Federated

Submission to the Honorable Troy A. Paredes Commissioner U.S. Securities and Exchange Commission On behalf of Federated Investors, Inc.

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August 7, 2008

The Honorable Troy A. Paredes
Commissioner
U.S. Securities and Exchange
Commission
100 F Street, NE
Washington, D.C. 20549

Re: Exchange Act Release 55431[1]

Dear Commissioner Paredes:

On behalf of our client Federated Investors, Inc. ("Federated")[2], I wish to request a meeting with you at your earliest convenience. The purpose of the meeting is to discuss our suggestions for changes to the Securities and Exchange Commission's (the "SEC" or the "Commission") financial responsibility rules, in the context of the rulemaking cited above. Eugene F. Maloney, Executive Vice President, Federated, and I would attend the meeting.

Federated has been seeking changes to the Commission's financial responsibility rules for over five years. Federated has altered its position several times to respond to concerns expressed by Chairman Christopher Cox, other Members of the Commission, and the Staff, as well as to respond to changes in the marketplace.[3] Although we prefer by far to see the Commission make these changes by rule, we also have sought legislation that would direct the Commission to adopt changes to the financial responsibility rules.[4] The public file clearly

1 March 9, 2007; 72 FR 12862 (March 19, 2007) (the "Release"). Comments are included in File No. S7-08-07.

2 Federated is one of the largest investment managers in the United States, managing $338.5 billion in assets as of March 31, 2008. With 147 mutual funds and various separately managed account options, Federated provides comprehensive investment management to more than 5,400 institutions and intermediaries including corporations, government entities, insurance companies, foundations and endowments, banks and broker-dealers.

3 Federated filed an initial petition for rulemaking on April 3, 2003; it filed an amended petition on April 4, 2005. It has filed additional comment letters and submissions to the Commission that reflect Federated's revised recommendations.

4 H.R. 1171 (110th Cong. 1st Sess.), Feb. 16, 2007, introduced by Cong. Gregory W. Meeks (D-NY) and Cong. Patrick J. Tiberi (R-OH) (original co-sponsor). Other sponsors include: Cong. Jason Altmire (D- PA); Cong. William Lacy Clay (D-MO); Cong. Phil

discloses our views on these issues; nonetheless we thought it important to outline our views in this letter for your consideration.

Amendments to the Customer Protection Rule – Rule 15c3-3

A. Special Reserve Bank Account

Federated believes that the Commission should amend customer protection rule, Rule 15c3-3 (17 CFR §240.15c3-3) to permit broker-dealers to use certain money market funds as "qualified securities" under the rule. According to one authority:

> Every broker-dealer must ... maintain with a bank or banks when deposits are required a "Special Reserve Bank Account for the Exclusive Benefit of Customers," separate from any other bank account of the broker or dealer. The broker-dealer must maintain in this Reserve Bank Account cash or qualified securities or both in amounts computed in accordance with Rule 15c3-3a. This formula requires, in essence, a deposit of the excess of total credits over total debits. This "Reserve Formula" is designed to eliminate the use of customers' funds and securities by broker-dealers in financing firm overhead and such dealer activities as market making, proprietary trading, and underwriting.[5]

Rule 15c3-3(e) provides that a broker-dealer may deposit only "cash and/or qualified securities in an amount not less than the amount computed in accordance with the formula set forth in

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English (R-PA); Cong. James Gerlach (R-PA); Cong. Steven C. LaTourette (R-OH). This legislation would have directed the Commission to amend the financial responsibility rules in accordance with a prior formulation that Federated advocated. This letter reflects Federated's current suggestions for changes to these rules.

5 Loss, Seligman, Paredes, Securities Regulation, ch. 8, Regulation of Brokers, Dealers, and Investment Advisers, B. Broker-Dealer Substantive Regulation, §1, Protection of Customers' Funds and Securities, c. Financial Responsibility, (iv) Segregation and Reserve Requirements (CCH)(footnotes omitted)(hereinafter referred to as "Loss, Seligman, and Paredes").

As described by the Commission, Rule 15c3-3 requires that:

> 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. *** The required amount of customer funds to be segregated is calculated pursuant to a formula set forth in Exhibit A to Rule 15c3–3. 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.'' This account must be segregated from any other bank account of the broker-dealer.

Release at 12862 (footnote omitted).

§240.15c3–3a." Rule 15c3-3(a) (6) defines the term *qualified security* as meaning "a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States."

In the Release, the Commission noted that Federated had filed a petition with Commission requesting that it amend Rule 15c3-3 to include certain types of money market funds in the definition of qualified securities. The Commission proposed expanding the definition to include only those money market funds that invest in the same assets as those in which the broker-dealer can invest directly.[6] Accordingly, the Commission proposed to add to the definition of "qualified security" the following:

> (ii) 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[7] that:
>
> > (A) Has assets consisting solely of cash and securities issued by the United States or guaranteed by the United States with respect to principal and interest[8];
> >
> > (B) Agrees to redeem fund shares in cash no later than the business day following a redemption request by a shareholder[9]; and

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6 Release at 12865.

7 We refer to a money market fund that satisfies the requirements of Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act") as a "Rule 2a-7 Fund." We discuss the characteristics of Rule 2a-7 Funds later in this letter.

8 For the sake of convenience, we refer to such money market funds as "Treasury-only funds." In fact, they could hold certain other securities, too.

9 We note that this requirement is much more strict than Section 22(e) of the 1940 Act, which 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
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> (3) for such other periods as the Commission may by order permit for the protection of security holders of the company.

> (C) 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.[10]

The Commission specifically solicited comment on this aspect of the Release:

> We solicit comment on all aspects of this proposal, including whether these types of money market funds are appropriate for the customer reserve account in terms of liquidity and safety and whether the 10% net asset limitation would be an adequate safeguard in terms of ensuring a broker-dealer could quickly redeem its shares.[11]

Federated now generally supports this formulation, but with one important change.[12] We respectfully urge the Commission to substitute the following language for subparagraph (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).[13]

The difference in the definition of portfolio assets would allow the fund to purchase securities issued by agencies including Government Sponsored Enterprises ("GSEs"), such as the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac").[14] A fund with such a portfolio investments would provide additional yield over Treasury-only funds but still would be extremely safe. In the absence of this additional yield, it is our belief that broker-dealers would not be interested in purchasing qualified money market funds for their special reserve bank accounts.[15] In other words, without this change, this aspect of the Release becomes a "dead letter."

The markets have always assumed that Fannie Mae and Freddie Mac bonds would have an implicit U.S. Government guarantee, but no one knew if that assumption was really true. Based on

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> 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.

10 Release at 12894.

11 Release at 12865.

12 As a matter of drafting, we also suggest that the Commission amend subparagraph (C) as follows with the underlined language:

> After the completion of the proposed purchase of shares of the investment company, 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.

13 For the sake of convenience, we refer to such a money market fund as "qualified money market fund."

14 We are not suggesting that the money market funds could invest in the common stock of Fannie Mae or Freddie Mac.

15 *See also* discussion of the haircut under Rule 15c3-1, *infra*.

recent events, we now know that the U.S. Government will back Fannie and Freddie bonds. President Bush stated in a press conference on July 15, 2008:

> In this case, there is a feeling that the government will stand behind mortgages through these two entities. And therefore, we felt a special need to step up and say that we are going to provide, if needed, temporary assistance through either debt or capital. *** [In response to a question:] You know, there is an implicit guarantee.[16]

On July 13, 2008, the Board of Governors of the Federal Reserve System announced:

> The Board of Governors of the Federal Reserve System announced Sunday that it has granted the Federal Reserve Bank of New York the authority to lend to Fannie Mae and Freddie Mac should such lending prove necessary. Any lending would be at the primary credit rate and collateralized by U.S. government and federal agency securities. This authorization is intended to supplement the Treasury's existing lending authority and to help ensure the ability of Fannie Mae and Freddie Mac to promote the availability of home mortgage credit during a period of stress in financial markets.[17]

Freddie Mac was able to sell $3 billion in securities after the Fed and Treasury's announcements.[18]

To put this situation in context, James B. Lockhart III, Director, OFHEO recently noted that:

> The combined credit market footprint of Fannie Mae and Freddie Mac rivals the liabilities of the Fed and the U.S. government. At the end of March [2008], those two housing GSEs had credit outstanding of $5.3 trillion, including debt of $1.6 trillion and guaranteed mortgage-backed securities (MBS) of $3.7 trillion ... That

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16 Press Conference of the Honorable George W. Bush, July 15, 2008, http://www.whitehouse.gov/news/releases/2008/07/20080715-1.html

17 http://www.federalreserve.gov/newsevents/press/other/20080713a.htm. *See also* testimony of the Honorable Henry Paulson, Secretary, Department of the Treasury, Testimony on GSE Initiatives before the Senate Banking Committee, HP-1080, July 15, 2008, (available at http://www.treas.gov/press/releases/hp1080.htm) regarding proposed legislation).

