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THE CLEARING HOUSE®
Advancing Payment Solutions Worldwide

June 18, 2007

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Ladies and Gentlemen:

The member banks of The Clearing House Association L.L.C.[1] ("The Clearing House") appreciate the opportunity to comment on the amendments to the financial responsibility rules for broker-dealers proposed by the Securities and Exchange Commission (the "Commission").[2] Among other things, the proposed amendments seek to amend the broker-dealer customer protection rule under the Securities Exchange Act of 1934 ("Rule 15c3-3"). Our comments are limited to certain aspects of the proposed amendments to Rule 15c3-3, although a number of our member banks have concerns about other aspects of the proposed amendments, which concerns have been expressed in separate comment letters (including other trade association comment letters).

1 The member banks of The Clearing House are: Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank National Association; LaSalle Bank National Association; UBS AG; U.S. Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association. Each of the member banks has at least one broker-dealer affiliate that would also be affected by the proposed amendments.

2 Release No. 34-55431, 72 Fed. Reg. 12,862 (Mar. 19, 2007) (the "Release").

Rule 15c3-3 requires broker-dealers to maintain in a special reserve account for the benefit of customers certain assets (cash and/or qualified securities) equal to the net of certain credit and debit items, as calculated pursuant to a formula set forth in Exhibit A to the rule. The proposed amendments to Rule 15c3-3 upon which we are commenting would (1) exclude cash deposits at an affiliated bank for purposes of meeting the customer or PAB[3] reserve requirements and (2) restrict the amount of cash on deposit with an unaffiliated bank that may be used to meet the reserve requirement to the lesser of 50 percent of the broker-dealer's excess net capital or 10 percent of the bank's equity capital.

It appears that both of these amendments are designed to address the concern the Commission has about the risk that cash in a broker-dealer's reserve account at a bank may prove to be unavailable to the broker-dealer or, in the worst case scenario, might be lost, if the bank experiences financial difficulties. The Commission's proposed approach to dealing with this perceived risk is to prohibit the deposit of cash in a reserve account with an affiliated bank, and to require broker-dealers to spread any such cash across several unaffiliated institutions. (We recognize that the rule does not restrict qualified securities held in a reserve account, whether with an affiliated or unaffiliated bank, but for a variety of reasons qualified securities are only a limited substitute for cash in a reserve account, and thus, the problems we see with the proposed amendments cannot be averted by the deposit of qualified securities.)

The Clearing House member banks are particularly concerned that these proposed amendments to Rule 15c3-3, if adopted, may result in broker-dealers placing – by necessity – reserve account funds in less stable, less well-capitalized banks or banks with little or no experience administering reserve accounts. As we discuss below, we believe that the Commission's goal of customer protection can be adequately addressed without the imposition of a flat prohibition on the depositing of funds with affiliated banks or hard and fast concentration limits.

Affiliated Banks

In the Release, the Commission expressed the view that the risk of deposited funds being unavailable or lost may be heightened when reserve account funds are deposited with an affiliated bank, on the theory that the broker-dealer might not conduct due diligence on an affiliated bank to the same extent as on an unaffiliated bank.

In our experience, broker-dealers have policies and procedures for the safe and sound conduct of their business. We believe that the general rule is that broker-dealers do exercise due care in considering whether to deposit reserve account funds with an affiliated bank. We are aware, in fact, of broker-dealers that do not place reserve account deposits with affiliated banks precisely because the broker-dealers view other banks as being better equipped, in terms

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3 The Commission has proposed to require broker-dealers to treat proprietary accounts carried for other broker-dealers ("PAB accounts") the same as other "customer" accounts for purposes of the reserve requirements. 72 Fed. Reg. at 12,863.

of expertise and experience, to handle reserve accounts and the various duties and services that must accompany such accounts. In any case, however, we believe that a flat prohibition on the use of an affiliated bank is too drastic a solution to the Commission's concern. Broker-dealers that have bank affiliates can enjoy operational and administrative efficiencies by placing reserve account funds with an affiliated bank. An affiliated bank may be familiar with the broker-dealer's systems and policies and procedures, and thus may more easily be able to accommodate the broker-dealer's needs. These advantages are lost by a total prohibition on the use of an affiliated bank. The approach prohibits all broker-dealers from achieving these benefits in order to prevent the possibility of abuse by bad actors.

