Comments on Proposed Amendments to Financial Responsibility Rules for Broker-Dealers
File Number S7-08-07

The following comments are in reference to proposed paragraphs (j)(2)(ii) and (j)(2)(iii) of Rule 15c3-3, which address the sweeping of free credit balances to either a money market fund or a bank deposit account.

In particular, this response to the Securities and Exchange Commission's request for comments on this proposed amendment concerns:

(1) Whether it would provide adequate protection to customers with respect to changes in the treatment of their free credit balances; and. . .

(4) Whether the treatment of free credit balances has already been adequately addressed by the self-regulatory organizations.

Mr. Justice Oliver Wendell Holmes, Jr. famously declared that our right to freedom of speech did not extend to those who falsely shout fire in a theater.

I ask the Commission, do broker-dealers have a right to pick their customers' pockets, provided they give advance notification that they intend to do so?

If, in fact, broker-dealers do enjoy such a right then I suggest that all references to customer "protection" be removed from this Rule, because in no sense would any reasonable person conclude that "notification" constitutes sufficient customer protection from such self-dealing, conflicts of interest that currently characterize the way in which free credit balances are swept into captive bank accounts and money market funds at almost all broker-dealers today.

Since the self-regulatory organization, The New York Stock Exchange, seems to have confined its interest in this issue solely to whether there has been adequate disclosure, I will say only that it is a perfect example of the failure of self-regulation. Member firms have cheated their customers out of billions of dollars by forcing them into captive bank deposits and the Exchange concerns itself only with whether the firms admit to doing so. Which, in fact, they do! The Wall Street Journal has published at least two articles exposing these practices.

I have in my possession the disclosure from one broker-dealer that clearly states near the end of pages and pages of "insurance policy-style fine print" that it is under no obligation to pay a market rate of interest nor does it intend to do so. But–and this point is critical–neither will it allow its customers to find a more competitive vehicle on their own, as described below.

As a victim of these practices, both as a private investor and fiduciary, I would ask you if these broker-dealers are, in fact, causing Investment Advisers to be in technical violation of the Investment Advisers Act. Are they doing so by making it difficult–if not nearly impossible–for Advisers to obtain market rates of interest on their clients' free credit balances in accounts carried at these firms, which is particularly the case for smaller, independent Advisers with less wealthy clients?

Should the Commission require registered Investment Advisers to notify their clients that the clients' pockets are being picked by these broker-dealers? Might the Commission require Investment Advisers to transfer these accounts to broker-dealers who do not engage in these shoddy practices?

I wish to make it clear that I recognize that so-called sweep accounts are a product provided by these firms and that the various broker-dealers have a right to tailor this service however which way they desire. What I am complaining about is that they have made it next to impossible (or have ordered their representatives to make such claims of impossibility) for customers to opt out of them, and then manually deposit their free credit balances into a non-sweep money fund.

In other words, the customer has been effectively denied the opportunity to opt out of bank account sweeps by preventing him or her from utilizing any other vehicle to park his or her free credit balances, even without the sweep service.

If one opts out of the sweep, then one is confined to a situation where the free credit balance cannot earn any kind of return at all! So exactly what kind of option is that? That is what troubles me.

My wife has a small IRA account with one of the major firms. Whatever funds were in their old money market fund, which they offered prior to switching to the bank deposit sweep, earns more than 200 basis points more than the minuscule return in the bank deposit, and the frozen money market fund, itself, pays 100-150 basis points less than most non-broker-dealer money market funds currently yield.

Worse, any securities purchases must first be used to deplete the funds in the old money market fund. I have been told over and over that no new deposits will be accepted into their old money market fund, that it is frozen, nor is there any other money fund vehicle available there.

For your additional information, please be advised that I have a Ph.D. in Economics. I acknowledge that, in a perfectly competitive environment, competition should lead to more accounts that pay market yields or very nearly so.

However, three factors combine to prevent the market from working as it should. First, this behavior is a direct consequence of the repeal of the Glass-Steagall Act, which destroyed the barrier that had existed between commercial banking and the investment industry.

Second, in a regime of relatively low interest rates, consumers are less sensitive to rates and to variations in yields from firm to firm. Recall that the few money market funds inhabited a backwater place among investment vehicles for years and years—until rates climbed to double-digit levels and then they exploded in popularity. Recall also, at the same time, that the rush to transfer savings and loan deposits into more generous instruments created a crisis in that industry that required a Congressional bailout.

Third, there is a confluence of interests here that works exactly as if there were outright (and still illegal) collusion to discourage the largest players from sabotaging a situation that is akin to shooting fish in a barrel.

Possibly the Commission feels that taking issue with these practices is not within its understanding of what its role in "customer protection" should be. Very well. Then perhaps the Congress should mandate some other agency to stop these practices. I sincerely believe that they would not be tolerated in any other industry.

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