-11, and we recommend they be made consistent with the scale described above if any change to warning levels is to be fully effective.[120] In particular, restrictions on the withdrawal of equity

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[120] SIFMA also urges the Commission to work with SROs to modify their early warning levels accordingly. For example, several SROs have adopted related rules that are triggered when a member firm's net capital falls below 5% of aggregate debit items (or another specified percentage in excess of the minimum established by Rule 15c3-1). See, e.g., NYSE Rules 325(b)(1)(iii), 326(a)(1)(c), 326(b)(1)(c), 326(c)(3), and 326(d)(3); NASD Rules 2720(e)(2), 3130(c)(1)(C), and 3130(d)(1)(C).

capital[121] and various requirements applicable to subordinated loan agreements[122] would need to be revised accordingly.[123]

B. Harmonization of Securities Lending and Repo Capital Charges

The Commission requested comment on harmonizing the net capital treatment of repos and securities lending transactions. The Proposing Release described these transactions as "economically similar," but noted that the capital charges applicable to them differ in ways that may create "regulatory arbitrage."[124] The Commission suggested that these differences could be eliminated by conforming the capital charges for securities loans and repos, and the capital charges for reverse repos and securities borrowings.

In our view, it may be appropriate for the Commission to consider adopting over the longer term a framework in which capital charges apply to any unsecured exposures of a broker-dealer, regardless of the form of the transaction under which such exposures arise – provided, that those charges are calibrated to the credit rating of, or other relevant financial tests with respect to, the counterparty. In addition, since developing and implementing such a framework will require significant time, it may be appropriate for the Commission to carefully define the types of "regulatory arbitrage" under the current rules that it views as problematic and develop more narrowly-tailored regulatory approaches to address such arbitrage. We further note that it may be helpful for the Commission to consider multi-prong approaches to these issues – for example, distinguishing between "intermediate" and "long-term" modifications to the capital rules, or between different types of firms based on their size and activities.

While all of these options should be considered, we emphasize that the Commission must also take into account the potential disruption to the marketplace that may well arise in connection with any effort to "harmonize" capital charges. Even efforts to address specific forms of perceived "regulatory arbitrage" should be carefully designed so as not to unduly limit bona fide transactions or create unnecessary disruption to the markets.

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121 Rule 15c3-1(e)(2)(vi).

122 Rule 15c3-1d.

123 Building on our comments in Part II above regarding the need for Commission and CFTC coordination to achieve full implementation of portfolio margining, we also encourage the Commission to work with the CFTC more broadly to harmonize the minimum capital rules and early warning levels applicable under their respective regulatory regimes.

124 In particular, with respect to repos and securities borrowings, the required deductions are triggered only when the deficit (i.e., the extent to which the value received by the broker-dealer is less than the value it delivers) exceeds certain percentages. See Rule 15c3-1(c)(2)(iv)(B) and (F)(*3*). With respect to reverse repos and securities loans, the deductions are triggered without regard to the size of the deficit (i.e., there is a 100% capital charge for any deficit). See Rule 15c3-1(c)(2)(iv)(B) and (F)(*2*).

We have set forth below three general points that in our view highlight the difficulties of seeking to "harmonize" regulatory capital charges and underscore the need to proceed with care in implementing either extensive revisions to the capital rule or limited modifications to address particular trading activities.

1. The Current Rule is Based on Long-Standing Market Practices

First, it is important to recognize that the net capital rule's current approach to repos and securities loans has a logical basis in light of the traditional objectives and functions of these transactions and long-standing market practices.

In particular, one party in these transactions has historically been viewed as a "creditor" that extends credit to the other party. In a repo, the initial purchaser of securities is the "creditor" because it provides cash financing to the initial seller against those securities. The transaction, which is similar in certain respects to a loan of cash against a pledge of securities,[125] is driven by the need of the initial seller to obtain cash, and the initial seller pays a fee for that financing. In a securities loan, in contrast, the lender of securities is the "creditor" because it provides securities to the borrower against a pledge of collateral. The transaction is driven by the need of the borrower to have securities to cover a short sale or other delivery obligation, and the borrower pays an economic fee for the use of the securities.[126] In each case, the "creditor" obtains an extra "cushion" of credit protection from the party to whom it is extending credit – in a repo, this "cushion" arises from the discounted price the initial purchaser pays for the securities, and in a securities loan, the "cushion" is in the form of collateral provided to the lender in excess of the value of the securities borrowed.

