E*TRADE
FINANCIAL

June 19, 2007

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

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

Dear Ms. Morris:

E*TRADE Financial Corporation and its subsidiaries (collectively, "E*TRADE")[1] is pleased to comment on the changes to the financial responsibility rules governing broker-dealers recently proposed by the Securities and Exchange Commission ("SEC" or "Commission").[2] Although E*TRADE supports most aspects of the proposal, E*TRADE is opposed to the proposed amendment to Rule 15c3-3 under the Securities Exchange Act of 1934 ("Exchange Act") that would: (1) impose limitations on the amount of cash a broker-dealer may deposit in a special reserve bank account at any one unaffiliated bank; and (2) altogether exclude cash deposits at an affiliated bank for purposes of meeting reserve requirements. As discussed below, E*TRADE believes that the SEC's stated goals for these proposed changes – to limit concentration risk that arises when a broker-dealer maintains its reserve deposit at a single bank and the potential conflict of interest that a broker-dealer may encounter when assessing the financial soundness of an affiliated bank – are better addressed through other prudential steps. We also believe that the proposed conditions will result in additional costs to broker-dealers that are not justified in light of the alternative means that exist to address the Commission's concerns.

---

1 The E*TRADE family of companies provides a broad array of financial services to both retail and institutional customers and includes brokerage firms engaged in retail, institutional trading (both agency and proprietary), clearing and market making businesses, as well as firms engaged in banking, mortgage lending and investment advisory businesses. Our U.S. brokerage business comprises the activities of the following registered broker-dealers: E*TRADE Securities LLC, E*TRADE Clearing LLC and E*TRADE Capital Markets, LLC.

2 Securities Exchange Act Release No. 55431 (March 9, 2007); 72 Federal Register 12862 (March 19, 2007) ("Proposing Release).

E*TRADE also is opposed to the proposed additional recordkeeping requirements regarding internal risk management controls established and maintained by a broker-dealer. As discussed below, we believe that this requirement, as currently proposed, is overly broad and ambiguous in several respects.

1. Banks Where Special Reserve Cash Deposits May Be Held

Rule 15c3-3[3] requires broker-dealers to take certain steps to protect customer assets, including to maintain in a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (hereinafter "Reserve Bank Account") cash and/or qualified securities that, in essence, equal the difference between the amount of money the firm owes customers and the amount of money customers owe the firm. The Commission proposes to add new paragraph (e)(5) to Rule 15c3-3, which would provide that, in determining whether it maintains the minimum required reserve deposits, a broker-dealer must: (1) exclude any deposits with an unaffiliated bank that exceed 50% of the broker-dealer's excess net capital or 10% of the bank's equity capital; and (2) exclude altogether cash deposits at banks affiliated with the broker-dealer. Both of these proposals are designed to address concerns that a broker-dealer could experience a loss or may not be able to access cash if the bank at which the Reserve Bank Account is maintained experiences financial difficulty and the reserve deposit is concentrated in cash at one bank. We address each of these proposals separately below.

A. Proposed Limitations with regard to Unaffiliated Banks

E*TRADE fully recognizes and appreciates the importance of safeguarding customer assets and ensuring accessibility to customer cash. Conceptually, a broker-dealer could be exposed to credit and operational risk when making a substantial deposit at one bank. Although the Commission's proposal effectively requires broker-dealers to spread such risk across several institutions, that result may not necessarily minimize the potential credit and operational exposures to the broker-dealer.

We are advised by one of our Reserve Bank Account bankers that the limitations set forth in the proposal are based upon the Commission Staff's advice provided to the New York Stock Exchange, Inc. ("NYSE") in 1988. Since that time, however, Congress has enacted legislation that requires the Federal bank supervisory agencies to adopt requirements that establish regulatory capital requirements for banks, including a system for assessing the capital adequacy of banks (which has been in effect for some time now) and empowering the Federal Reserve to take supervisory action in the event a bank is deemed not to be adequately capitalized.[4] It would seem, therefore, that the concerns which gave rise to the Commission Staff's 1988 letter and those expressed in the proposal have been significantly mitigated by regulations requiring prompt corrective action in the event that a bank's capital position deteriorates.

