MEMORANDUM

To: File

From: Hester Peirce

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

Date: June 6, 2008

On June 6, 2008, Stuart Kaswell of Bryan Cave, representing Federated Investors, met with Commissioner Paul Atkins and his counsel, Hester Peirce. They discussed the attached documents.

Stuart J. Kaswell
Partner
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VIA E-MAIL

May 30, 2008

Hester M. Peirce
Counsel
Office of Commissioner Paul S. Atkins
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Ms Peirce:

On behalf of our client Federated Investors, Inc. ("Federated"), I am enclosing drafts of two releases for your consideration regarding proposed changes to Rule 15c3-1 and Rule 15c3-3 under the Securities Exchange Act of 1934. As you know, for a number of years Federated has been seeking changes to these rules to permit broker-dealers to make greater use of money market funds in conjunction with certain obligations under those rules. We understand that one of the few remaining obstacles to completing this project has been the lack of Staff resources needed to prepare the adopting releases.

In an effort to facilitate this process, we have prepared two draft releases for the Commission's consideration. The first release would: (i) amend Rule 15c3-3(a)(6) to classify certain money market funds as "qualified securities", thereby allowing broker-dealers to deposit or pledge such money market funds shares to their Special Reserve Bank Account required under Rule 15c3-3(e); and (ii) reducing the haircut under Rule 15c3-1 for money market funds. The second release would permit broker-dealers to use money market funds as collateral for fully-paid or excess margin securities under Rule 15c3-3(b)(3)(iii)(A).

We submit these drafts in an effort to reduce the burden on the Staff. We appreciate that the Commission will make its own determination on whether to take the action we seek, and if so, how to phrase its adopting releases. Nonetheless, we hope our actions will be helpful and analogous to litigation parties preparing draft orders for a judge's consideration.

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Please do not hesitate to contact me about this matter if you have any questions.

Sincerely yours,

/s/
Stuart J. Kaswell

SJK
Attachments

cc: Eugene F. Maloney, Executive Vice President, Federated Investors Management Company, Inc., Vice President and Corporate Counsel of Federated Investors, Inc. and member of the Executive Committee.

FEDERATED DRAFT – June 3, 2008

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–XXXXX; File No. S7–08–07]

RIN 3235–AJXX

Amendments to Customer Protection and Net Capital Rules

AGENCY: Securities and Exchange Commission

ACTION: Final rule

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting amendments to Rule 15c3-1, the net capital rule, and Rule 15c3-3, the customer protection rule, under the Securities Exchange Act of 1934 (the "Exchange Act"). These changes will allow broker-dealers greater flexibility to use money market in meeting their financial obligations. More specifically, the amendments to the net capital rule will lower the capital charges for broker-dealers when they invest their funds in money market funds. The amendments to the customer protection rule will allow broker-dealers to invest in certain money market funds for holding money in their Special Reserve Bank Accounts. These changes should reduce costs and lower operational risks for broker-dealers, without compromising investor protections.

DATES: *Effective Date:* [Insert one week after publication in the *Federal Register*]

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551–5525; Thomas K. McGowan, Assistant Director, at (202) 551–5521; Randall Roy, Branch Chief, at (202) 551–5522; or Bonnie Gauch, Attorney, (202) 551–5524; Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–6628.

SUPPLEMENTARY INFORMATION: We are amending Rule 15c3-1 [17 CFR 15c3-1] and Rule 15c3-3 [17 CFR 240.15c3-3].

I. Background

On March 9, 2007, the Commission proposed[1] amendments to the broker-dealer net capital rule (Rule 15c3–1)[2], customer protection rule (Rule 15c3–3)[3], books and records rules (Rules 17a–3 and 17a–4)[4], and notification rule (Rule 17a–11).[5] In this release we are adopting

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1 Exchange Act Release 55431 (March 9, 2007); 72 FR 12862 (March 19. 2007) ("the Proposing Release").

2 17 CFR 240.15c3–1.

3 17 CFR 240.15c3–3.

4 17 CFR 240.17a–3 and 17 CFR 240.17a–4.

certain amendments to the broker-dealer net capital rule (Rule 15c3–1) and the customer protection rule (Rule 15c3–3).[6] We also are issuing a companion order with regard to collateral under Rule 15c3-3(b)(3)(iii)(A).

II. Amendments

A. Amendments to the Customer Protection Rule

The Commission adopted the customer protection rule (Rule 15c3–3) under the Exchange Act in 1972 in response to a congressional directive to strengthen the financial responsibility requirements for broker-dealers that carry customer assets.[7] The rule requires a broker-dealer to take certain steps to protect the credit balances and securities it holds for customers. Under the rule, a broker-dealer must, in essence, segregate customer funds and fully paid and excess margin securities held by the firm for the accounts of customers.[8] The intent of the rule is to require a broker-dealer to hold customer assets in a manner that enables their prompt return in the event of an insolvency, which, in turn, increases the ability of the firm to wind down in an orderly self-liquidation and thereby avoid the need for a proceeding under the Securities Investor Protection Act of 1970 (''SIPA'').[9]

The required amount of customer funds to be segregated is calculated pursuant to a formula set forth in Exhibit A to Rule 15c3–3.[10] Under the formula, the broker-dealer adds up various credit and debit line items. The credit items include cash balances in customer accounts and funds obtained through the use of customer securities. The debit items include money owed by customers (*e.g.*, from margin lending), securities borrowed by the broker-dealer to effectuate customer short sales, and required margin posted to certain clearing agencies as a consequence of customer securities transactions. If, under the formula, customer credit items exceed customer debit items, the broker-dealer must maintain cash or qualified securities in that net amount in a Special Reserve Bank Account for the Exclusive Benefit of Customers (the "Special Reserve Bank Account'').[11] This account must be segregated from any other bank account of the broker-dealer. Generally, a broker-dealer with a deposit requirement of $1 million or more computes its reserve requirement on a weekly basis as of the close of the last business day of the week (usually Friday).[12] The weekly calculation determines the required minimum balance the broker-dealer must maintain in the Special Reserve Bank Account.

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5 17 CFR 240.17a–11.

6 The Commission may consider taking action on the other issues raised in the Proposing Release at a later time.

7 *See* Exchange Act Release No. 9856 (November 10, 1972), 1972 SEC LEXIS 189.

8 Subparagraph (a)(3) of Rule 15c3–3 defines ''fully paid securities'' as securities carried in any type of account for which the customer has made a full payment. Subparagraph (a)(5) defines ''excess margin securities'' as securities having a market value in excess of 140% of the amount the customer owes the broker-dealer and which the broker-dealer has designated as not constituting margin securities.

9 15 U.S.C. 78aaa *et seq.*

10 17 CFR 240.15c3–3a.

11 17 CFR 240.15c3-3(e).