18 On July 15, 2008, THE WALL STREET JOURNAL reported:

> Freddie Mac passed a crucial test of investor confidence Monday when there was strong demand for short-term debt it was selling, but that was no solace to stock investors who continue to watch the stocks erode. A closely watched auction of $3 billion in Freddie's short-term debt drew more bids than usual. The company was able to sell its three- and six-month notes at lower-than-expected yields, which in turn helped keep its borrowing costs low.

"Freddie Mac Auction Eases Concerns," July 15, 2008; Page A15, available at http://online.wsj.com/article/SB121603898437750725.html?mod=googlenews_wsj On July 18, 2008, Freddie Mac became a voluntarily reporting company with the Commission. Fannie Mae achieved similar status in 2004. *See* SEC, Freddie Mac Now SEC Reporting Company, Press Release 2008-145, available at http://www.sec.gov/news/press/2008/2008-145.htm, and authorities cited therein.

was equal to the publicly held debt of the U.S. government, of which over $600 billion was not so publicly held by the Fed.[19]

It was inconceivable that the U.S. Government would let these GSEs fail, with enormous ripple effects on both the housing markets and on the institutions holding their debt. What ever question lingered about whether the Federal Government would back the GSEs was answered in recent days by President Bush, Chairman Bernanke, and Secretary Paulson. Moreover in recent days, Congress has passed legislation that President Bush signed, that statutorily authorizes the U.S. Treasury to purchase any obligations and other securities issued by the GSEs.[20] Accordingly, we believe that there should be no question about the safety of such investments, since the U.S. Government has indicated its intention to stand behind them.

We also suggest that the Commission permit such portfolios to include repurchase and reverse repurchase agreements with respect to such securities. We do not believe that the addition of repurchase and reverse repurchase transactions would be a significant departure from current practice. Under current law, broker-dealers may use borrowed Treasury securities for deposit into their special reserve accounts.[21]

Federated's request would modernize Rule 15c3-3(a)(6) and place it on an equal footing with other regulatory changes. As noted, under current law, a broker-dealer may deposit only cash or a qualified security into the special reserve account. Accordingly, a broker-dealer must either:

- Assemble a portfolio of U.S. Treasury securities, constantly buying and selling them to ensure that the broker-dealer has sufficient funds in the Special Reserve Bank account. The Release notes that a:

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19 Remarks of James B. Lockhart III Director, OFHEO 44th Annual Conference on Bank Structure and Competition, Chicago, IL May 16, 2008, available at http://www.ofheo.gov/newsroom.aspx?ID=433&q1=0&q2=0

20 HR. 3221, P.L. No. 110-289, Sections 1117-1118. See letter from Raymond Natter, Barnett, Sivon & Natter, P.C., to Eugene F. Maloney, Executive Vice President and Corporate Counsel, Federated, July 31, 2008

21 The Staff has indicated as follows:

> A qualified security, as defined by SEC Rule 15c3-3(a)(6), which has been borrowed may be deposited into a Reserve Bank Account provided the broker-dealer is a Primary Dealer. Borrowed qualified securities must be secured by cash or other qualified securities to be acceptable for 15c3-3 deposits.
>
> The value allowed for the deposit is the lesser of the contract or market value of the securities borrowed. In lieu of valuing the securities at the lesser of contract or market, the broker-dealers can take a 2 percent reduction to the market value in valuing these securities for reserve formula deposit purposes.
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> *SEC Staff [of the Division of Market Regulation] to NASD, November 1993* (available at http://www.finra.org/RulesRegulation/PublicationsGuidance/InterpretationsofFinancialOperationalRules/CustomerProtectionRule_SECRule15c3-3/P016817; *see also* letter from the SEC *Staff of the Division of Market Regulation to New York Stock Exchange,* November *27, 1989* (regarding establishing possession or control of reverse repurchase agreement securities).

A broker-dealer might choose to deposit qualifying money market fund shares into the customer reserve 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 discussed above with respect to customer reserve account cash deposits into affiliate and non-affiliate banks. A broker-dealer that deposits cash into the customer reserve 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.[22]

  - Even major houses with active government trading desks have indicated that they would prefer to avoid the operational risks associated with this activity.
  - Broker-dealers would have much greater efficiency in their ability to maintain the appropriate level of deposit in the Special Reserve Bank Account;

OR

- Deposit cash into the account, putting the funds at risk of the balance sheet of the bank.
  - Bank regulations do not require the type of separation of assets that the 1940 Act requires. Banks are not required hold the cash separately from the bank's other assets.[23]
  - By comparison, Rule 17f-1 under the 1940 Act requires registered investment companies to hold portfolio assets with a custodian.[24]

By using a qualified money market fund, the broker-dealer avoids the operational risk of purchasing and selling Treasury securities and avoids subjecting a cash deposit to the risk of bank failure. Moreover, the change we suggest would place qualified money market funds on a more competitive basis with bank deposit products, which clearly was a goal of the Gramm-Leach-Bliley Act.

We also believe it is useful to compare the proposed qualified money market funds for the Special Reserve Bank Account with cash deposits, usually held in a "trust ledger account" at commercial banks. In particular, we understand that some U.S. banks that offer this product for

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22 Release at 12865.

23 We appreciate that Rule 15c3-3(e) requires the broker-dealer to establish a Special Reserve Bank Account that shall be separate from any other bank account of the broker or dealer. Nonetheless, the funds in the account become subject to the same risks as any other bank deposit and are not invested in a separate pool of assets that are held with a custodian (or are otherwise protected).

24 *See* Attachment 1 at Item 1 for text marked to show Federated's recommended changes to the Release.

broker-dealers' Special Reserve Bank Accounts do not have strong balance sheets. For example, one bank that is offering the trust ledger product announced plans to issue convertible preferred shares to raise $1 billion in Tier 1 capital, reduced its dividend, and is selling off non-core businesses. It is inconceivable that the Commission would favor deposits in such shaky banks over investments in qualified money market funds, with all of the protections of the 1940 Act for registered investment companies; the strict requirements of Rule 2a-7 under the 1940 Act;[25] and the stability of portfolio assets limited to investments in securities issued or guaranteed by the United States government or its agencies or instrumentalities (including repurchase and reverse repurchase transactions).

In addition, other regulators allow the use of money market funds for similar purposes. For example, the Commodity Futures Trading Commission allows futures commission merchants to use Rule 2a-7 Funds to satisfy the segregation requirements.[26] Section 4(d)(2) of the Commodity Exchange Act ("CEA") established the hallmark principle of segregation of customer funds and the trust-like nature of the broker's duties in respect of such funds. Because of the absence of an analogue to the Securities Investor Protection Corporation ("SIPC"), the segregation requirements are of critical importance under the CEA's regulatory scheme, and are arguably more important under commodities law than under securities law. Accordingly, we believe it is all the more telling that the CFTC has permitted the use of Rule 2a-7 Funds for this purpose and has had good experience with this rule.[27] Similarly, the UK's Financial Services Authority ("FSA")[28] allows use of money market funds in analogous situations. Federated believes that the Commission should follow these examples and allow broker-dealers to use qualified money market funds to satisfy their obligations under Rule 15c3-3(e).

B. Collateral Requirements

Rule 15c3-3(b) requires broker-dealers to maintain physical possession or control of securities. More specifically, subsection (1) provides that:

> A broker or dealer shall promptly obtain and shall thereafter maintain the physical possession or control of all fully-paid securities and excess margin securities carried by a broker or dealer for the account of customers.

However, subsection (3) of the rule provides that a broker-dealer may borrow customer's fully-paid or excess margin securities, provided that the broker-dealer satisfies certain conditions. Among those conditions is that the broker-dealer provide the customer with collateral permitted

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25 *See* discussion *infra.*

26 *See* Attachment 2 – Excerpts from CFTC Rule 1.25 (17 CFR §1.25).