The current net capital rule reflects these traditional objectives and functions of repos and securities loans by recognizing that the "creditor" in these transactions reasonably requires a collateral "cushion." In effect, the rule appropriately permits a broker-dealer to enter into these transactions on market terms without penalizing it with a capital charge for the deficit that arises when it provides such a "cushion" to a "creditor."

This expectation that one party will obtain a credit "cushion" from the other is deeply ingrained in current market practice. Any modifications to the net capital rule that are inconsistent with this approach therefore may result in substantial costs for broker-dealers and potential disruption to the markets. U.S. broker-dealers cannot unilaterally change commercial

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[125] We note in this regard that given the economic similarities between secured loans of cash and repos, it may also be appropriate to consider secured loans in connection with any review of the need to "harmonize" the treatment of various financing transactions under the net capital rule.

[126] This fee may be in the form of cash paid by the borrower to the lender or, if the borrower has provided cash collateral to the lender, may be reflected in the "rebate" rate paid by the lender to the borrower in respect of such cash collateral.

practices relating to credit and collateral requirements that are widely accepted in the domestic and international markets. For example, they cannot expect to be able to impose unilaterally on institutional investors that lend securities a 100% collateral requirement (rather than 102% or 105%). Nor can they expect to be able to consistently demand extra collateral when they are a "creditor," but consistently refuse to provide extra collateral when they are on the other side of the same transaction. More likely, broker-dealers would continue to be required as a commercial matter to provide the standard credit "cushion" and then take a capital charge for it, which could limit their ability to engage in these transactions that are so vital to the settlement of securities trades and the free flow of liquidity through the markets.[127]

2. The Current Approach is Also Reflected in Other Regulatory Regimes

This market practice of providing the "creditor" in a repo or securities loan an extra credit "cushion" is also reflected in other regulatory requirements. For example, under applicable U.S. margin requirements a broker-dealer that is the initial purchaser in a repo is viewed as extending credit and must comply with margin requirements that may limit the amount of cash it may provide to the initial seller. In other words, the margin rules historically have required a broker-dealer to obtain a credit "cushion" when it is the initial buyer. In contrast, when a broker-dealer borrows securities, it traditionally has not been viewed as extending credit to the securities lender, and therefore may provide collateral in excess of the value of securities borrowed (and in fact Rule 15c3-3 requires the broker-dealer to deliver collateral at least equal in value to the securities borrowed from a customer). Any "harmonization" initiative should take into account the interaction of the new capital requirements with the margin rules and other relevant regulatory regimes.

3. "Regulatory Arbitrage" May Not Be Driven by Capital Charges

As noted above, repos and securities lending transactions have traditionally had different functions and purposes, and the Commission's description of them as "economically similar" is, in that respect at least, an oversimplification. SIFMA recognizes, however, that over time and in certain markets – particularly the U.S. Treasury market – there has been a "convergence" between these types of transactions. For example, in the U.S. Treasury market reverse repos may be used in lieu of securities borrowing transactions to obtain specific securities, and in certain instances the "cushion" to the "creditor" may be de minimis.

It is not clear, however, that the use of one type of transaction to achieve a purpose for which the other type of transaction has traditionally been used necessarily results in

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[127] The multi-year efforts of the industry and regulators to implement the agent lending disclosure initiative provides some indication of the difficulty and time required to develop and implement changes to securities lending practices on an industry-wide basis.

opportunities for "regulatory arbitrage" under the net capital rule in every instance.[128] In addition, certain transactions that the Commission staff might view as driven by "regulatory arbitrage" may in fact reflect the impact of other rules and regulations, such as margin or accounting rules, rather than the net capital rule itself.[129]

Accordingly, in our view the Commission should identify more precisely the scenarios in which it is concerned about "regulatory arbitrage" under the net capital rule, consider whether those situations arise as a result of the capital rule, and consider whether there are narrowly tailored approaches to addressing its concerns that could be adopted in lieu of amendments to the rule that would impact all securities lending and repo transactions generally.

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

The Commission requested comment as to how third-party liens against a customer's fully-paid securities carried by a broker-dealer should be treated under the financial responsibility rules. In particular, the Commission inquired whether a broker-dealer carrying securities subject to such liens should be required to: (i) include the amount of the customer's obligation to the third party as a credit item in the reserve formula; (ii) move the securities subject to the lien into a separate pledge account in the name of the pledgee(s); or (iii) record on its books and records and disclose to the customer the existence of the lien, the identity of the pledgee(s), the obligation of the customer, and the amount of securities subject to the lien.[130]

We offer below some general observations on the issues raised by the Commission. Most importantly, we strongly urge the Commission not to require a broker-dealer to include the amount of any lien as a credit item in the reserve formula, since this approach is

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[128] For example, if a broker-dealer borrows securities, it is permitted to provide a "credit" cushion; when it reverses in securities, it is not (and in fact, it may be required under applicable margin rules to obtain a "credit" cushion). Therefore, in terms of the objectives of the net capital rule, acquiring securities through a reverse repo rather than a securities borrowing transaction does not permit the broker-dealer to achieve a better net capital treatment – indeed, it is in a worse position because it can no longer incur any deficit without taking a capital charge.