12 17 CFR 240.15c3–3(e)(3)

As noted, Rule 15c3–3 also requires a broker-dealer to maintain physical possession or control of all fully paid and excess margin securities carried for customers.[13] This means the broker-dealer cannot lend or hypothecate these securities and must hold them itself or, as is more common, in a satisfactory control location. Under the rule, satisfactory control locations include regulated securities clearing agencies, U.S. banks, and, with the approval of the Commission, certain foreign financial institutions.[14] In order to meet the possession or control requirement, a broker-dealer must determine on a daily basis the amount of customer fully paid and excess margin securities (by issuer and class) it holds for customers.[15] It then compares that amount with the amount of securities it holds free of lien in its own possession or at one of the satisfactory control locations. If a shortfall exists, the firm must take certain actions under the rule.[16] The actions include: (i) removing liens on securities collateralizing a bank loan; (ii) recalling securities loaned to a bank or clearing corporation; (iii) buying-in securities that have been failed to receive over thirty days; or (iv) buying-in securities receivable as a result of dividends, stock splits or similar distributions that are outstanding over forty-five days.[17]

1. Expanded Definition of "Qualified Securities"

As noted above, a broker-dealer is limited to depositing cash or "qualified securities" into the Special Reserve Bank Account it maintains to meet the customer reserve deposit requirements under Rule 15c3-3. Paragraph (a)(6) of Rule 15c3-3 defines "qualified securities" as securities issued by the United States or guaranteed by the United States with respect to principal and interest ("U.S. Treasury securities").[18] These strict limitations on the types of assets that can be used to fund a broker-dealer's Special Reserve Bank Account are designed to further the purpose of Rule 15c3-3; namely, that customer assets be segregated and held in a manner that makes them readily available to be returned to the customer. For example, paragraph (e)(2) of Rule 15c3-3 makes it unlawful for a broker-dealer to use customer credits (generally, cash balances in securities accounts) for any purpose other than financing customer debits (fully secured margin loans).[19] Under the rule, the amount of excess credits (*i.e.*, credits net of debits) must be held in the Special Reserve Bank Account and, as noted, the account must be funded with either cash or U.S. Treasury securities.[20]

As we noted in the Proposing Release, Federated Investors, Inc. ("Federated") filed a petition with the Commission requesting that Rule 15c3-3 be amended to include certain types of money market funds in the definition of qualified securities.[21] In the Proposing Release, we stated that we believed that expanding the definition to include money market funds that only invest in securities meeting the definition of "qualified security" in Rule 15c3-3 would be appropriate. The assets held by such a money market fund would be same as those a broker-

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13 17 CFR 240.15c3–3(b)(1).
14 17 CFR 240.15c3–3(c).
15 17 CFR 240.15c3–3(d).
16 *Id.*
17 *Id.*
18 17 CFR 240.15c3-3(a)(6).
19 17 CFR 240.15c3-3(e)(2).
20 *Id.*
21 *See* Public Petition for Rulemaking No. 4-478 (April 3, 2003), as amended (April 4, 2005), available at http://www.sec.gov/rules/petitions/petn4-478.htm.

dealer can hold directly in its Special Reserve Bank Account. Consequently, a broker-dealer might choose to deposit qualifying money market fund shares into the Special Reserve Bank Account based on operational considerations such as avoiding the need to actively manage a portfolio of U.S. Treasury securities. This operational benefit also could decrease burdens on those broker-dealers that would be impacted by our proposed amendments with respect to Special Reserve Bank Account cash deposits into affiliate and non-affiliate banks. A broker-dealer that deposits cash into the Special Reserve Bank Account to avoid the operational aspects of holding and managing U.S. Treasury securities would have the option of depositing a qualifying money market fund to replace the cash deposit.

We also stated in the Proposing Release that we believed, however, that there should be safeguards in place designed to ensure that qualifying money market fund shares could be redeemed quickly. A broker-dealer in financial difficulty must be able to liquidate quickly the assets in its Special Reserve Bank Account so that customer credit balances can be returned without delay. Consequently, in addition to the limitations on holdings discussed above, our proposal to expand the definition of "qualified securities" to include money market funds included the following safeguards. First, the money market fund may not be a company affiliated with the broker-dealer. The broker-dealer may experience financial difficulty caused by liquidity problems at the holding company level that are adversely impacting an affiliated money market fund as well in terms of the fund's ability to promptly redeem shares. Second, our proposal would require the broker-dealer to use a fund that agrees to redeem fund shares in cash on the next business day. There should be no ability of the fund to delay redemption beyond one-day or to require a multi-day redemption notification period.

Finally, our proposal required that the money market fund have an amount of net assets (assets net of liabilities) that is at least ten times the value of the fund's shares held by the broker-dealer in its Special Reserve Bank Account. This is designed to prevent a broker-dealer from holding too concentrated a position in a single fund. It also limits a potential redemption request by the broker-dealer to 10% or less of the fund's assets. While a redemption request that equaled 10% of a fund's net assets would be very substantial, we believe it is a reasonable threshold between a request that could be handled promptly and one that could have the potential to cause the fund some degree of difficulty in meeting the request within one business day. We sought comment on this threshold, particularly with respect to whether it should be smaller (*e.g.*, 5% or 2%) or higher (*e.g.*, 15% or 25%).

For the foregoing reasons, in the Proposing Release we proposed amending the definition of "qualified security" in paragraph (a)(6) of Rule 15c3-3 to include an unaffiliated money market fund that: (1) is described in Rule 2a-7[22] of the Investment Company Act of 1940 (the "1940 Act"); (2) invests solely in securities issued by the United States or guaranteed by the United States as to interest and principal; (3) agrees to redeem fund shares in cash no later than the business day following a redemption request by a shareholder; and (4) has an amount of net assets equal to at least 10 times the value of the shares deposited by the broker-dealer in its customer reserve account (*i.e.*, the Special Reserve Bank Account).[23]

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22 17 CFR 270.2a-7.

23 Proposing Release, at 12865 and 12894

We solicited comment on all aspects of this proposal, including whether these types of money market mutual funds are appropriate for the Special Reserve Bank Account in terms of liquidity and safety and whether the 10% net asset limitation would be an adequate safeguard in terms of ensuring that a broker-dealer could quickly redeem its shares.

2. Public Comment

In response to this proposal, we received a number of comments that addressed these issues. With regard to whether the Commission should expand the definition of qualified securities to include money market funds that have assets consisting solely of cash and securities issued by the United States or guaranteed by the United States with respect to principal and interest, we received a range of views.

One letter opposed any expansion of the definition of "qualified securities" to include money market funds.[24] Another letter appears to endorse the Commissions' proposal as published in the Proposing Release.[25] Every other letter that commented on the issue supported expanding the definition of "qualified securities," to include a broader range of money market funds than suggested in the Proposing Release.