27 *See* Attachment 2 – Letter to Michael A. Macchiaroli, Associate Director, Office of Risk Management, Division of Market Regulation, SEC, from Stuart J. Kaswell, Dechert LLP, July 5, 2006 and Memorandum to Eugene F. Maloney, Executive Vice President and Corporate Counsel, Federated, from Susan C. Ervin, Dechert LLP, July 5, 2006.

28 FSA, Client Assets Sourcebook ("CASS"), ch. 7.

under the rule.[29] Federated believes that the Commission should approve Rule 2a-7 Funds as permissible collateral under the rule.

As indicated in note 29, Rule 15c3-3(iii)(A) specifies certain types of collateral that the broker-dealer may use, including an unsecured letter of credit. It also allows the Commission to designate additional types of collateral, provided that the collateral meets specified standards. The Commission has delegated authority to the Division of Trading & Markets to designate such

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[29] Rule 15c3-3(3) provides:

> (3) A broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) of this section regarding physical possession or control of fully-paid or excess margin securities borrowed from any person, provided that the broker or dealer and the lender, at or before the time of the loan, enter into a written agreement that, at a minimum;
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> (i) Sets forth in a separate schedule or schedules the basis of compensation for any loan and generally the rights and liabilities of the parties as to the borrowed securities;
> (ii) Provides that the lender will be given a schedule of the securities actually borrowed at the time of the borrowing of the securities;
> (iii) Specifies that the broker or dealer:
>
> (A) Must provide to the lender, upon the execution of the agreement or by the close of the business day of the loan if the loan occurs subsequent to the execution of the agreement, collateral, which fully secures the loan of securities, consisting exclusively of cash or United States Treasury bills and Treasury notes or an irrevocable letter of credit issued by a bank as defined in section 3(a)(6)(A)–(C) of the Act (15 U.S.C. 78c(a)(6)(A)–(C)) or such other collateral as the Commission designates 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; and
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> (B) Must mark the loan to the market not less than daily and, in the event that the market value of all the outstanding securities loaned at the close of trading at the end of the business day exceeds 100 percent of the collateral then held by the lender, the borrowing broker or dealer must provide additional collateral of the type described in paragraph (b)(3)(iii)(A) of this section to the lender by the close of the next business day as necessary to equal, together with the collateral then held by the lender, not less than 100 percent of the market value of the securities loaned; and
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> (iv) Contains a prominent notice that the provisions of the Securities Investor Protection Act of 1970 may not protect the lender with respect to the securities loan transaction and that, therefore, the collateral delivered to the lender may constitute the only source of satisfaction of the broker's or dealer's obligation in the event the broker or dealer fails to return the securities.

See also Loss, Seligman, Paredes, *id.*

securities.[30] The Commission itself has taken such action and approved an order designating additional forms of collateral.[31]

Federated believes that a Rule 2a-7 Fund is a stable and safe asset class that should be available to broker-dealers and would protect customers if used to collateralize loans of fully-paid or excess margin securities. It is our understanding that the Commission was on the verge of approving such a change, but that it has deferred for some reason. We believe that the Commission should move forward on this initiative and approve Rule 2a-7 Funds for this purpose. Rule 2a-7 Funds would be as safe as many other types of collateral that the Commission has approved and certainly would be safer than an unsecured bank letter of credit.[32]

Amendments to the Net Capital Rule – Rule 15c3-1

Federated urges the Commission to amend Rule 15c3-1 (17 CFR §240.15c3-1) to reduce the "haircut" on money market funds, as described more fully below. According to one authority, under the net capital rule:

> the broker-dealer's net worth (assets minus liabilities) is adjusted, among other ways, by adding unrealized profits or deducting unrealized losses in his or her own accounts; deducting altogether fixed assets and assets that cannot be readily converted into cash (less any indebtedness secured thereby); deducting the market value of all short securities differences unresolved after discovery in accordance with a required schedule; excluding liabilities that are subject of a satisfactory subordination agreement; and **deducting specified percentages (called in the trade haircuts) of the market value of all securities**, money market instruments, or options in the proprietary or other accounts of the broker or dealer.[33]

The Commission has proposed reducing the "haircut" on money market funds from 2% to 1%. In the Release, the Commission specifically stated:

> We request 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.[34]

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30 In 2003, the Commission amended the rule to allow it to expand the categories of permissible collateral by order. Exchange Act Release No. 47480 (March 11, 2003); 68 FR 12780 (March 17, 2003). *See* Attachment 3.

31 Exchange Act Release No. 47683 (April 16, 2003); 68 FR 19864 (April 22, 2003). *See* Attachment 3.

32 *See* Attachment 1 for text marked to show Federated's recommended changes to the Release.

33 Loss, Seligman, Paredes, at ch. 8, Regulation of Brokers, Dealers, and Investment Advisers, B. Broker-Dealer Substantive Regulation, §1, Protection of Customers' Funds and Securities, c. Financial Responsibility, (ii) Uniform Net Capital Rule (**emphasis added**)(footnotes omitted).

34 Release at 12874.

Federated no longer urges the Commission to reduce the haircut to 0%, but believes that the Commission should: (i) reduce the haircut to 1% for a money market fund that satisfies Rule 2a-7; and (ii) reduce the haircut to 0.5% for a qualified money market fund, as defined above.[35]

Federated believes that money market funds have an extraordinary track record of safety that warrant a reduction in the haircut as suggested. In our view the current haircut is out of proportion to other capital charges. We also have compared the proposed haircut of money market funds to other haircuts for other asset classes. Based on that comparison, we believe that a 1%/0.5% haircuts are justified and proportionate. For example, Rule 15c3-1 imposes a ⅛ of 1% haircut on certain municipal securities and commercial paper, bankers' acceptances, and certificates of deposit. Rule 15c3-1 (c)(2)(vi)(B)(l) provides:

1. In the case of any municipal security which has a scheduled maturity at date of issue of 731 days or less and which is issued at par value and pays interest at maturity, or which is issued at a discount, and which is not traded flat or in default as to principal or interest, the applicable percentages of the market value on the greater of the long or short position in each of the categories specified below are:

***

ii 30 days but less than 91 days to maturity—⅛ of 1 %.

We believe that the liquidity of both the money market fund shares and its portfolio securities is at least as good or superior to that of municipal securities.

Similarly, the SEC also imposes a ⅛% of 1 % haircut on certain commercial paper, bankers' acceptances, and certificates of deposit. Rule 15c3-1 (c)(2)(vi)(E) provides:

> In the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, and which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited and is rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations, * * * or in the case of any negotiable certificates of deposit or bankers acceptance or similar type of instrument issued or guaranteed by any bank as defined in Section 3(a)(6) of the Securities Exchange Act of 1934, the applicable percentage of the market value of the greater of the long or short position in each of the categories specified below are:
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> * * * * *
>
> 2. 30 days but less than 91 days to maturity [--] - ⅛ of 1 percent.
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> * * * * *

35 *See* Attachment 1 for text marked to show Federated's recommended changes to the Release..

With regard to certificates of deposit or bankers acceptances, the rule includes no explicit limitations on the credit-worthiness of the bank.[36] Indeed, a Staff interpretive letter specifically permits broker-dealers to apply this haircut to marketable certificates of deposit issued by federal savings and loan associations.[37] Accordingly, we believe that a haircut of 1% for Rule 2a-7 Funds and 0.5% for qualified money market funds is extremely cautious and would achieve the Commission's goal of "better align[ing] the net capital charge with the risk associated with holding a money market fund."[38]

Safety of Money Market Funds

We appreciate that rules 15c3-3 and 15c3-1 are central to the system of protecting customers' funds and securities held in broker-dealers.[39] We would not ask for these reforms if we did not believe that the changes we urge were consistent with investor protection, and indeed, in some instances, would enhance investor protection, as noted above.

The Commission's regulatory program for money market funds under Rule 2a-7 has been an unqualified success story. The Commission adopted Rule 2a-7 in 1983[40] and has revised and strengthened the rule periodically.[41] The Investment Company Institute ("ICI") reports that money market fund assets were $3.498 trillion for the week ended Wednesday, July 16, 2008.[42]

A Rule 2a-7 Fund must meet very rigorous standards. These include:

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36 We believe that neither the Commission nor the Staff has imposed any standards for domestic banks. *See* NYSE Interpretation Handbook at Rule 15c3-1 (c)(2)(iv)(E)/06 1.