[129] For example, after the Federal Reserve Board amended Regulation T to permit non-purpose loans of equity securities between broker-dealers that qualify as "exempted borrowers," such loans became a means for broker-dealers to finance each other in lieu of repos. See Regulation T Section 20.10(a). This development apparently was viewed by the Commission staff as creating incentives for "regulatory arbitrage" – in this case, by conducting financing transactions as securities loans rather than as margin loans or repos – and the Commission staff took steps to limit these incentives through interpretation. See NYSE Interpretation Handbook Rule 15c3-1(c)(2)(iv)(B)/093. The advantage of using securities loans rather than repos in this context, however, resulted from applicable margin rules rather than the net capital rule.

[130] Proposing Release at 12875.

unnecessary to achieve full customer protection and would impose significant funding costs on broker-dealers without addressing any of the issues raised by the Commission.

In our view, the issue of third-party liens is another area in which it would be productive to have a detailed discussion between the Commission staff and the industry before any rule amendments are proposed. Such discussion would assist in addressing with greater specificity the range of scenarios in which third-party liens may arise, and in identifying the issues such liens may present. SIFMA would welcome the opportunity to facilitate further dialogue on these issues.

1. The Need for Third-Party Liens

As a threshold matter, we believe it is essential to recognize that the ability of customers to provide third parties with liens on such customers' accounts at U.S. broker-dealers facilitates customer access to a broader range of financial products and services and helps such third parties reduce and manage their credit risk exposures.[131] The Commission therefore should seek to promote these arrangements, including by creating greater legal certainty regarding the implications for such liens under SIPA.

Third-party liens on customer assets may be documented and perfected in a number of different ways, may cover different types of accounts (or portions thereof), and may be used to facilitate a variety of different types of transactions or credit arrangements. In analyzing and addressing the implications of such arrangements under SIPA, it will be necessary to take these potentially important distinctions into account (which is one of the reasons we believe this issue should be the subject of more in-depth analysis and discussion).

As a general proposition, however, we believe that the most common circumstances in which such liens arise involve transactions between a customer and affiliates of the broker-dealer. A typical example would be a situation in which a customer enters into transactions with the broker-dealer's affiliate(s) (e.g., a swap transaction or a foreign exchange transaction), and collateralizes its obligations to the affiliate through a pledge of cash and securities held at the broker-dealer. This security interest provides credit protection to the affiliate(s), while permitting the customer to maintain its portfolio at the broker-dealer (where, depending on the circumstances, it may continue to trade that portfolio) rather than incurring the operational costs of transferring the assets to another custodian or otherwise to the broker-dealer's affiliate(s).

Security arrangements involving assets held at a broker-dealer therefore facilitate investors' access to a range of financial products and services that they may not be able to obtain

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[131] We note that although liens may be placed on a customer's account involuntarily (e.g., a tax lien or another lien established by court order), we believe that liens arising in this manner are limited.

directly from their broker-dealer. In addition, by providing credit support to the broker-dealer's affiliate, these arrangements also help reduce the risk of an insolvency of that affiliate that could adversely affect the broker-dealer itself. Depending on how these arrangements are structured, moreover, they may also offer additional direct credit support to the broker-dealer – e.g., by providing the broker-dealer with rights under certain circumstances to use the assets in the pledged account, or assets of the customer held at affiliates (or representing receivables from affiliates), to satisfy obligations of the customer to the broker-dealer.

In light of these considerations, any actions that the Commission takes in this area should seek to facilitate the use of such third-party liens, to the extent consistent with the policy objectives of SIPA, rather than impose unnecessary burdens or limitations on such arrangements. The Commission should also have due regard for the fact that arrangements in which third parties (particularly affiliates) are provided security interests on customer accounts are already widespread, and therefore it should avoid any interpretations or requirements that would unduly disrupt the prevailing commercial expectations of the parties to these arrangements. It would not serve the purposes of the Commission's financial responsibility rules if efforts to simplify the SIPA liquidation process and reduce potential ministerial and administrative costs of a SIPC trustee inadvertently resulted in less effective credit risk mitigation techniques and consequently greater risk that broker-dealers would become subject to SIPA proceedings.