Consistent with its amended rule petition, Federated initially urged the Commission to expand the definition of "qualified securities" to include, among other things, money market funds that meet the requirements of Rule 2a-7 and that have received the highest money market fund rating from a nationally recognized statistical rating organization.[26] Federated subsequently amended its views and urged the Commission to expand the definition of "qualified securities" to include a money market fund that, among other things, "limits its investments to securities issued or guaranteed by the United States government or its agencies or instrumentalities (including repurchase and reverse repurchase transactions...)."[27] American Beacon Advisers[28],

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24 Letter from Josephine Wang, General Counsel, Securities Investor Protection Corporation ("SIPC"), May 17, 2007 ("SIPC Letter"). SIPC raised concerns about expanding the definition of qualified securities to include certain money market funds. SIPC raised concerns that: (i) money market funds added an additional intermediary into the process; and (ii) a number of broker-dealer liquidations have involved the mishandling of money market or mutual fund shares or the confirmation or purchases of nonexistent money market funds. The SIPC Letter stated that "experience suggests that a money market fund that "invests in nothing but qualified securities" may be more easy to falsify than the qualified securities themselves." One commentator took issue with the SIPC Letter, suggesting that there are already banks and intermediaries involved in the special reserve bank account, that it is no more or less difficult to falsify a money market fund statement than it is to falsify a bank statement, and that a fraudster will have no compunction about either. Letter from Stuart J. Kaswell, Partner, and David J. Harris, Partner, Dechert LLP, August 6, 2007.

25 Letter from Michael Bell, President and CEO, Curian Capital LLC, May 7, 2007 ("Curian Letter").

26 Letter from Stuart J. Kaswell, Partner, Dechert LLP, and David J. Harris, Partner, Dechert LLP, dated May 1, 2007 ("Federated May 2007 Letter"). *See also* Federated amended rule petition, April 4, 2005, attached as Attachment 1 to the Federated May 2007 Letter.

27 Letter from Stuart J. Kaswell, Partner, Dechert LLP, to Erik R. Sirri, Director, Division of Trading & Markets, SEC, Jan. 7, 2008 ("Federated January 2008 Letter). This letter superseded Federated's earlier position of suggesting that the Commission approve money market funds that were AAA-rated. Letter from Stuart J. Kaswell, Partner, and David J Harris, Partner, Dechert LLP, May 1, 2007. *See also* Memorandum from the Office of the Chairman regarding a telephone conference with representatives of Federated Investors, Inc. and Bryan Cave, May 12, 2008.

BlackRock[29], the Securities Industry and Financial Markets Association ("SIFMA")[30], Brown Brothers Harriman ("BBH")[31], and FAF Advisers ("FAF")[32] supported expanding the definition of qualified securities to include money market funds that meet the requirements of Rule 2a-7 and that have a AAA rating. Barclays Global Investors supported expanding the scope of money market funds to include funds that invest in "first tier" securities.[33] The Investment Company Institute ("ICI") made similar comments.[34] Fidelity Investments[35], the U.S. Chamber of Commerce[36], UBS Global Asset Management[37], and The Reserve[38] went further and urged the

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28 Letter from Michael W. Fields, Chief Fixed Income Officer, American Beacon Advisors, June 18, 2007.

29 Letter from Robert E. Putney, III, Director and Senior Counsel, BlackRock June 18, 2007 ("BlackRock Letter").

30 Letter from Marshall Levinson, Chair, SIFMA Capital Committee, June 15, 2007.

31 Letter from Frank A. Perrone, Senior Vice President, BBH, June 14, 2007, ("BBH Letter") at 5.

32 Letter from Charles R. Manzoni, Jr., General Counsel, FAF, May 23, 2007 ("FAF Letter"). FAF supported the Federated comment letter of May 1, 2007. FAF also indicated that "if the Commission does not determine to so revise the proposed definition [as described], we urge it to at least clarify that shares of money market funds that engage in repurchase transactions involving Government Securities, in accordance with Rule 5b-3 under the Investment Company Act, be considered Qualified Securities."[footnote omitted]

33 Letter from David Lonergan, Head of US Cash Management, Barclays Global Investors ("Barclays"), June 18. 2007.

34 ICI states that

> We recommend expanding the proposal to include money market funds that invest exclusively in "first tier" securities as defined under Rule 2a-7. Under Rule 2a-7, a "first tier" security includes a security that has received the highest short-term rating from a nationally recognized statistical rating organization ("NRSRO"), an unrated security that is of comparable quality to a security that has received the highest short-term rating from an NRSRO as determined by a fund's board of directors, a security issued by a money market fund, or a "government security" as defined in the Investment Company Act.

In the event the Commission chose not to expand the definition of qualified securities to include securities beyond the scope of the Proposing Release, ICI stated that "at the very least, we recommend that it clarify that shares of money market funds that invest in repurchase agreements collateralized fully by U.S. Treasury securities be considered "qualified securities" for purposes of the broker-dealer responsibility rules." Letter from Jane G. Heinrichs, Associate Counsel, ICI, June 18, 2007 ("ICI Letter"), at 2-4.

See also letter from Diane V. Eshleman, Executive Vice President, JP Morgan Chase Bank, NA, May 18, 2007, which endorses the ICI Letter with regard to this issue.

35 Letter from Charles S. Morrison, Senior Vice President and Money Market Group Leader, Fidelity Management & Research Company, and John Valenti, Vice President, National Financial Securities LLC, July 23, 2007 ("Fidelity Letter").

36 Letter from David Hirschman, Executive Vice President, National Chamber Foundation of the United States Chamber of Commerce (the "Chamber"), June 18, 2008 ("Chamber Letter").

37 Keith A. Weller, Executive Director & Senior Associate General Counsel, UBS Global Asset Management (Americas) Inc., June 18, 2007 ("UBSGAM"). UBGSAM suggested the following in the alternative: (i) any money market fund that invests only in first tier securities and that has an average daily maturity of sixty days or less; (ii) a money market fund that receives a "AAA" rating from a nationally recognized statistical rating organization; or if the Commission is unwilling to include the broader formulations suggested above, it should at least clarify that a money market fund constituting a qualified security may engage in "repo" transactions that are fully collateralized by U.S. Treasury securities.

38 Email from Bruce Bent, Chairman, The Reserve ("the Reserve"), June 13, 2007.

Commission to expand the definition of qualified securities to include any money market fund satisfying the requirements of Rule 2a-7.[39]

As noted, the Proposing Release would require that: (i) the money market fund not be a company affiliated with the broker-dealer; (ii) the broker-dealer use a fund that agrees to redeem fund shares in cash on the next business day; and (iii) the money market fund must have an amount of net assets (assets net of liabilities) that is at least 10 times the value of the fund's shares held by the broker-dealer in its Special Reserve Bank Account. We discuss comments on each of these issues in turn.

Fidelity objected to the restriction on a broker-dealer using an affiliated money market fund, stating that "a money market fund is a distinct entity, liquidity problems at the holding company level of a broker-dealer will not adversely affect an affiliated money market fund and will not impair the money market fund's ability to promptly redeem shares."[40] ICI[41] and BlackRock[42] took a similar view, as did the American Bankers Association Securities Association, ("ABASA")[43] and SIFMA.[44] First Clearing also raised similar concerns.[45] The American Bar Association Section of Business Law ("ABA") objected to the Commission's imposing this restriction without a factual record. Instead, the ABA suggested that the "Commission use objective standards, such as adequacy of regulation and oversight, management independence, the affiliate's creditworthiness, and the rating assigned to money market fund by a nationally recognized statistical rating organization."[46] Federated supported the proposal.[47]

There was some disagreement on the proposed requirement that the broker-dealer not invest more than ten percent of the money market fund's assets. FAF agreed with the proposal.[48] By comparison, the Reserve stated that "fund assets of 10 times the assets invested is excessive. [Five] times should not be a problem in a triple 'A' fund."[49] Most observers thought that the proposed limitation was too strict. For example, Barclays disagreed with the proposed 10% limitation. ICI also objected to the concentration requirement as too restrictive and urged a higher figure of 25%.[50] BlackRock also recommended a higher figure of 25%.[51] UBSGAM

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39 Apparently, the *Money Fund Intelligence* concurs with this recommendation. Email from Peter G. Crane President, Crane Data LLC, publisher of *Money Fund Intelligence*.