---

[3] 17 C.F.R. § 240.15c3-3.

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

In lieu of the Commission's proposed restrictions, E*TRADE believes that the risk that broker-dealer deposits could be inaccessible because of an institution's financial difficulty can be sufficiently and appropriately managed and reduced by requiring a broker-dealer to take a number of steps as part of a due diligence process on banks holding Rule 15c3-3 deposits. Using this approach, broker-dealers would be required to:

- Ascertain that the bank is either "well capitalized" or "adequately capitalized" as defined under regulations issued by the Federal bank supervisory agencies;[5]

- Examine the credit rating of the bank, as measured by one or more nationally-recognized statistical rating organizations;

- Ensure that the contract between the broker-dealer and banks holding Reserve Bank Account deposits contain provisions that allow the broker-dealer immediately to withdraw all funds from the Reserve Bank Account at any time; and

- Obtain a representation by the bank that it is at least "adequately capitalized" and that it will immediately inform the broker-dealer should its status deteriorate.

Both broker-dealers and banks are regulated entities that are required to have policies and procedures requiring them to behave in a manner consistent with safe and sound business practices. Prudent business practice requires that broker-dealers perform due diligence on a bank in which they will hold customer deposits.

Moreover, this approach is consistent with the principles-based regulation recently called for by Treasury Secretary Paulson[6] and other U.S. regulators and is similar to other regulatory schemes analogous to the Commission's. For example, in the United Kingdom, the Financial Services Authority ("FSA") requires that a firm in selecting a bank to hold customer deposits owes a duty of care to a client when it decides where to place client money.[7]

---

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

6 *See* Benton Iven-Halperin, "Treasury's Paulson Suggests 'Principles-Based' Regulation," *Wall Street Journal*, March 13, 2007.

7 *See* FSA CASS Manual 4.3.41. Rather than imposing strict numerical limitations, the FSA requires a firm to undertake due diligence when opening a client bank account and to consider a number of factors in making a decision as to an appropriate bank. Although the FSA requires firms to consider diversifying placements of client money where the amounts are of a sufficient size to warrant diversification, the FSA does not impose a strict limitation on the size of a deposit with any one institution. Rather, the FSA requires a firm to perform due diligence on the bank and act accordingly.

E*TRADE believes that requiring broker-dealers to perform due diligence on banks holding Rule 15c3-3 deposits, using the standards discussed above, achieves the Commission's objectives without imposing arbitrary constraints on broker-dealers.

Permitting broker-dealers to maintain deposits at one bank, when it is determined by the broker-dealer to be prudent to do so, provides the broker-dealer with a liquid and administratively efficient means to manage its Rule 15c3-3 deposits. In E*TRADE's experience, it also allows the broker-dealer to use volume to negotiate the most competitive return on its deposit, without sacrificing any safety and soundness considerations. On the other hand, limiting Rule 15c3-3 deposits to 50% of a broker-dealer's excess net capital will require a significant number of broker-dealers to open a number of additional cash and/or securities accounts and devote ongoing operational resources to the management of such accounts. To the extent that a broker-dealer elects to maintain all its Rule 15c3-3 deposits in cash it will need to devote resources to engage in ongoing due diligence on a number of banks, reconcile account statements, maintain balances, send wires from various accounts, and perform other similar account management duties. The broker-dealer will transition from a liquid and flexible system where it can easily move deposits in accordance with the reserve requirement to a situation requiring additional resources, oversight, management and reconciliation in order to effectively manage cash in accounts at multiple institutions. Moreover, from an economic perspective broker-dealers will not be able to leverage deposit volume as effectively to obtain the best rate on their deposits, directly impeding their ability to grow capital through higher earnings.