The Commission also expressed a concern that a broker-dealer's customers may not derive significant benefit from the reserve requirement if deposits are held at an affiliated bank and that bank becomes insolvent. We respectfully submit that the Commission should give greater weight to the extensive regulatory scheme to which banks are subject, which greatly reduces the risk of bank insolvency. Banks and bank holding companies are subject to substantial measures to ensure their safety and soundness, including routine examination, restrictions on transactions with affiliates and insiders and significant regulation of nearly all aspects of their activities. Banks have access to discount window borrowing from the Federal Reserve System and their deposits are subject to federal deposit insurance. In addition, the federal bank regulatory agencies employ capital measures to evaluate the capital adequacy of banks and bank holding companies that are continuously evolving and being evaluated. These requirements help to ensure that banks have adequate capital and liquidity to meet their obligations and assist the bank regulatory agencies in monitoring the capital levels and overall financial health of banks. We believe that the regulatory regimes governing both bank and bank holding company capital should largely mitigate the Commission's concern regarding insolvency.[4]

The Clearing House does not believe that a flat prohibition on placing deposits with an affiliated bank is warranted. We believe that the measures we describe below, equally applied to affiliates and non-affiliates, would be sufficient to accomplish the Commission's goals.

Nevertheless, if the Commission believes that such a prohibition is truly necessary in some cases, we respectfully submit that it should not apply in the case of special reserve account deposits held at an affiliated bank that is "well-capitalized" as defined by the regulations of its federal bank regulatory agency. In 1999, as part of the Gramm-Leach-Bliley Act, Congress established the "well-capitalized" standard as one of the key standards under the Bank Holding Company Act of 1956 for bank holding companies to become "financial holding companies", thereby permitting their bank subsidiaries to affiliate with full service broker-dealers. We believe that a bank that meets that capital standard should, if it has the necessary operational and other capabilities, be an acceptable location for an affiliated broker-dealer's special reserve account.

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[4] See 72 Fed. Reg. at 12,864.

Concentration Limit

The Clearing House believes that the Commission's proposal to require broker-dealers, when calculating compliance with the minimum reserve requirement, to exclude cash deposits with a single bank to the extent those deposits exceed certain numerical limits is too restrictive and would have unintended negative consequences.

First, in the experience of the broker-dealer affiliates of our member banks, only a limited number of banks have the experience, expertise and personnel to deal with customer reserve account deposits. As noted above, we are aware of broker-dealers that do not place their reserve accounts with their affiliated banks because such affiliated banks are not as capable as another bank to address the detailed requirements applicable to these accounts. Banks that operate in this market typically have a dedicated team that knows the broker-dealer client, a treasury function that is familiar with the requirements for the administration of the accounts and any volatility in the accounts, and an operations system capable of the detailed deposit time and date stamping and other requirements applicable to the accounts. We believe that limiting the amount of deposits that can be held with these experienced banks will harm the overall safety and security of customer funds. We are concerned that these amendments, if adopted, could, in effect, require broker-dealers to focus not on the strength of the bank or banks with which they place their reserve account(s) but on seeking a multiplicity of banks, causing broker-dealers that have been "capped out" with one or more of the top-tier banks placing reserve accounts with less well-capitalized, weaker banks.

Second, we believe that imposing regulatory numerical limits, particularly a limit based on a broker-dealer's excess net capital, is not the best way to protect the broker-dealer. We are aware that this particular limit may have its origin in advice the Commission staff gave to the New York Stock Exchange in 1988, but even that advice was less limiting, in that it applied only to deposits into money market deposit accounts.[5] Such a low numerical limit, expressed in terms of a broker-dealer's excess net capital, ignores the extensive system of federal and state regulation that helps protect the safety and soundness of the banking system and of individual banks. Moreover, the use of limits fails to take into account the fact that certain banks, because of their resources, have ready access to multiple sources of liquidity and stand out even within the banking industry as safe places for depositing funds. In addition, since 1988, the bank regulatory regime has become even more robust as it applies to monitoring, reporting and enforcement of a bank's safety and soundness. We believe very strongly that the Commission's rules in this area should reflect all of these factors.