40 Fidelity Letter, at 3-4.

41 ICI Letter, at 4-5.

42 BlackRock Letter, at 4.

43 Letter from Sarah A. Miller, General Counsel, ABASA, June 18, 2007, at 4.

44 SIFMA Letter, at 11.

45 Letter from Matthew M. Hughey, Chief Financial Officer, First Clearing, LLC , June 15, 2007 ("First Clearing Letter"). The letter suggest that if the Commission adopts it proposed narrow definition of qualified securities, it would not be risky for a broker-dealer to use an affiliated money market fund. First Clearing Letter, at 5.

46 Letter from Keith F. Higgins Chair, Committee on Federal Regulation of Securities, ABA, July 3, 2007, at 2-3.

47 Federated January 2008 Letter, at 3.

48 FAF Letter, at 9.

49 The Reserve email.

50 ICI Letter, at 5.

51 BlackRock Letter, at 4.

suggested eliminating the 10% restriction, but suggested a 25% cap in the alternative.[52] Federated initially opposed this restriction[53], but subsequently withdrew its objection.[54]

Some commentators objected to the Commission's proposal to shorten the redemption period to one day, rather than the seven days permitted under Section 22(e) of the 1940 Act.[55] BlackRock generally endorsed the next day redemption requirement, but suggested that the Commission clarify the definition of business day to reference the money market fund's next business day, and include "an exception to the proposed condition for those rare instances where there are unscheduled closings (including early closings) of a Federal Reserve Bank or registered securities exchange, or as otherwise permitted by the Commission."[56] UBSGAM made similar comments.[57] Federated initially endorsed the one-day redemption period with certain exceptions for market emergencies[58] but subsequently withdrew that suggestion.[59] SIFMA expressed concerns that broker-dealers would need to negotiate special arrangements with each money market fund.[60] One commentator disagreed, stating that "a one day redemption [period] is acceptable but [the period] should be same day for [a] redemption prior to 2:00 p.m."[61]

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52 UBSGAM Letter, at 7.

53 Federated May 2007 Letter, at 30.

54 Federated January 2008 Letter, at 4.

55 *E.g.*, Fidelity Letter at 2-3; SIFMA letter at 12; ICI Letter, at 4-5. Section 22(e) of the 1940 Act provides:

> No registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption, except—
>
> > (1) for any period (A) during which the New York Stock Exchange is closed other than customary week-end and holiday closings or (B) during which trading on the New York Stock Exchange is restricted;
> >
> > (2) for any period during which an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets; or
> >
> > (3) for such other periods as the Commission may by order permit for the protection of security holders of the company.
>
> The Commission shall by rules and regulations determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist within the meaning of this subsection.

56 BlackRock Letter, at 4.

57 UBSGAM Letter, at 8.

58 Federated May 2007 Letter, at 28. That letter cites to a similar provision in portfolio margining and Options Clearing Corporation rules.

59 Federated January 2008 Letter, at 3. That letter notes the longer period provided in Section 22(e) of the 1940 Act, as discussed *supra.*

60 SIFMA Letter, at 12. SIFMA suggests as an alternative 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" an approach which it says is analogous to that used for security futures and portfolio margin accounts.

61 The Reserve email.

One commentator objected to the proposed requirement that redemptions must be exclusively in cash, rather than in-kind, as permitted under the 1940 Act.[62]

3. Discussion

The Commission believes that it is appropriate to expand the definition of "qualified securities" in Rule 15c3-3(a)(6) to include certain money market funds.[63] Commentators overwhelmingly concluded that broker-dealers would benefit from the greater flexibility and reduced operational risk associated with allowing broker-dealers to use certain money market funds for purposes of the Special Reserve Bank Account required under Rule 15c3-3(e). Only one commentator opposed allowing broker-dealers to use certain money market funds for the Special Reserve Bank Account. It is our view that the opportunities for fraudsters to falsify the existence of a money market fund is no greater than it is to falsify the existence of a bank account. Moreover, broker-dealers that pledge U.S. Treasury securities to their Special Reserve Bank Account must inevitably use one or more intermediaries in the process.[64] As a consequence, we find the investor protection arguments against allowing broker-dealers to use any money market funds to be unpersuasive. Accordingly, we do not believe that it is appropriate to deny broker-dealers the benefits of the reduced costs and operational risks that would attend their use of money market funds.

The next issue is whether the Commission should accept the weight of the commentators' views that qualified securities should include more than just money market funds that have assets consisting solely of cash and securities issued by the United States or guaranteed by the United States with respect to principal and interest. The initial rationale for such an approach is that it would essentially replicate the assets that the broker-dealer could hold directly in the Special Reserve Bank Account. Commentators suggested, however, that the proposal was unduly restrictive and pointed to the extraordinary record of money market funds over the past decades. The Commission observes that conventional money market funds, *i.e.*, funds that meet the requirements of Rule 2a-7, have been able to maintain a net asset value of $1.00 per share and

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62 Fidelity Letter. Section 2(a)(32) of the 1940 Act provides:

> "Redeemable security" means any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.

See also SEC, Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation,* (May 1992), at 467; Rule 18f-1 under the 1940 Act; and discussion in Lemke, Lins, and Smith, Regulation of Investment Companies (2008) at §8.06[3][b].

63 We refer to money market funds that constitute "qualified securities" under Rule 15c3-3(a)(6)(ii) as a "qualified money market fund."

64 NYSE Regulation Rule Interpretation Handbook, SEC Rule 15c3-3, which provides for depositing uncertificated securities to the special reserve account and for reverse repurchase agreement securities, citing New York Stock Exchange, *Interpretation Memo* No. 89-13 dated November 27, 1989, (SEC Staff to NYSE) (No. 90-1, February, 1990). Interpretation available at http://apps.nyse.com/commdata/pubsecruleinterp.nsf/docs/CCF1397F9A2F40EC852572CD0051D411/$FILE/SEA%20Rule%2015c3-3%20Interpretations.pdf.

have not experienced problems that have resulted in harm to investors.[65] We are concerned that the proposed universe of money market funds would force too many broker-dealers to compete for too few money market funds that would meet the proposed definition, needlessly exacerbating demand for U.S. Treasury securities.[66] Accordingly, we are adopting a definition of qualified securities to include a money market fund that, among other things, limits its investments to securities issued or guaranteed by the United States government or its agencies or instrumentalities (including repurchase and reverse repurchase transactions).