37 As indicated on the FINRA website:

> **Certificates of Deposit Issued by Federal Savings and Loan Associations and State Chartered Insured Institutions**
>
> The haircut provisions of subparagraph (c)(2)(vi)(E) of SEC Rule 15c3-1 apply to marketable certificates of deposit issued by federal savings and loan associations and certain state chartered insured institutions, as authorized by the Federal Home Loan Bank Board.

Letter from SEC staff of DMR to A.G. Becker & Co., Inc., March 10, 1976, available at http://www.finra.org/RulesRegulation/PublicationsGuidance/InterpretationsofFinancialOperationalRules/NetCapitalRule_SECRule15c3-1/p012875

38 Release at 12874.

39 Securities Investor Protection Act of 1970, P. L. No. 91-598, Section 7(d) (amending Section 15(c) of the Exchange Act); Securities Act Amendments of 1975, P. L. No. 94-29; 89 Stat. 97, 126, Section 11 (amending Section 15 of the Exchange Act); *see also Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R.* Doc. No. 92-231 (1971).

40 Release No. IC-13380 (July 11, 1983); 48 FR 32555 (July 18, 1983) ("Rule 2a-7 Adopting Release").

41 Release No. IC-21837 (March 21, 1996); 61 FR 13956 (March 28, 1996).

42 ICI, available at http://www.ici.org/stats/latest/mm_07_17_08.html#TopOfPage

1. **portfolio diversification** – a taxable money market fund must limit its investments in the securities of any one issuer (other than Government securities) to five percent of fund assets;[43]

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;[44]

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;[45] and

4. **portfolio liquidity** – a money market fund may not invest more than ten percent of its assets in illiquid securities.[46]

We have sought to increase the level of safety with our proposed formulation of the qualified money market fund. Accordingly, we believe that our proposal is very much consistent with the Commission's mandate to protect investors.

Only one money market fund has ever had a net asset value ("NAV") (*i.e.*, "broken the buck") of less than $1.00 per share. This incident occurred in 1994, resulting in an NAV of 96¢.[47] The Commission adopted amendments to Rule 2a-7 in 1996 to strengthen the rule.[48] By comparison, between 1994 and 2008, the Federal Deposit Insurance Corporation ("FDIC") reports that 80 institutions failed, incurring losses of over $2 trillion, and that dollar amount does not include recent failures such as IndyMac, First National Bank of Nevada, and First Heritage Bank NA.[49] We think that the comparison overwhelmingly favors money market funds, as compared with bank deposits.

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

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

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

46 Rule 2a-7 Adopting Release. That 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.

47 Securities Act Release No. 7625 (Jan. 11, 1999). Of course we understand that some advisers to money market funds may have purchased assets at par value to ensure the continued NAV of $1.00; nonetheless, no investor has suffered any harm.

48 Securities Act Release No. 7275 (March 21, 1996); 61 FR 13956 (March 28, 1996).

49 FDIC website calculation of closings and assistance transactions between 1994 and 2008. http://www4.fdic.gov/HSOB/hsobrpt.asp, updated to include First National Bank of Nevada and First Heritage Bank NA.

Broad Support

We have proposed these changes to Rule 15c3-1 and Rule 15c3-3 in response to broad support for these changes from the broker-dealer community. Federated simply is trying to respond to the needs of its customer base. The financial services industry, including the broker-dealer community, broadly supports these changes to the rules. Of the sixty-five comment letters or memoranda of meetings in the public file, only one opposed amending these rules as we suggest.[50] Numerous other commentators support amending these rules and urge the Commission to broaden its proposal along the lines that we now suggest. The commentators differed only on *how* to make the changes we seek.[51]

Federated has repeatedly demonstrated to the Commission and the Staff that the broker-dealer community eagerly seeks these changes and that Federated is simply responding to the needs of its customers. For example, on May 12, 2008, we arranged a conference call with James Eastman of Chairman Cox's Staff to respond to his questions about broker-dealer interest in the proposal. Representatives of Lehman Brothers and Harris Trust participated.[52] Federated remains confident of broker-dealers' support because it receives constant inquiries from broker-dealers about their desire to use money market funds for the purposes we seek. If Federated did not believe that the market for this product existed, we would have abandoned this effort years ago.

Federated seeks changes that would be available to any money market fund that meets the Commission's standards.[53] These changes would not solely benefit Federated. Federated has proposed an approach that would be an open and transparent standard that other funds could meet. Federated fully expects that other fund complexes will compete with Federated for broker-dealers' assets.[54]

Finally, we note that we have had strong support from current and former Members of the Commission. For example, Commissioner Kathleen L. Casey has been supportive. Commissioner

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50 SIPC opposed expanding the definition of "qualified security" under Rule 15c3-3(a)(6) to include Treasury-only money market funds, out of concern that broker-dealers could fabricate the existence of money market fund deposits. Briefly, it is our view that it is no more or less difficult to fabricate the existence of a money market fund than of a bank deposit.

51 For example, SIFMA had specific recommendations on which money market funds should constitute "qualified securities" and on the amount of the haircut. Marshall J. Levinson, Senior Managing Director, Bear, Stearns & Co. Inc., Chair, SIFMA Capital Committee, June 15, 2007, available at http://www.sec.gov/comments/s7-08-07/s70807-32.pdf.

52 Memorandum, Meeting with representatives of Federated Investors, Inc. relating to rule amendments proposed in Securities Exchange Act Release No. 55431 (File No. S7-08-07), titled "Amendments to Financial Responsibility Rules for Broker- Dealers" From: Office of the Chairman May 12, 2008, available at http://www.sec.gov/comments/s7-08-07/s70807-65.pdf. We have arranged similar meetings and calls between the Staff and representatives of other firms, such as Deutsche Bank.

53 Attached are Federated's proposals for a "qualified money market fund" that would constitute a qualified security under Rule 15c3-3(a)(6) and therefore would be qualified for the special reserve bank account. We also include our other proposals for change.

54 For example, UBS Global Asset Management filed a letter on June 18, 2007 in support of these changes and urging specific changes to the proposal. In response to Federated's original rule petition of April 3, 2003, Dreyfus Corporation filed a letter in support on January 7, 2004.

Paul S. Atkins,[55] Commissioner Annette L. Nazareth,[56] and Commissioner Roel C. Campos were strong supporters.

Conclusion

Federated seeks these changes because it wishes to respond to the needs of its customers. Broker-dealers have a strong desire to avoid the operational risks of managing portfolios of U.S. Treasury securities or risking their funds in bank deposits and moving to the ease of money market fund transactions. Money market funds are ubiquitous in the U.S.[57] Average Americans use money market funds every day to hold cash balances with the well-founded confidence that their money will earn market rates of return and will be available when they need it. FCMs and UK financial firms enjoy the same conveniences for purposes analogous to the Special Reserve Account requirement. We believe that it is long over due for the SEC to allow broker-dealers to enjoy these same advantages.

Please do not hesitate to contact me if you have any questions regarding these matters.

Sincerely yours,

/s/
Stuart J. Kaswell
Partner

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55 Commissioner Atkins was especially helpful in ensuring that the Release addressed certain of Federated's concerns, as noted above.

56 Commissioner Nazareth's support is particularly noteworthy because she was a former Director of the division of Market Regulation and a former Acting Director of the Division of Investment Management.

57 One of many examples of the broad use of money market funds in the financial services industry is that Options Clearing Corporation ("OCC") allows clearing members to use money market funds that meet certain standards as margin. OCC Rule 604(b)(3). OCC also allows clearing members to deposit GSE debt under specified circumstances. *Id* at paragraph (2). Exchange Act Release 47599 (March 31, 2003); 66 FR 16849 (April 7. 2003). *See also* New York Stock Exchange Rule 431(g) (portfolio margin).

Copy: 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.

Attachments:

1. Proposed Amendments to Rule 15c3-1 and Rule 15c3-3.
2. CFTC Materials:
    a. Excerpt from CFTC Rule 1.25;
    b. Letter to Michael A. Macchiaroli, Associate Director, Office of Risk Management, Division of Market Regulation, SEC, from Stuart J. Kaswell, Dechert LLP, July 5, 2006; and
    c. Memorandum to Eugene F. Maloney, Executive Vice President and Corporate Counsel, Federated, from Susan C. Ervin, Dechert LLP, July 5, 2006.
3. SEC Releases increasing permissible forms of collateral for fully-paid and excess margin securities:
    a. Exchange Act Release No. 47480 (March 11, 2003); 68 FR 12780 (March 17, 2003)(rule change); and
    b. Exchange Act Release No. 47683 (April 16, 2003); 68 FR 19864 (April 22, 2003)(increasing permissible forms of collateral).