In addition, we note that due to the proposed establishment of reserve requirements for PAB accounts, broker-dealers are likely to be have larger amounts of funds that need to be held in special reserve accounts at banks. The Commission's proposal simultaneously limits the universe of available banks (by excluding affiliates) and increases the number of banks required to meet a broker-dealer's needs (by expanding the universe of accounts for which

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5 NYSE Interpretation Handbook No. 88-1 (Feb. 1988).

reserves must be maintained and limiting the amount of funds that can be placed at any one institution). For some broker-dealers the proposed rule could require the maintenance of over 30 different bank accounts. The increased administrative and operational costs associated with opening, overseeing, managing and reconciling a plethora of new accounts and relationships with new banks will, in our view, substantially exceed the Commission's estimates, [6] as set forth in the Release, particularly for small to medium sized broker-dealers. The costs include statement reconciliation, account maintenance, wire transfer coordination and similar time-consuming, expensive administrative tasks. The complexity of managing a large number of bank accounts will be a burden for broker-dealers, and will greatly increase the risk of errors, which creates a risk for broker-dealers' customers. The process of managing multiple reserve accounts so as to not inadvertently breach either limit will be a further burden and cost for broker-dealers.

Finally, the Commission's approach may reduce broker-dealers' ability to negotiate the best interest rates in connection with a large volume of deposits at a particular institution. This would result in higher costs for broker-dealers in their business, which will almost certainly negatively affect the interest that broker-dealers themselves can pay on their customers' free credit balances. We are concerned that these costs, and in particular the potential cost to broker-dealers' customers, have not been adequately factored into the Commission's cost-benefit analysis of these proposed amendments to Rule 15c3-3.

Alternative Proposal

The Clearing House respectfully submits that a better approach would be to require that a broker-dealer have in place policies and procedures for determining how to place its reserve account funds and to conduct an analysis, as appropriate, of each bank (affiliated or unaffiliated) before it places any deposits at that bank, and to monitor each bank, as appropriate, thereafter. The review and monitoring would need to take into account the bank's credit ratings (as measured by nationally recognized statistical ratings organizations), financial strength as disclosed in its Call Reports and any periodic reports filed with the Commission by its parent holding company, past performance, sources of liquidity, and experience in administering special reserve accounts. Of course, the broker-dealer also should have appropriate contractual arrangements with any such bank to protect the broker-dealer. With this information and analysis, the broker-dealer would be able to make an informed determination about the appropriate allocation of deposits among institutions. This approach is more in line with a standard counterparty credit risk analysis and would, we believe, adequately manage the broker-dealer's exposure. We note that the Financial Services Authority in the United Kingdom has adopted a similar approach and, to our knowledge, there have been no negative ramifications.

The Clearing House believes that this more nuanced approach would focus broker-dealers on the appropriate questions, rather than forcing them to sign up reserve accounts with a multiplicity of banks. We believe this approach would meet the Commission's goal of

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6 72 Fed. Reg. at 12,881.

reducing a broker-dealer's risk of the unavailability or loss of funds as a result of a bank failure, while simultaneously allowing a broker-dealer to exercise appropriate case-by-case judgment of its needs and the capabilities of banks to provide the safest place for customer funds.

Nevertheless, if the Commission believes that a fixed numerical concentration limit is truly necessary, we respectfully submit that any such limit should not apply in the case of special reserve account deposits held at a bank that is "well-capitalized" as defined by the regulations of its federal bank regulatory agency. For the reasons stated above, we believe that such institutions are the safest possible place for cash deposits to be held, and the amount of funds held at such an institution should not be limited.

In our view, there are many instances in which it is consistent with safe and sound business practices for a broker-dealer to maintain special reserve account deposits at a small number of banks, or even a single bank. As noted above, the burden of administering and monitoring special reserve accounts and the banks at which they are held obviously increases with the number of banks with which a broker-dealer deals. Broker-dealers should have the flexibility to evaluate the risks and benefits of various allocations among accounts and institutions and exercise prudent judgment in maximizing their customers' returns (by keeping costs down) consistent with protecting their interests. A fixed, mandated limit on special reserve account deposits limits a broker-dealer's flexibility to consider all options when evaluating the best interests of its customers.

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The Clearing House would be pleased to discuss any of our comments in more detail. If you have any questions, please contact Norman R. Nelson, General Counsel, at (212) 612-9205.

Sincerely,