We have determined not to embrace the suggestions of some commentators that the Commission adopt a requirement for funds that have received a top rating from an NRSRO. The Commission believes that it would not be wise in this context to confer regulatory status on ratings that private organizations award.[67] Similarly, the Commission does not believe that the protection of customer funds should be dependent on rating standards over which it has no control.

The Commission has concluded that its initial formulation would be too restrictive and would unduly limit the benefits of the proposal. Accordingly, the Commission is adopting a compromise, defining a qualified money market fund as the redeemable securities of a registered investment company that, among other things, limits its investments to securities issued or guaranteed by the United States government or its agencies or instrumentalities (including repurchase and reverse repurchase transactions).[68]

The Commission has considered the comments on the other aspects of its proposal and we discuss each in turn. With regard to the requirement that the money market fund be unaffiliated from the broker-dealer, we appreciate that the requirements of the 1940 Act and Rule 2a-7 require the strict segregation of portfolio assets from the adviser's other assets, or from the assets of other affiliates. Nonetheless, we are concerned at this juncture that it would be premature to allow broker-dealers to use affiliated money market funds for the Special Reserve Bank Account. The Commission believes that it would be wise to allow the marketplace to have

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65 On February 14, 2008, Chairman Cox testified before U.S. Senate Committee on Banking, Housing and Urban Affairs that:

> Commission rules limit money market funds to investing in high-quality, short-term investments in an effort to ensure that these bedrocks of the financial system are reliable in all market conditions. Losses by a money market fund would be reflected by the fund re-pricing its securities below $1.00 (known as "breaking the buck"). Only one fund, and that of very modest size, has ever broken the buck since the development of money market funds in the 1970s. The Commission is closely monitoring the fund industry and while we have seen some instances of funds requiring infusions of capital from the corporate parents of fund advisers, we are not aware of any money market fund that is threatened with having to reprice below $1.00.

Available at http://www.sec.gov/news/testimony/2008/ts021408cc.htm.

66 *Cf.* UBSGAM Letter.

67 The Commission is not suggesting that this concern applies in other contexts.

68 The Commission intends that broker-dealers deposit or pledge shares in one or more qualified money market funds to their Special Reserve Bank Accounts using various appropriate means. For example, a broker-dealer could pledge such shares through the facilities of a clearing agency registered under Section 17A of the Exchange Act.

some experience with this change, and perhaps consider the use of affiliated money market funds at a later date.

The Commission also has concluded that it will require money market funds to agree to redeem shares in cash no later than the business day following a redemption request by a shareholder. The Commission appreciates that Section 22(e) of the 1940 Act allows for a seven day redemption period and that it includes an exemption for certain market emergencies. Of course Rule 2a-7 itself establishes additional, and sometimes more rigorous standards for money market funds, as distinguished from other types of redeemable investment companies, because of the special liquidity and stable net asset value requirements of money market funds. The Commission believes that broker-dealers must have access to funds held in the Special Reserve Bank Account on a same day or next day basis to ensure liquidity and to protect customers. Consequently, the Commission does not believe that it would be appropriate to embrace the seven day standard of Section 22(e) of the 1940 Act in this context. The Commission appreciates that market emergencies may make it impractical for funds to redeem shares in certain market emergencies. Accordingly, the Commission anticipates that broker-dealers and qualified money market funds (and their advisers) would work with the staff on a case-by-case basis under such circumstances.

With regard to the ten percent net asset test in proposed Rule 15c3-3(6)(ii)(C), the Commission is not persuaded that this restriction is inappropriate at this time. The Commission believes it would be prudent to diversify the use of qualified money market funds and prevent a broker-dealer having too great a concentration of money in a single qualified money market fund. The Commission plans to revisit this issue at a future date to determine whether it should permit greater concentration in one qualified money market fund.

B. Adjusted Net Capital Requirements for Money Market Funds

1. Description of Proposal

We proposed an amendment that would reduce the "haircut" broker-dealers apply under Rule 15c3-1 for money market funds from 2% to 1%. In 1982, the Commission adopted a 2% haircut requirement for redeemable securities of an investment company registered under the 1940 Act that holds assets consisting exclusively of cash or money market instruments and which is known as a "money market fund."[69] The 2% haircut was adopted before the Commission adopted certain amendments to Rule 2a-7 that strengthened the risk-limiting investment restrictions for money market funds.[70] Rule 2a-7 defines a money market fund generally as an investment company limited to investing in U.S. dollar denominated securities that present minimal credit risks and that are, at the time of acquisition, "eligible securities."[71] In particular, the rule requires that the securities purchased by a money market fund be short-term

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69 Exchange Act Release No. 18737 (May 13, 1982), 47 FR 21759 (May 20, 1982). *See* 17 CFR 240.15c3-1(c)(2)(vi)(D)(*1*).

70 Investment Company Act Release No. 18005 (February 20, 1991), 56 FR 8113 (February 27, 1991).

71 17 CFR 270.2a-7.

instruments of issuers that are deemed a low credit risk.[72] The rule also requires the fund to diversify its portfolio of securities.[73] Based on the enhancements to Rule 2a-7, as well as the historical stability of money market funds as investments, we proposed to amend paragraph (c)(2)(vi)(D)(*1*) of Rule 15c3-1 to reduce the haircut on such funds from 2% to 1%. This proposed amendment is designed to better align the net capital charge with the risk associated with holding a money market fund. A further amendment would clarify that a money market fund, for the purposes of paragraph (c)(2)(vi)(D)(*1*), is a fund described in Rule 2a-7.

We requested comment on all aspects of this amendment, including on whether it is appropriate to reduce the haircut to 1% and, alternatively, whether the haircut for certain types of money market funds should be reduced to 0% as suggested by Federated in its petition to the Commission.[74]

2. Public Comment

We received substantial comments on the proposed reduction in haircut, all of which supported a reduction in the haircut for money market funds. Commentators unanimously supported a greater reduction below 1%, although they differed as to how much of a reduction was appropriate and under what circumstances.

ICI indicated its support for reducing the haircut on money market funds. ICI stated that "given the safety, stability, and liquidity of money market funds and the strict requirements of Rule 2a-7, ... we believe the Commission should lower the haircut for money market funds to zero percent.[75] BlackRock similarly urged a reduction to zero percent.[76] Barclays,[77]

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72 *See id.*

73 *Id.*

74 *See* Public Petition for Rulemaking No. 4-478 (April 3, 2003), as amended (April 4, 2005), available at http://www.sec.gov/rules/petitions/petn4-478.htm.

75 ICI Letter, at 6-7. In the alternative, ICI stated:

> To the extent the Commission determines it is necessary to impose a haircut of greater than zero percent on money market funds, we recommend that a bifurcated haircut scheme be implemented. Bifurcation could, for example, recognize the distinction between Rule 2a-7 money market funds generally (which would be subject to a haircut greater than zero percent) and money market funds that qualify for deposit in a broker-dealer's special reserve account under Rule 15~3-3 (which would be subject to a zero percent haircut).

Id at 7.