Attachment 1

Attachment 1

SEC proposal from the Release marked to show Federated's suggested ~~deletions~~ and *additions*:

1. Definition of "qualified money market fund":

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) ~~Has assets consisting solely of cash and securities issued by the United States or guaranteed by the United States with respect to principal and interest;~~ *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*, ~~H~~*h*as 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.*

2. Definition of collateral for pledge to customers' for fully-paid or excess margin securities (not in Release but permitted by SEC order):

Order pursuant to Section 36 of the Exchange Act, designating an additional type of collateral as permissible under Rule 15c3-3(b)(3)(iii)(A) 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:

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* Federated suggests this amendment to subsection (C) only in the interest of clarifying what we understand to be the Commission's intention.

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.

3. Proposed Reduction in the haircut under the net capital rule:

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.*

Attachment 2

Attachment 2

CFTC Materials:

a. Excerpt from CFTC Rule 1.25;
b. Letter to Michael A. Macchiaroli, Associate Director, Office of Risk Management, Division of Market Regulation, SEC, from Stuart J. Kaswell, Dechert LLP, July 5, 2006; and
c. Memorandum to Eugene F. Maloney, Executive Vice President and Corporate Counsel, Federated, from Susan C. Ervin, Dechert LLP, July 5, 2006

Commodity Futures Trading Commission
Excerpts from Rule 1.25

17 CFR §1.25 Investment of customer funds.

(a) *Permitted investments.*

(1) Subject to the terms and conditions set forth in this section, a futures commission merchant or a derivatives clearing organization may invest customer money in the following instruments (permitted investments):

***

(viii) Interests in money market mutual funds.

(2)

(i) In addition, a futures commission merchant or derivatives clearing organization may buy and sell the permitted investments listed in paragraphs (a)(1)(i) through (viii) of this section pursuant to agreements for resale or repurchase of the instruments, in accordance with the provisions of paragraph (d) of this section.

***

(b) *General terms and conditions.* A futures commission merchant or a derivatives clearing organization is required to manage the permitted investments consistent with the objectives of preserving principal and maintaining liquidity and according to the following specific requirements:

(1) *Marketability.* Except for interests in money market mutual funds, investments must be "readily marketable" as defined in §240.15c3–1 of this title.

(2) *Ratings.*

(i) *Initial requirement.* Instruments that are required to be rated by this section must be rated by a nationally recognized statistical rating organization (NRSRO), as that term is defined in Securities and Exchange Commission rules or regulations, or in any applicable statute. For an investment to qualify as a permitted investment, ratings are required as follows:

(A) U.S. government securities and money market mutual funds need not be rated;

***

(3) *Restrictions on instrument features* . (i) With the exception of money market mutual funds, no permitted investment may contain an embedded derivative of any kind, except as follows:

*****

(4) *Concentration* .

(i) *Direct investments* .

(A) U.S. government securities and money market mutual funds shall not be subject to a concentration limit or other limitation.

***

(v) *Treatment of securities issued by affiliates* . For purposes of determining compliance with the concentration limits set forth in this section, securities issued by entities that are affiliated, as defined in paragraph (b)(6) of this section, shall be aggregated and deemed the securities of a single issuer. An interest in a permitted money market mutual fund is not deemed to be a security issued by its sponsoring entity.

(5) *Time-to-maturity* .

(i) Except for investments in money market mutual funds, the dollar-weighted average of the time-to-maturity of the portfolio, as that average is computed pursuant to §270.2a–7 of this title, may not exceed 24 months.

***

(c) *Money market mutual funds* . The following provisions will apply to the investment of customer funds in money market mutual funds (the fund).

(1) The fund must be an investment company that is registered under the Investment Company Act of 1940 with the Securities and Exchange Commission and that holds itself out to investors as a money market fund, in accordance with §270.2a–7 of this title.

(2) The fund must be sponsored by a federally-regulated financial institution, a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, an investment adviser registered under the Investment Advisers Act of 1940, or a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation.

(3) A futures commission merchant or derivatives clearing organization shall maintain the confirmation relating to the purchase in its records in accordance with §1.31 and note the ownership of fund shares (by book-entry or otherwise) in a

custody account of the futures commission merchant or derivatives clearing organization in accordance with §1.26(a). If the futures commission merchant or the derivatives clearing organization holds its shares of the fund with the fund's shareholder servicing agent, the sponsor of the fund and the fund itself are required to provide the acknowledgment letter required by §1.26.

(4) The net asset value of the fund must be computed by 9 a.m. of the business day following each business day and made available to the futures commission merchant or derivatives clearing organization by that time.

(5)

(i) General requirement for redemption of interests. A fund shall be legally obligated to redeem an interest and to make payment in satisfaction thereof by the business day following a redemption request, and the futures commission merchant or derivatives clearing organization shall retain documentation demonstrating compliance with this requirement.

(ii) Exception. A fund may provide for the postponement of redemption and payment due to any of the following circumstances:

(A) Non-routine closure of the Fedwire or applicable Federal Reserve Banks;
(B) Non-routine closure of the New York Stock Exchange or general market conditions leading to a broad restriction of trading on the New York Stock Exchange;
(C) Declaration of a market emergency by the Securities and Exchange Commission; or
(D) Emergency conditions set forth in section 22(e) of the Investment Company Act of 1940.

(6) The agreement pursuant to which the futures commission merchant or derivatives clearing organization has acquired and is holding its interest in a fund must contain no provision that would prevent the pledging or transferring of shares.

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July 5, 2006

Michael A. Macchiaroli
Associate Director
Office of Risk Management
Division of Market Regulation
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Dear Mr. Macchiaroli:

As you know, on behalf of our client, Federated Investors, Inc. ("Federated"), we have petitioned the Securities and Exchange Commission (the "SEC" or the "Commission") regarding amendments to Rule 15c3-1 and Rule 15c3-3 under the Securities Exchange Act of 1934 (the "Exchange Act").[1] We also understand that the Commission may issue a proposal for rulemaking that raises some of issues addressed in our Amended Petition.

We wish to provide some information comparing the SEC's treatment of money market funds under Rule 15c3-3 to the Commodity Futures Trading Commission's ("CFTC") analogous treatment of money market funds. Attached is a memorandum prepared by my partner, Susan Ervin, outlining the CFTC's segregation requirements for futures commissions merchants ("FCMs"). The memorandum discusses how FCMs may use money market funds to hold segregated customer funds. The memorandum makes the following points:

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1 *See* petition from Federated Investors, Inc., to the Securities and Exchange Commission, April 3, 2003, amended April 4, 2005, available at http://www.sec.gov/rules/petitions/shtml (the "Amended Petition").

Dechert LLP

- It has been a hallmark of regulation under the Commodity Exchange Act ("CEA") to maintain strict segregation of customer funds and property.

- After decades of drastically limiting the permissible investments of customer funds, in 2000 the CFTC allowed FCMs to invest such fund in money market funds. The rule initially limited FCMs to using money market funds that received the highest rating from a nationally recognized statistical rating agency, if rated at all.

- After several years of favorable experience, the CFTC amended its rule and allowed FCMs to use any money market fund. To our knowledge, the CFTC has not publicly identified any problems that have resulted as a consequence of this further change.

We compare the CFTC's regime to the regulation of broker-dealers:

- Unlike the regulation of broker-dealers, there is no analog to the Securities Investor Protection Corporation and the Securities Investor Protection Act of 1970. As a consequence, the CFTC's segregation requirements are essential to protecting the customers of FCMs.

- Under Section 4d(d) of the CEA, an FCM may not borrow customers' funds or property. By comparison, Rule 15c3-3(b)(3) allows broker-dealers to borrow customers' fully paid or excess margin securities, provided that they are fully secured.

- At the close of each day, an FCM must have segregated sufficient funds to meet 100% of its obligations to customers. It must make up any deficiency with its own funds that day. By comparison, under Rule 15c3-3(e)(3) a broker-dealer must calculate the amount to be deposited in the special reserve bank account on a weekly, and in some instances, on a monthly, basis.

Despite (or, indeed because of,) the critical importance of the segregation requirements under the CEA and CFTC's rules, and the need to calculate that amount every single day, the CFTC allows FCMs to use money market funds for deposits of segregated funds. We respectfully submit that the SEC should allow broker-dealers analogous authority to use money market funds in a regulatory regime that also has protections augmenting the segregation requirements. We do not believe that there can be any customer protection justification that allows FCMs to use money market funds for segregation purposes, but denies broker-dealers the authority to use money market funds in an analogous function, especially when the SEC itself regulates money market funds.