2. Potential Concerns in a SIPA Liquidation

In the Proposing Release, the Commission appeared especially concerned about third-party liens on an account in the customer's name. In particular, the Commission noted that such liens could result in the trustee "owing the securities both to the customer and to the third-party holding the lien," which "could increase the costs of a SIPA liquidation."[132] In addition, the Commission expressed concern about situations in which liens are held by multiple creditors, which "could increase the number of parties with potentially competing claims for the securities, and thereby increase the complexity and costs of the liquidation."[133]

We have several general comments with respect to these concerns and the Commission's proposals for how to address them.

First, we concur with the Commission that structures in which the pledgor and pledgee agree that securities constituting collateral are to be transferred into an account in the name of the pledgee generally should not implicate these concerns. In these situations, the trustee would presumably treat the pledgee as the account owner for all relevant purposes under SIPA. We do not believe, however, that the parties should be required to structure all pledge

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132 Proposing Release at 12875.

133 Id.

arrangements in this manner (which was one of the approaches suggested in the Proposing Release), and we are concerned that such a requirement would impose severe restrictions on the ability of U.S. broker-dealers to accommodate their customers' commercial objectives. It is important for parties to have flexibility in structuring their credit support arrangements. In many instances, customers may prefer to keep securities in an account in their own name – for example, because those securities are part of a portfolio that the customer is actively trading, and frequent transfers of those securities back and forth between multiple accounts would create operational burdens and costs. The customer may also prefer to maintain the securities in its own account at a broker-dealer so that it may have a direct customer claim for its net equity in a SIPA proceeding of the broker-dealer (rather than having any claims in respect of the pledged securities depend on the status and net equity of the pledgee), and to otherwise preserve its ability to claim coverage from SIPC.[134]

Second, we do not agree that a lien on an account in the customer's name could result in the SIPC trustee "owing the securities both to the customer and to the third party holding the lien." In a SIPA liquidation, the account would be treated like any other account – i.e., its entitlement to SIPC fund protection and the extent of its claim for customer property of the insolvent broker-dealer would be governed by its "customer" status under SIPA, its net equity, and other relevant factors. Regardless of how distributions in respect of the account are eventually allocated between the pledgee and the pledgor, we are not aware of any basis for concern that the trustee would be required to make the full amount of those distributions twice, once for each party. Thus, the SIPC fund would not be subject to the cost of providing protection to both the pledgee and the pledgor.[135]

For this reason, we strongly oppose the suggestion that a broker-dealer be required to include the amount of the customer's obligation to the third party as a credit item in the reserve formula. The account's claim for cash and securities is already adequately protected by Rule 15c3-3's reserve formula and possession or control requirements, under which the broker-dealer must segregate the necessary funds and securities in respect of the account. The credit item proposal would create substantial and unwarranted economic burdens on broker-dealers – not only would the broker-dealer be required to maintain fully-paid securities in a control location, but it may also have to fund an additional reserve account requirement with its own funds. We also note, moreover, that the Commission's concerns regarding the increased "complexity" of a liquidation in which there are third-party liens simply would not be addressed

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134 If the pledgee is unable to return securities delivered to it by the pledgor (because of the bankruptcy of the broker-dealer or otherwise), the pledgor may have a claim against the pledgee that, depending on the circumstances, may be that of a general creditor if the pledgor is also insolvent.

135 We understand that SIPC does not disagree with this conclusion, based on the statements in the SIPC Comment Letter that "[r]elative to the broker, the customer's net equity is the value of the securities" and "the customer's claim for the fully-paid securities would be allowed."

by the credit item proposal, since it would do nothing to clarify claims in respect of the account under SIPA.

Third, disclosure to the customer of "the existence of the lien, identity of the pledgee(s), obligation of the customer, and amount of securities subject to the lien," as suggested in the Proposing Release, also will not address the concerns expressed by the Commission. A security interest established in connection with a financial transaction with a third party is created by the customer, not the broker-dealer. Indeed, these liens may even be established and perfected without the knowledge of the broker-dealer, although that is not typically the case. Similarly, the customer would know as much or more about the amount of its obligations to the third party, and the amount of securities subject to a lien, as the broker-dealer. None of these factors should affect the nature of the customer's claim in a SIPA proceeding. In our view, additional recordkeeping or disclosure requirements (including disclosures by or to the broker-dealer) should not be adopted until they can be properly tailored to address a clear objective related to the purposes of SIPA.