76 Similar to the ICI Letter, BlackRock noted:

> To the extent the Commission determines it is necessary to impose a haircut of greater than zero percent on money market funds, we recommend that a bifurcated haircut scheme be implemented. Bifurcation could, for example, recognize the distinction between Rule 2a-7 money market funds generally (which would be subject to a haircut greater than zero percent), and money market funds that qualify for deposit in a broker-dealer's special reserve account under Rule 15c3-3 (which would be subject to a zero percent haircut).
>
> If the Commission determines it necessary to impose a haircut on those money market funds that do not qualify for deposit in a broker-dealer's special reserve account, we

UBSGAM,[78] BBH,[79] and Curian[80] urged reducing the haircut to zero percent for money market funds that satisfy Rule 2a-7. The Chamber[81] and FAF[82] urged a 0% haircut for AAA-rated money market funds. Deutsche Bank Securities supported a reduction in the haircut and stated that a further reduction, such as to ½ of 1%, would be appropriate.[83] SIFMA urged the Commission to adopt a lower haircut of 0.625% or $\frac{5}{8}^{ths}$ of 1%.[84]

Federated indicated its initial comment letter that the Commission should reduce the haircut to 0% and stated that no AAA-rated money market fund had ever had a failure. It also compared the proposed 1% haircut for money market funds to the haircuts imposed on other securities. Based on that comparison, Federated suggested that the proposed haircut was disproportionately high.[85] Federated subsequently favored a reduction of the haircut to 0.25%.[86] or 0.50%.

> suggest that the haircut certainly should not exceed 1/8 of 1%. We suggest this because a 1/8% haircut is imposed on commercial paper that is rated in one of the three highest categories and, therefore, may be expected to be of lesser credit quality than these money market funds, whose quality will be at least equivalent to the top two rating categories. The low risk associated with holding a money market fund merits application of the lowest possible net capital charge.

BlackRock Letter, at 5.

77 Barclays Letter, at 2

78 UBSGAM Letter, at 9-10.

79 BBH Letter, at 5.

80 Curian Letter, at 3.

81 Chamber Letter, at 3.

82 FAF Letter, at 10.

83 Letter from Marcelo Riffaud, Managing Director, Legal Department, Deutsche Bank Securities, Inc., June 18, 2007, at 9.

84 SIFMA noted:

> 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 $1/8^{th}$ 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. Certain municipal securities with similar maturities also require a capital charge of $1/8^{th}$ of 1%
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> ***
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> In our view, an appropriate maximum capital charge for money market funds would be 0.625%, or $\frac{5}{8}^{ths}$ of 1%. This charge reflects a combination of (i) a charge of $\frac{1}{8}^{th}$ 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. [Footnotes omitted.]

SIFMA Letter, at 39.

85 Federated May 2007 Comment letter. For example, Federated noted that Rule 15c3-1 imposes a 1/8 of 1 % haircut on certain municipal securities and commercial paper, bankers' acceptances, and certificates of deposit. Federated suggested that these securities had as much or greater risk than AAA-rated money market funds. *Id* at 24-25.

86 Federated Letter January 2008. at 2.

3. Discussion

The Commission believes that its proposal to reduce the net capital charge from the current 2% is appropriate. The commentators that discussed the issue all urged various further reductions in the haircut. As noted below, the Commission believes that there are several justifications for a further reduction in the haircut.

As noted, a number of commentators suggested that the proposed 1% haircut is not proportionate to haircuts that the rule imposes on other types of securities. For example, we agree with the suggestion that ⅛th of 1% haircut on municipal securities, commercial paper, bankers' acceptances, and certificates of deposit with maturities of 30 days to less than 91 days, warrants a haircut of less than 1% on money market funds. Commentators[87] also pointed to the process by which Rule 2a-7 and fund boards[88] must monitor any disparities between the amortized cost method of calculating net asset values[89] and the current asset value per share using available market quotations (or an appropriate substitute).[90]

Based on the comments, the Commission concurs that a greater reduction in haircut is appropriate for qualified money market funds. Accordingly, the Commission is adopting as proposed the 1% haircut for any money market fund that satisfies Rule 2a-7, and is adopting a haircut of 0.5% for a qualified money market fund. The Commission believes that such a differentiation would better align the net capital charges with the risks associated with holding different types of money market funds.[91]

C. Collateral for Fully-Paid and Excess Margin Securities

In addition to the matters that the Commission proposed for comment, a number of commentators made an additional suggestion regarding Rule 15c3-3(b)(iii)(A). These commentators suggested that the Commission should permit broker-dealers to use money market funds as collateral for fully-paid or excess margin securities.[92]

Money market funds that satisfy Rule 2a-7 must meet high standards of portfolio diversification, quality, maturity, and liquidity. As noted, the Commission believes that money market funds have demonstrated a strong record of safety and stability. We believe that this record warrants granting the relief requested. Accordingly, the Commission is issuing a companion release granting the relief.

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87 *See*, e.g., SIFMA Letter, at p. 39 and note 116; UBSGAM Letter, at 10.

88 Rule 2a-7(c)(1) and (c)(7)(ii)(3)(B)

89 Rule 2a-7(a)(2).

90 *See* Rule 2a-7(c)(1)

91 *See e.g.* discussion above re ICI Letter, BlackRock Letter, and Federated January 2008 Letter.

92 These suggestions include Federated's amended rule petition, the Federated May 2007 Comment Letter at 20, Federated January 2008 Letter at 6; ICI Letter, at note 3 (general support for other initiatives); Chamber Letter, at 2; UBSGAM Letter, at 9; and FAF Letter at 3 (regarding top rated money market funds). *Cf.* Letter from James J. Angel, Associate Professor of Finance, McDonough School of Business, Georgetown University, June 15, 2007 (urging the Commission to ease restrictions on lending fully-paid securities).

III. Paperwork Reduction Act

The rule amendments do not impose recordkeeping or information collection requirements, or other collections of information that require approval of the Office of Management and Budget under 44 U.S.C. 3501, *et seq*. Accordingly, the Paperwork Reduction Act does not apply. We received no comments on this issue.

IV. Consideration of Benefits and Costs

A. Expansion of the Definition of Qualified Securities To Include Qualified Money Market Funds

The proposed amendment to Rule 15c3–3 would permit broker-dealers to deposit certain money market funds in the Special Reserve Bank Account. In the Proposing Release, we stated that this change would benefit broker-dealers subject to the customer reserve requirements in Rule 15c3–3 by creating a deposit alternative to cash and U. S. Treasury securities. We also said that it would not result in any additional costs to broker-dealers. In addition, we indicated in the Proposing Release that we did not believe the proposal would result in costs to broker-dealers.[93] We asked commentators to provide information on both benefits and costs.

As noted, several commentators recommended that the Commission adopt a definition of qualified security that would permit money market funds to invest in a broader range of securities than those initially proposed. One commentator, Federated, stated that the costs of the proposal would be minimal and also suggested that the benefits of the original proposal would be minimal.[94] Federated has supplemented its views and supports the definition of qualified money market fund with the formulation we are adopting.[95]

The Commission believes that the costs of the proposal will be minimal and that it will be a simple matter for broker-dealers to use certain types of money market funds for the Special Reserve Bank Account. We understand that broker-dealers may pledge these money market funds through the facilities of a registered securities depository to their Special Reserve Bank Account at little or no cost.