We appreciate your consideration of our views and would be pleased to discuss these issues with you at your convenience.

Sincerely yours,

Stuart J. Kaswell
Partner

Attachment: Money Market Funds as Eligible Customer Fund Investments Under the Commodity Exchange Act, June 30, 2006.

Cc: The Honorable Christopher Cox
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Annette L. Nazareth

Jon Kroeper, Counsel to Chairman Cox
Daniel M. Gallagher, Counsel to Commissioner Atkins

Eugene F. Maloney, Executive Vice President and Corporate Counsel, Federated Investors, Inc.

Dechert LLP

MEMORANDUM

DATE	July 5, 2006
TO	Eugene F. Maloney Executive Vice President and Corporate Counsel Federated Investors, Inc.
FROM	Susan C. Ervin Partner Dechert LLP
COPY	Stuart J. Kaswell Partner Dechert LLP
RE	Money Market Fund Shares as Eligible Customer Fund Investments Under the Commodity Exchange Act

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Question Presented

You have asked us to review the history of the rules permitting a futures commission merchant ("FCM") to hold segregated customer funds in a money market mutual fund. This memorandum reviews that history.

Summary

For 70 years, a futures broker's duty to segregate customer funds sufficient at all times to meet one hundred percent of its obligations to each customer has been a cornerstone of the futures regulatory structure. The Commodity Exchange Act ("CEA") and Commodity Futures Trading Commission ("CFTC") rules govern the segregated status, permissible investments, authorized locations, accounting requirements, replenishment of shortfalls and other matters relevant to the safeguarding of segregated funds held for customers. The effect of the CEA and CFTC requirements is that futures customer funds are held in a statutory trust, assuring satisfaction of customer ownership claims despite the absence of any government-sponsored account insurance for futures accounts. Since 1936, when Congress enacted the CEA segregation requirements, the CEA and subsequent CFTC rules have closely limited investments of such funds to maximize the safety and stability of the segregated account. Since 1968, only government securities and government-guaranteed securities have been permissible investments. In 2000, however, the CFTC adopted rule amendments that "acknowledge the development of new financial instruments over the last 60 years and should both enable [FCMs] to remain competitive globally and domestically and maintain safeguards against systemic risk."[1] These amendments authorized FCMs to invest segregated customer funds in money market fund shares, among other specified instruments. Following this initial authorization, the CFTC has amended its rules to further enhance the ability of FCMs to invest in money market shares, reaffirming the appropriateness of money market fund investments for customer segregated funds.

Discussion

<u>The CEA Section 4d(2) Segregation Requirement</u>. Since its enactment in 1936, Section 4d(2) of the CEA has established the fundamental principle of segregation of customer funds and the trust-like nature of the broker's duties in respect of such funds. An essential premise of the futures customer-broker relationship is that the broker holds customer funds at all times on behalf of and as the property of the customer: under Section 4d(2), the FCM must "treat and deal" with each customer deposit "as belonging to such customer," refrain from using such funds or property on behalf of any other customer for its own purposes and use its own capital to replenish any deficit in the funds held for customers. Customer funds must be "segregated" fully from the broker's own funds or those of any other person, a safeguard designed to assure that customer funds are readily identifiable in the event of an FCM's insolvency. At the close of each business day, an FCM must have in its segregated fund accounts sufficient funds to meet 100% of its obligations to its customers. The CEA and CFTC rules create multiple ancillary safeguards applicable to FCMs -- minimum capital requirements, early warning reporting requirements, periodic financial reports, audited financials, and recordkeeping duties, among others -- which serve the principal goal of preserving the integrity of the segregated customer funds account by ensuring the ability of the FCM to replenish any shortfall in

[1] 65 FR 77993, 78007 (December 13, 2000).

segregation funds. Protection of customer funds thus "is one of the most important purposes of the [CEA] and [CFTC] regulations."[2]

Investment of Customer Funds. Since its enactment in 1936, Section 4d(2) has permitted FCMs to invest customer funds, subject to significant constraints on the nature of the permissible investments. As originally enacted, Section 4d(2) authorized FCMs to invest customer funds only in governmental obligations and in certain investment securities. Subsequently, the investments specified in Section 4d(2) were narrowed to government obligations of the U.S., general obligations of any state or political subdivision thereof, or obligations fully guaranteed as to principal and interest by the U.S., all such investments "to be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe." CFTC Rule 1.25 gives effect to the statutory restraints upon investments of customer funds.

In addition to restricting investments of customer funds, Section 4d(2) also regulates deposits of customer funds with banks and clearinghouses, providing that customer funds and property "may, for convenience, be commingled and deposited in the same amount or accounts with any bank or trust company or with the clearinghouse organization" of the futures exchange on which the customers' futures transaction is entered. From 1937 until 2000, the CFTC construed Section 4d(2) of the CEA to require that when customer funds were deposited in banks or other depositories, they must be placed in demand deposit accounts in which they were available for immediate withdrawal and thus earned no interest.[3] Given these constraints, FCMs were limited to investing customer funds in U.S. or other governmental obligations or placing such funds in non-interest bearing accounts. The effect of these limitations was that only a meager return on customer funds could be obtained, despite the fact that investments outside the statutory categories were likely to be as or more secure than the permitted investments and would also generate additional income.

Investment of Segregated Funds in Money Market Shares. While Section 4d(2) of the CEA continues to specify government obligations as the only permissible investments

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[2] 67 FR 52641, 52644 (August 13, 2002).

[3] *See* Financial and Segregation Interpretation No. 9 – Money Market Deposit Accounts and NOW Accounts, 1 Comm. Fut. L. Rep. (CCH) ¶ 7119 (Nov. 23, 1983) (Opinion of the CFTC's Division of Trading and Markets).

of customer funds, in 2000 the CFTC undertook a major review of its regulation of FCMs and other futures intermediaries and proposed extensive rule amendments designed to modernize its regulatory framework. In considering the subject of investment of customer funds, the CFTC has observed that its primary interest is "in preserving the integrity of the customer segregated account."[4] To fulfill the objectives of the segregated funds requirement, "[n]ot only must there be sufficient value in the account at all times, but the quality of investments must reflect an acceptable level of credit, market and liquidity risk."[5] The CFTC proposed to permit investments of customer segregated funds in money market shares (among other specified investments), based upon its conclusion that "an expanded list of permitted investments could enhance the yield available to FCMs, clearing organizations and their customers without compromising the safety of customer funds."[6]

By amendments to Rule 1.25 adopted in December 2000, investments of customer funds were permitted in: (1) obligations issued by any agency sponsored by the U.S.; (2) certificates of deposit issued by a bank, as defined in Section 3(a)(6) of the Securities Exchange Act of 1934, or a domestic branch of a foreign bank issued by the FDIC; (3) commercial paper; (4) corporate notes; and (5) interests in money market mutual funds.[7] With respect to money market funds, the CFTC required that the money market fund be an investment company that is registered under the Investment Company Act of 1940 and holds itself out to investors as a money market fund, be sponsored by a federally regulated financial institution or other specified entities, have its net asset value computed by 9:00 a.m. each business day and be able to redeem interests by the next business day following a redemption request. Funds rated by a nationally-recognized statistical rating organization were required to be rated at the highest rating issued by that organization.

Subsequent Rulemaking Reaffirming Eligibility of Money Market Fund Shares. Since its 2000 amendments to Rule 1.25, the CFTC has revisited and further amended the

[4] 70 FR 5577, 5581 (February 3, 2005).

[5] *Id.*

[6] 65 FR 39008, 39014 (June 22, 2000).

[7] 65 FR 77993 (December 13, 2000).

relevant rule provisions, including those relating to money market funds. In 2003, the CFTC published for comment a proposed rule change to eliminate of one of the previously adopted restrictions upon eligible money market shares, together with several clarifying changes.[8] The CFTC did not identify any adverse effects of the previously adopted Rule 1.25 amendments, and it received only favorable comments on the proposed amendments. In its final rule amendments, the CFTC clarified the requirement of next-day redemption and eliminated the requirement that money market funds rated by a nationally recognized statistical rating organization be rated at the highest rating of that organization.[9] In taking this action, the CFTC noted both that the rating requirement was anomalous in that unrated money markets were permissible, and that SEC Rule 2a-7 establishes important risk-limiting standards governing the portfolio quality, diversification, and maturity of money market mutual funds.[10] The CFTC's expansion of its initial rule amendments authorizing segregated customer funds to be invested in money market fund shares reflects its continuing view that these investments are fully consistent with the framework of strict safeguards for segregated customer funds and the absence of any adverse experience with this category of investments.