Fourth, it may be useful for the Commission and SIPC to adopt rules, protocols or interpretations that establish more clearly how an account subject to a third-party lien would be treated in a SIPA proceeding. SIPC has adopted rules for identifying accounts of "separate customers" of broker-dealers, and for the treatment of accounts introduced by another broker-dealer, among other issues.[136] Similarly, clearer standards for how third-party security interests will be handled may better enable the parties to these arrangements to confirm that their contractual obligations and their risk management assumptions are appropriate.

In its comments on the Proposed Amendments, SIPC stated that although the "customer's claim for the fully-paid securities would be allowed," because of the lien "the collateral would not be delivered in the ordinary course to the customer. In the event of a dispute between the borrower and the 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."[137]

Nevertheless, there are several related points that could be clarified by the Commission and SIPC and that would be relevant whether or not there is a dispute between the pledgor and pledgee that is referred to the Bankruptcy Court. For example, the Commission and SIPC could: (i) confirm that (as indicated in the SIPC Comment Letter) the account will be treated as an account of the customer (rather than the pledgee) for purposes of determining the

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136 See SIPC Series 100 and 200 Rules.

137 SIPC Comment Letter at 7.

account's status under SIPA;[138] (ii) address whether the account will be aggregated with other accounts of the pledgor for purposes of determining a net equity claim or the amount of SIPC coverage; (iii) address whether these answers would be different if, pursuant to a "control" agreement executed by the broker-dealer, the broker-dealer has agreed to take instructions from the pledgee with respect to the account; and (iv) consider procedures under which – consistent with the purposes of SIPA – the account may be transferred promptly to another broker-dealer in a manner that preserves the rights of the customer and the third party.

The paramount objective of the Commission and SIPC should be to protect and promote the commercial expectations and contractual rights of the parties to the pledge arrangement, consistent with the purposes of SIPA. For example, a transfer of the customer's account to another broker-dealer under circumstances that would not preserve the pledgee's rights with respect to the customer's assets would result in significant risk for the pledgee and would not facilitate the purposes of the lien arrangement. In general, we believe that consent or agreement of the pledgee should be required for any such actions with respect to the pledgor's account that could adversely affect the pledgee.

Similarly, consideration could be given to whether the expectations of the parties and the purposes of SIPA would be served by requiring the trustee to promptly perform any obligations the broker-dealer has undertaken in connection with the pledge arrangement. For example, it may be appropriate to identify circumstances under which the trustee may follow the directions of the pledgee with respect to distributions on the account if under the applicable documentation the broker-dealer has an obligation to do so.

Once the appropriate rules or protocols for the treatment of accounts subject to third-party liens in a SIPA liquidation have been clarified, the Commission would be in a position to determine whether any modifications to its rules are necessary or appropriate – for example, whether it would be appropriate to require the broker-dealer to maintain information about third-party liens that would be relevant to the treatment of the accounts in a SIPA proceeding under the relevant rules or protocols.

As noted above, we believe that efforts to address these issues in greater specificity should occur through interactive dialogue between the industry and the staff of the Commission and SIPC. We would be pleased to facilitate this dialogue, including if appropriate, by establishing a committee to assist in identifying the issues that need to be addressed and developing more specific recommendations.

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[138] For example, if the pledgor is an investor, the pledgee is a bank and the account's status is determined by reference to the pledgee, the account would not be entitled to SIPC fund protection.

VII. Conclusion

We wish to thank the Commission and its staff again for their work in developing the Proposed Amendments and for this opportunity to comment on them. SIFMA would be pleased to discuss any of these comments with the Commission staff in greater detail, or to provide any other assistance that would help facilitate the Commission's review of the Proposed Amendments. If you have any questions, please do not hesitate to contact the undersigned (212-272-0531), Gerard J. Quinn, Managing Director and Associate General Counsel of SIFMA (212-618-0507), or Robert W. Cook of Cleary Gottlieb Steen & Hamilton LLP, counsel to SIFMA in this matter (202-974-1538).

Sincerely,

/s/ Marshall J Levinson

Marshall J Levinson
Senior Managing Director
Bear, Stearns & Co. Inc.
Chair, SIFMA Capital Committee

cc: Michael A. Macchiaroli, Associate Director
Thomas K. McGowan, Assistant Director
Randall W. Roy, Branch Chief
Bonnie Gauch, Attorney
SEC Division of Market Regulation