The Commission believes that, as adopted, the definition of qualified money market fund will provide additional safety and convenience to broker-dealers in complying with the reserve account requirements. In particular, broker-dealers will have less difficulty ensuring that they have the necessary amount of cash and U.S. Treasury securities to comply with the requirements of Rule 15c3-3(e). Moreover, we believe that broker-dealers will have lower operational risk as a consequence of using qualified money market funds, instead of buying individual U.S. Treasury securities.

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93 72 FR at 12881.

94 Federated May 2007 Letter, at 31.

95 Federated January 2008 Letter.

B. Net Capital Rule Adjustments

In the Proposing Release, we stated that these proposed amendments would adjust required charges for broker-dealers under Rule 15c3–1. The Commission intended that the proposed adjustments would better align the net capital requirements of affected firms with the risks Rule 15c3–1 seeks to mitigate. The amendments are relaxing existing requirements and, therefore, would not result in costs to broker-dealers. Moreover, because they seek to better match capital requirements with actual risk, the amendments should not have an adverse impact on the financial strength of broker-dealers.[96]

As noted, several commentators urged the Commission to make further reductions in the haircut for different types of money market funds. The Commission believes that a reduction to 1% for any money market fund that satisfies Rule 2a-7, and a further reduction to 0.5% for qualified money market funds is warranted and reflects the relevant costs and benefits.

V. Consideration of Burden on Competition, and on Promotion of Efficiency, Competition, and Capital Formation

The amendment expanding the definition of "qualified securities" to include qualified money market funds would reduce operational burdens associated with holding securities in the Special Reserve Bank Account and, thereby, promote efficiency.[97] As noted, one commentator objected to the original proposal, but supports the definition of qualified money market fund as adopted.[98] The Commission believes that the definition of qualified securities, as adopted, will better achieve these objectives.[99]

The amendments to the net capital rule will reduce the amount of net capital certain broker-dealers must maintain and will improve efficiency and competition and promote capital formation by allowing firms to employ such capital in other areas of their business activities. They also would lower the costs of capital for broker-dealers.

VI. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA"[100] we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in (1) an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease), (2) a major increase in costs or prices for consumers or individual industries, or (3) significant adverse effect on competition, investment

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96 72 FR at 12887.

97 *See* section II.A.1 of this release.

98 Federated May 2007 Letter, at 32; Federated January 2008 Letter.

99 *Cf.* Financial Services Authority (U.K.), Client Assets, CASS 7.4.4 (permitting firms to hold customer funds in a qualifying money market fund).

100 Pub. L. No. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

or innovation. If a rule is ''major,'' its effectiveness will generally be delayed for 60 days pending Congressional review. We requested comment on the potential impact of these proposed amendments on the economy on an annual basis. We received no specific comment on this issue.

Based on its understanding of the operations of broker-dealers and money market funds, the Commission believes that when adopted, these changes are unlikely to result in (1) an annual effect on the economy of $100 million or more (either in the form of an increase or a decrease), (2) a major increase in costs or prices for consumers or individual industries, or (3) significant adverse effect on competition, investment or innovation.

VII. Final Regulatory Flexibility Analysis

The Commission has prepared a Final Regulatory Flexibility Analysis (''FRFA''), in accordance with the provisions of the Regulatory Flexibility Act (''RFA''),[101] regarding the amendments to Rule 15c3-3 and Rule 15c3-1 under the Exchange Act. An Initial Regulatory Flexibility Analysis (''IRFA'') was prepared in accordance with the RFA and was included in the Proposing Release. We solicited comments on the IRFA, but received none.

A. Amendments to the Customer Protection Rule

1. Reasons

The amendment would expand the definition of "qualified securities" is intended to provide broker-dealers with another option with respect to assets that can be deposited into the Special Reserve Bank Account.

2. Objectives

The amendment would expand the definition of qualified security is intended to lower operational burdens of broker-dealers.

3. Legal Basis

Pursuant to the proposal is the Exchange Act and, particularly, Section 15, 15 U.S.C. 78o.

4. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0–10[102] states that the term "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–

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101 5 U.S.C. 604.

102 17 CFR 240.0–10(c)(1).

5(d);[103] and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

The Commission estimates there are approximately eight broker-dealers that performed a customer reserve computation pursuant to Rule 15c3–3 and were ''small'' for the purposes of Rule 0–10.[104]

5. Reporting, Recordkeeping, and Other Compliance Requirements

The amendments would not impose any new restrictions on broker-dealers. To use a qualified money market fund for the Special Reserve Bank Account, a broker-dealer only would need to be certain that the qualified money market fund was not affiliated with the broker-dealer and ensure that each fund's net assets (assets net of liabilities) is equal to at least 10 times the value of the fund shares held by the broker-dealer in the Special Reserve Bank Account.

6. Duplicative, Overlapping or Conflicting Federal Rules

We believe that there are no Federal rules that duplicate, overlap or conflict with the amendments.

7. Significant Alternatives

Pursuant to Section 3(a) of the RFA,[105] the Commission must consider certain types of alternatives, including (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities, (3) the use of performance rather than design standards, and (4) an exemption from coverage of the rule, or any part thereof, for small entities.

Given the negligible burden that these amendments would have on small entities, we do not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities; or exempt small entities from coverage of the rule, or any part thereof. The Commission also does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed amendments as the amendments already propose performance standards and do not dictate for entities of any size any particular design standards (*e.g.*, technology) that must be employed to achieve the objectives of the proposed amendments.

B. Adjusted Net Capital Requirements

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103 17 CFR 240.17a–5(d).

104 This estimate is based on FOCUS Report filings.

105 5 U.S.C. 603(c).

1. Reasons

The Commission's experience over the past several years in overseeing the capital requirements of broker-dealers indicates that certain capital charges may be adjusted downward without impairing the goal of the net capital rule. These amendments are a result of this experience.

2. Objective

The amendments are intended to better align the capital requirements with the risks these requirements are designed to address.

3. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 15 and 17 thereof, 15 U.S.C. 78o and 78q.

4. Small Entities

Subject to the Rule Paragraph (c)(1) of Rule 0–10[106] states that the term "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d);[107] and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

The Commission estimates that there are approximately 915 broker-dealers that are "small" for the purposes Rule 0–10.[108] The reduction of the haircut for money market funds from 2% to 1% could impact all "small" firms, since they may hold these securities as part of their net capital.

5. Reporting, Recordkeeping, and Other Compliance Requirements

The amendment would lower the haircut for money market funds from 2% to 1%. As noted, we estimate that generally only the second amendment would affect "small" broker-dealers.

6. Duplicative, Overlapping or Conflicting Federal Rules

We believe that there are no federal rules that duplicate, overlap or conflict with the amendments.

7. Significant Alternatives

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106 17 CFR 240.0–10(c)(1).

107 17 CFR 240.17a–5(d).