* * * * *

[8] 68 FR 38654 (June 30, 2003).

[9] 70 FR 28190, 28194-28195 (May 17, 2005).

[10] *Id.*

Attachment 3

Attachment 3

SEC Releases increasing permissible forms of collateral for fully-paid and excess margin securities:

a. Exchange Act Release No. 47480 (March 11, 2003); 68 FR 12780 (March 17, 2003)(rule change); and
b. Exchange Act Release No. 47683 (April 16, 2003); 68 FR 19864 (April 22, 2003)(increasing permissible forms of collateral).

Federal Register

Monday,
March 17, 2003

Part III

Securities and Exchange Commission

17 CFR Parts 200 and 240

Customer Protection—Reserves and Custody of Securities; Delegation of Authority to the Director of the Division of Market Regulation; Final Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200 and 240

[Release No. 34–47480; File No. S7–20–02]

RIN 3235–AI51

Customer Protection—Reserves and Custody of Securities; Delegation of Authority to the Director of the Division of Market Regulation

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting an amendment to its broker-dealer customer protection rule. Currently, broker-dealers are required to provide cash, U.S. Treasury bills or notes, or irrevocable bank letters of credit as collateral when borrowing securities from customers. The amendment allows the Securities and Exchange Commission to expand the categories of permissible collateral by order. In addition, the Securities and Exchange Commission is adopting a rule amendment delegating authority to the Director of the Division of Market Regulation to issue such orders.

EFFECTIVE DATE: April 16, 2003.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, 202/942–0131; Thomas K. McGowan, Assistant Director, 202/942–4886; or Randall W. Roy, Special Counsel, 202/942–0798, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is adopting amendments to rule 15c3–3 [1] under the Securities Exchange Act of 1934 ("Exchange Act") and rule 30–3 [2] of its Rules of Organization and Program Management.

I. Discussion

A. Introduction

On June 10, 2002, the Securities and Exchange Commission ("Commission") proposed amending its broker-dealer customer protection rule, rule 15c3–3, and one of its authority delegation rules, rule 30–3.[3] The proposed amendments would allow the Commission to expand the categories of collateral broker-dealers may pledge when borrowing customer securities.[4] Today, the Commission is adopting the amendments.

The amendment to rule 15c3–3 provides that broker-dealers may pledge such collateral as the Commission designates by order after giving consideration to the collateral's liquidity, volatility, market depth, and location, and the issuer's creditworthiness. This will give the Commission greater flexibility to impose conditions on the pledging of certain collateral to account for differences among collateral types. This flexibility will permit the establishment of safeguards designed to ensure that the rule's objective—the receipt of full collateral by customers—is not compromised. The amendment also will allow for a wider range of broker-dealer assets to be deemed permissible collateral, thereby adding liquidity to the securities lending markets and lowering borrowing costs for broker-dealers. The amendment to rule 30–3 will allow the Commission to react sooner to changes in the securities lending markets.

B. Background

The Commission adopted rule 15c3–3 in 1972 in response to a congressional directive to create rules regarding, among other things, the acceptance, custody, and use of customer securities.[5] The rule requires broker-dealers to take steps to protect the securities that customers leave in their custody. These steps include the requirement that broker-dealers promptly obtain and thereafter maintain possession or control of all "fully paid" [6] and "excess-margin" [7] securities carried for the accounts of customers [8] ("customer securities"). The possession or control requirement is designed to ensure that broker-dealers do not put customers at risk by borrowing their securities to expand or otherwise further the broker-dealer's proprietary activities.

Paragraph (b)(3) of rule 15c3–3 sets forth conditions under which broker-dealers may borrow fully paid or excess margin securities from customers for their own use without violating the rule's possession or control requirement. These conditions include the requirement that broker-dealers and their lending customers enter into written agreements that (1) set forth the basis of compensation for the loans as well as the rights and liabilities of the parties in the borrowed securities, (2) require the broker-dealers to provide the lenders with schedules of the securities actually borrowed, (3) require the broker-dealers to provide the lenders with, at least, 100% collateral consisting exclusively of cash, United States Treasury bills and notes, or an irrevocable letter of credit issued by a bank, and (4) contain a prominent notice that the provisions of the Securities Investor Protection Act of 1970 [9] may not protect the lenders with respect to the securities loan transactions.[10] Moreover, the loaned securities and pledged collateral must be marked to market daily, and additional collateral posted if necessary to maintain the 100% collateralization requirement.[11] These requirements are designed so that borrowings of customer securities remain fully collateralized for the term of the loan.

C. Proposing Release and Comments

In addition to the collateral types currently permitted, the amendment to rule 15c3–3 would allow broker-dealers to pledge such other collateral as the Commission designates by order after giving consideration to the collateral's liquidity, volatility, market depth and location, and the issuer's creditworthiness. The relative weight given these factors will vary on a case-by-case basis. The Commission's orders may impose limitations and conditions on the use of a particular type of collateral depending on its characteristics. This will further the rule's goal of providing customers with full collateral while their loans remain outstanding.

The Commission received three comment letters in response to the proposing release—one from a broker-dealer that engages in borrowings of customer securities,[12] one from a bank

[1] 17 CFR 240.15c3–3.

[2] 17 CFR 200.30–3.

[3] *See* Exchange Act Release No. 34–46019 (June 3, 2002), 67 FR 39642 (June 10, 2002).

[4] The Commission proposed amendments to rule 15c3–3 to add certain categories of collateral in 1989. *See* Exchange Act Release No. 26608 (March 8, 1989), 54 FR 10680 (March 15, 1989). The Commission did not adopt the proposed amendments.

[5] Exchange Act Release No. 9856 (Nov. 10, 1972).

[6] 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.

[7] Subparagraph (a)(5) of rule 15c3–3 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.

[8] Subparagraph (a)(1) of rule 15c3–3 defines the term "customer." Generally, a customer is any person from whom or on whose behalf the broker-dealer has received or acquired securities for such person's securities account. The definition does not include general partners, directors, or principals of the broker-dealer, or other broker-dealers to the extent of they have proprietary accounts at the broker-dealer.

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

[10] Rule 15c3–3(b)(3).

[11] Rule 15c3–3(b)(3)(iii).

[12] Letter from Morgan Stanley & Co., dated August 7, 2002 ("Morgan Stanley letter").

that lends its clients' securities to broker-dealers,[13] and a joint letter from two trade associations, which collectively represent broker-dealers, mutual fund companies and banks.[14] All three expressed support for the proposed amendment.[15]

In the proposing release, the Commission requested comment on whether authority to issue orders should be delegated to the Division. Two commenters provided comments on this proposal. Both expressed support for such a delegation of authority.[16]

The Commission identified in the proposing release categories of collateral being considered for an order should the amendment to rule 15c3–3 become effective.[17] It also set forth certain conditions for the use of these collateral types. The Commission sought comment on whether the collateral and conditions were appropriate. All commenters supported the issuance of such an order.[18] The Commission intends to issue an order exempting these collateral types after the amendment becomes effective.

The Commission also sought comment on whether institutional lenders of securities should be allowed to negotiate collateral agreements other than those required by rule 15c3–3. Two of the commenters responded that the Commission should consider whether the minimum requirements are necessary for certain narrowly defined institutional customers. However, they also urged the Commission to act quickly on the amendment as proposed and not let such consideration delay its adoption.[19] They suggested that any changes to address institutional lenders be accomplished through separate orders or rulemakings. Due to the complexities of the issue and in order to act expeditiously on the proposed amendment, further consideration of any change to the collateral requirements for institutional lenders will be addressed by subsequent Commission action.

D. Final Rule

The Commission is adopting a final rule amendment substantially in the form proposed in the proposing release.[20] The amendment adds language to paragraph (b)(3) of rule 15c3–3 providing that broker-dealers may pledge "such other collateral as the Commission designates 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." This is in addition to the categories of collateral (cash, U.S. treasury bills and notes, and bank letters of credit) currently permitted.