Should a broker-dealer elect to use qualified securities as opposed to cash to meet all or part of its reserve requirement, then the broker-dealer likely will have a significant amount of additional operational and transactional costs. While larger broker-dealers may be able to reallocate existing trading desk, operational, regulatory reporting and treasury functions to assist in ongoing maintenance activities, midsized and smaller broker-dealers may be required to hire additional staff to manage and maintain a securities portfolio. Managing a pool of qualified securities involves myriad tasks such as monitoring income collection, redemption processing, marking the securities to market, collateral substitutions and collateral segregation amongst other tasks. In addition, securities pose additional operational risks such as failures to settle in a given market. In sum, E*TRADE believes that the upfront and ongoing cost to each broker-dealer is far higher than the one-time cost of $2,630 the Commission estimates in the Proposal.

B. Proposed Exclusion of Cash Deposits Held at Affiliated Banks

As noted above, the Commission's proposed amendments to Rule 15c3-3 also would exclude altogether cash deposits at an affiliated bank for purposes of meeting the broker-dealer's reserve requirement. E*TRADE is opposed to this provision for all of the same reasons it opposes the limitations on the amount of cash a broker-dealer may maintain at an unaffiliated bank. Moreover, if the Commission were to adopt a more flexible "due

diligence" approach as described above, which includes objective factors for the broker-dealer to consider when evaluating banks to hold Reserve Bank Accounts (e.g., that the bank is well capitalized or adequately capitalized), there would be no reason to prohibit firms from making use of an affiliated bank. In keeping with its obligation to use due care in selecting a bank to hold Reserve Bank Accounts, the broker-dealer would be required to review independent, objective criteria to help ensure that it was acting impartially and not favoring its affiliated bank in assessing the financial soundness of the bank.

As the Commission is no doubt aware, an existing NYSE interpretation already limits the ability of NYSE member firms to maintain Reserve Bank Accounts at affiliated banks.[8] Because we believe that the due diligence approach discussed above obviates the need to maintain this outright prohibition, we would ask the Commission to direct the NYSE to eliminate its interpretation on this subject. At a minimum, however, E*TRADE respectfully recommends that the Commission not adopt this aspect of the Proposal and maintain the status quo. Although none of the E*TRADE broker-dealers currently maintain Reserve Bank Accounts with any of their affiliated banks, the firm believes that, from a policy perspective, there should be no impediment to this practice should E*TRADE wish to do so in the future.

2. Proposed Amendments Regarding Documentation of Risk Management Procedures

The Commission also proposes to create an additional books and records requirement under Rules 17a-3 and 17a-4. Specifically, the Commission proposes to amend 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. Although E*TRADE agrees with the Commission that, a well-documented system of internal controls enables a broker-dealer's management to identify, analyze, and manage the risks inherent in the firm's business activities, E*TRADE believes that the proposed documentation requirement for "any" risk management controls is overly broad. Risk is associated with virtually every aspect of a broker-dealer's business, and every procedure could be viewed as a "risk management control" procedure under this broad definition. We believe the documentation requirement should be limited to internal controls that address market, credit, and liquidity risk, which have more commonly understood meanings within the industry.

E*TRADE also implores the Commission to make clear that, for broker-dealers that are part of a family of companies 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. Put another way, the rule should

---

[8] NYSE Interpretation Handbook Rule 15c3-3(e)(3)/051.

make clear that the written policies need not be prepared exclusively for the broker-dealer.

Finally, E*TRADE recommends that the proposed documentation requirement be revised so as not to require a broker-dealer to maintain outdated versions of its risk management controls. From a risk management perspective, it is important that the firm's current controls are documented. Imposing an obligation to maintain older versions of such controls reflecting every change that is made over time creates unnecessary operational burdens and may act as a disincentive for the firm to make more frequent minor changes to its written controls as conditions warrant.

* * * * *

We appreciate this opportunity to submit our comments on the Commission's proposal. If you have any questions or would like to discuss our comments, please do not hesitate to contact me at (703) 236-8165.

Sincerely,

James T. McHale
Associate General Counsel
E*TRADE Brokerage Holdings, Inc.

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Roel C. Campos, Commissioner
The Hon. Annette L. Nazareth, Commissioner
The Hon. Kathleen L. Casey, Commissioner