108 This estimate is based on FOCUS Report filings.

Pursuant to Section 3(a) of the RFA,[109] the Commission must consider certain types of alternatives, including: (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities, (3) the use of performance rather than design standards, and (4) an exemption from coverage of the rule, or any part thereof, for small entities.

Given the deregulatory impact of these amendments, we do not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities; or exempt small entities from coverage of the rule, or any part thereof.

The Commission also does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed amendments as the amendments already propose performance standards and do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed amendments.

VIII. Statutory Authority

The Commission is adopting amendments to Rule 15c3–1 and Rule 15c3–3 under the Exchange Act pursuant to the authority conferred by the Exchange Act, including Sections 15, 17, 23(a), and 36.[110]

Text of Final Rule Amendments

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, the Commission amends Title 17, Chapter II of the Code of Federal Regulation as follows.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The general authority for part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–l, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

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109 5 U.S.C. 603(c).

110 15 U.S.C. 78o, 78q, 78w, and 78mm.

2. Section 240.15c3–1 is amended by revising paragraph (c)(2)(vi):

(D)(*1*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets consist of cash or money market instruments and which is described in § 270.2a–7 of this Chapter, the deduction shall be 1% of the market value of the greater of the long or short position; *provided however* that in the case of redeemable securities of a qualified money market fund as defined in § 240.15c3-3(a)(6)(ii) of this Chapter, the deduction shall be 0.50% of the market value of the greater of the long or short position

3. Section 240.15c3–3 is amended by revising paragraph (a) to provide:

(6) The term *qualified security* shall mean:

(i) A security issued by the United States or guaranteed by the United States with respect to principal or interest; and

(ii) A *qualified money market fund,* which shall be defined as a redeemable security of an unaffiliated investment company registered under the Investment Company Act of 1940 and described in § 270.2a–7 of this chapter that:

(A) Limits its investments to securities issued or guaranteed by the United States government or its agencies or instrumentalities (including repurchase and reverse repurchase transactions);

(B) Agrees to redeem fund shares in cash no later than the business day following a redemption request by a shareholder; and

(C) After the completion of the purchase, has net assets (assets net of liabilities) equal to at least 10 times the value of the fund shares held by the broker-dealer in the customer reserve account required under paragraph (e) of this section.

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By the Commission.
Dated: June [ ], 2008

[ ]
Secretary

6/3/2008 3:30 PM

FEDERATED DRAFT – May 30, 2008

SECURITIES AND EXCHANGE COMMISSION

[Securities Exchange Act of 1934: Release No. XXXX and International Series Release No. XXXX]

Order Regarding the Collateral Broker - Dealers Must Pledge When Borrowing Customer Securities

June XX, 2008.

Section 36 of the Securities Exchange Act of 1934 ("Exchange Act") authorizes the Securities and Exchange Commission ("Commission"), by rule, regulation, or order, to conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions from any provision or provisions of the Exchange Act or any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

By this Order, the Commission will allow broker-dealers that borrow fully-paid[1] or excess margin[2] securities from customers to pledge redeemable securities issued by one or more investment companies that meet the requirements of Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act")[3]. Rule 15c3-3(b)(3)(iii)(A) permits the Commission to designate additional types of collateral as permissible by order as necessary or appropriate in the public interest and consistent with the protection of investors after giving consideration to the collateral's liquidity, volatility, market depth and location, and the issuer's creditworthiness. The Commission believes that Rule 2a-7 Funds satisfy these requirements.

Rule 2a-7 establishes strict requirements for money market funds including:

1. portfolio diversification – taxable money market funds must limit their investments in the securities of any one issuer (other than Government securities) to five percent of fund assets;[4]

2. portfolio maturity — a money market fund must not (with certain limitations) acquire any instrument that has a remaining maturity of greater than 397 days or have a dollar-weighted average maturity that exceeds ninety days;[5]

3. portfolio quality – a taxable money market fund shall not have invested more than five percent of its total assets in securities that are second tier securities;[6] and

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1 As defined in rule 15c3–3, "fully paid" securities are securities carried by a broker-dealer for which the customer has paid the full purchase price in cash. 17 CFR 240.15c3–3(a)(3).

2 As defined in rule 15c3–3, "excess margin" securities are securities carried by a broker-dealer that have a market value in excess of 140% of the amount the customer owes the broker-dealer. 17 CFR 240.15c3–3(a)(5)

3 We refer to these mutual funds as "Rule 2a-7 Funds".

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

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

6 Rule 2a-7(c)(3)(ii)(A).

4. portfolio liquidity – a money market fund may not invest more than ten percent of its assets in illiquid securities.[7]

The Order is consistent with the objectives of paragraph (b)(3) of Rule 15c3–3, which is designed to ensure that broker-dealers' borrowings from customers remain fully collateralized.

The Commission took into account several considerations in deciding whether to provide this exemptive relief and designate an additional category of permissible collateral. For example, the Commission considered whether the risks of customer losses associated with permitting a new category of collateral were sufficiently small relative to the benefits that additional kinds of collateral will provide. Those benefits include, among other things, adding liquidity to the securities lending markets and lowering borrowing costs for broker-dealers. In issuing this Order, the Commission is drawing on its experience in assessing the liquidity of markets in a variety of contexts including, for example, the net capital requirements for broker-dealers.

Rule 15c3-3 currently requires that the collateral provided by a broker-dealer fully collateralize its obligation to a customer, and that the value of the loaned securities and the collateral be marked to market on a daily basis to meet this requirement. We note that Section 22(c) of the 1940 Act and Rule 22c-1 thereunder require registered investment companies issuing redeemable securities to calculate the fund's net asset value on a daily basis.

The Commission finds that this exemption is appropriate in the public interest, and consistent with the protection of investors. The exemption will add liquidity to the securities lending markets and lower borrowing costs while maintaining the customer protection objectives of Rule 15c3–3.

Accordingly, it is ordered, pursuant to Section 36 of the Exchange Act, that, broker-dealers may pledge, in accordance with all applicable conditions set forth below and in paragraph (b)(3) of Rule 15c3–3, the following type of collateral (in addition to those permitted under paragraph (b)(3) of Rule 15c3–3) when borrowing fully paid and excess margin securities from customers:[8]

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[7] Adopting release for Rule 2a-7. Release No. IC-13380 (July 11, 1983); 48 FR 32555 (July 18, 1983). The release notes that:

> Money market funds relying on the rule, like any other open-end management company, must limit their portfolio investments in illiquid instruments to not more than ten percent of their net assts. However, because of the nature of money market funds, the difficulties that could arise in conjunction with the purchase of illiquid instruments by such funds might be even greater than for other types of open-end management companies. Therefore, the board of directors of a money market fund relying on the rule may have a fiduciary obligation to limit further the acquisition of illiquid portfolio investments [footnotes omitted].

Id at 32561.

[8] Any prior staff interpretation or no-action positions concerning Rule 2a-7 Funds as collateral under paragraph (b)(3) of Rule 15c3–3 is herewith withdrawn.

Redeemable securities issued by one or more open-end management companies registered under Section 8 of the Investment Company Act of 1940 and described in 17 CFR 270.2a-7.

By the Commission.

[ ]
Secretary.

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