II. Paperwork Reduction Act

The Commission stated in the proposing release that the amendment will not require a new collection of information. The amendment does not alter the range of collateral that a broker-dealer can pledge when borrowing customer securities, but instead amends the rule to establish criteria that the Commission will consider when issuing an order allowing additional collateral. The comment letters did not disagree with this assessment. In connection with rule 15c3–3, the Commission previously submitted to the Office of Management and Budget, pursuant to the Paperwork Reduction Act, a request for approval and received an OMB control number for the rule, OMB control number 3235–0078.

III. Costs and Benefits of the Rule Amendments

In the proposing release, the Commission requested comment on the costs and benefits of the amendment to rule 15c3–3. The Commission estimated that the primary benefits of the amendment would be lowered borrowing costs and increased liquidity in the securities lending markets. All three commenters concurred with this estimate.[21] Two commenters also pointed out that the amendment will increase their ability to compete in foreign securities markets.[22]

The Commission estimated that there would not be any direct costs associated with the amendment because of its deregulatory nature. The Commission did not receive any comments on this estimate.

A. Benefits

The primary benefits of the amendment should be lowered borrowing costs and increased liquidity in the securities lending markets, and greater opportunity for U.S. firms to compete abroad. The current collateral requirements in rule 15c3–3 make it more economical for broker-dealers to borrow securities from other broker-dealers (which are not customers) since customers must be provided with a limited range of collateral. In such a case, the broker-dealer would be limited to borrowing the securities from broker-dealers agreeable to accepting another type of collateral. Expanding the categories of collateral will increase the supply of eligible lenders, which should decrease costs as a consequence of greater competition.

On the other side, customers will have the opportunity to enter into more lending transactions with broker-dealers. This will allow them to earn the fees associated with such transactions and thereby realize greater returns on their securities portfolios. The increased opportunities to borrow and lend securities should add liquidity to the securities lending markets.

[13] Letter from State Street Bank and Trust Company, dated July 31, 2002 ("State Street letter").

[14] Letter from The Bond Market Association, and Securities Industry Association, dated July 25, 2002 ("Associations letter").

[15] *See* Morgan Stanley letter ("We strongly support the proposed amendments to rule 15c3–3 and urge the Commission to adopt them without delay."); State Street letter ("State Street strongly supports and welcomes the Proposed Amendment."); Associations letter ("The Associations fully support the Commission's proposed amendment.").

[16] *See* Morgan Stanley letter ("[Delegation] will enable the Commission to be more responsive to short-term market conditions—including liquidity crises and settlement failures—as well as longer-term developments, such as evolving approaches to risk management and tightening settlement periods."); State Street letter ("State Street also supports and welcomes the delegation of the Commission's authority to the Division of Market Regulation.").

[17] The categories of collateral identified in the proposing release were: "Government securities" as defined in sections 3(a)(42)(A) and (B) of the Exchange Act; certain "government securities" meeting the definition in section 3(a)(42)(C) of the Exchange Act; securities issued or guaranteed by certain Multilateral Development banks; "mortgage related securities" as defined in section 3(a)(41) of the Exchange Act; certain negotiable certificates of deposit and bankers acceptances; foreign sovereign debt securities; foreign currency; and certain corporate debt securities.

[18] *See* Morgan Stanley letter ("Morgan Stanley also supports prompt issuance of the Commission's proposed order. Permitting the assets described in the order to be used as collateral for securities borrowing transactions would not, in our view, undermine in any way the Commission's customer protection objectives."). State Street letter; Associations letter ("[T]he conditions specified for each of the collateral types are appropriate to meet the goal of ensuring that borrowings of customer securities remain fully collateralized.").

[19] *See* State Street letter; Associations letter.

[20] After the rule becomes effective, the Commission will consider whether to issue an order similar to the draft order included in the proposing release. *See* footnote 18 and accompanying text.

[21] *See* Morgan Stanley letter ("[T]he ability to use these new types of collateral will provide substantially greater flexibility and reduced borrowing costs for U.S. broker-dealers, as well as increased liquidity in the securities markets."); State Street letter ("[T]he prompt issuance of the Final Rule and Collateral Orders will facilitate and promote efficient securities markets, decrease costs, increase competition and enhance the liquidity of securities markets."); Associations letter ("The Associations believe that these collateral types would materially increase liquidity and decrease borrowing costs * * *").

[22] *See* Morgan Stanley letter; Associations letter.

B. Costs

There should not be any direct costs associated with the amendment. It will have no impact on broker-dealers that do not borrow customer securities or customers that do not lend securities. For those who participate in such transactions, the amendment is not imposing any changes as to how they must be structured. As described above, it will provide greater opportunities; however, it also maintains the status quo, and therefore, broker-dealers and customers do not have to avail themselves of these new opportunities. Broker-dealers can continue to pledge the types of collateral currently allowed under the rule and, while new categories of collateral may have risk characteristics that differ from those applicable to currently permitted collateral, customers could choose not to accept new categories of collateral.

IV. Effects on Competition, Efficiency, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, when engaged in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act requires the Commission to consider the impact on competition of any rule proposed under that Act. In addition, the law requires that the Commission not adopt any rule that would impose a burden on competition not necessary or appropriate in the furtherance of the purposes of the Exchange Act.

The Commission stated in the proposing release, and continues to believe, that the proposed amendment should improve efficiency, competition, and capital formation by adding liquidity to the securities lending markets, lowering the costs of borrowing securities, and providing investors with the opportunity to realize greater returns on their securities portfolios. All commenters agreed that the amendment would increase liquidity and lower borrowing costs.[23] In addition, the Commission stated that the amendment should have no anticompetitive effects not necessary or appropriate in furtherance of the purposes of the Act because it will apply equally to all broker-dealers. The Commission did not receive any comments on this assessment of the possibility of anticompetitive effects. Therefore, the Commission believes that the amendment should have no anticompetitive effects not necessary or appropriate in furtherance of the purposes of the Act.

V. Regulatory Flexibility Act Certification

Section 3(a) of the Regulatory Flexibility Act[24] requires an agency to undertake an initial regulatory flexibility analysis of the effects of proposed rules and rule amendments on small entities, unless the agency certifies that the rules and rule amendments, if adopted, would not have a significant economic impact on a substantial number of small entities.[25] The Chairman of the Commission has certified that the amendment to rule 15c3–3 would not have a significant economic impact on a substantial number of small entities.[26] The final amendment is identical to the proposed amendment. Accordingly, there have been no changes to the proposal that would alter the basis upon which the certification was made.

VI. Amendment to Rule 30–3

The Commission has adopted an amendment to rule 30–3 of its rules of Organization and Program Management governing delegations of authority to the Director of the Division of Market Regulation ("Director").[27] The amendment divides paragraph (a)(10) of rule 30–3 into two paragraphs, (a)(10)(i) and (ii). Paragraph (a)(10)(i) now contains the previously existing delegation of authority in paragraph (a)(10), which authorizes the Director to find and designate certain broker-dealer accounts as control locations for the purposes of paragraph (c)(7) of rule 15c3–3.[28] Paragraph (a)(10)(ii) contains a new delegation authorizing the Director, under section 36(a) of the Exchange Act, to exempt types of collateral from certain requirements in paragraph (b)(3) of rule 15c3–3, provided the collateral exempted by the Division has similar characteristics to collateral previously exempted by the Commission.

Section 36(a) provides, in pertinent part, that the Commission may by rule, regulation or order exempt any classes of persons, securities or transactions from any rule or regulation under the Exchange Act, provided the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. The Commission is delegating to the Director its exemptive authority pursuant to section 36(a) for the limited purpose of exempting collateral types from certain requirements set forth in paragraph (b)(3) of rule 15c3–3.

The delegation of authority to the Director is intended to conserve Commission resources by permitting the staff to review and act on exemptive applications under section 36(a) when appropriate. Nevertheless, the staff may submit matters to the Commission for consideration as it deems appropriate. In addition, under section 4A(b) of the Exchange Act, the Commission retains discretionary authority to review, upon its own initiative or upon application by a party adversely affected, any exemption granted or denied by the Division pursuant to delegated authority. Information concerning the filing of exemptive relief applications can be found in Release No. 34–39624; rule 240.0–12, 17 CFR 240.0–12.

The Commission finds, in accordance with the Administrative Procedure Act, 5 U.S.C. 553(b)(3)(A), that this amendment to rule 30–3 relates solely to agency organization, procedure, or practice. Accordingly, notice and opportunity for public comment, as well as publication 30 days before its effective date are unnecessary. Because notice and comment are not required for this final rule, a regulatory flexibility analysis is not required under the Regulatory Flexibility Act.

The amendment to rule 30–3 does not contain any collection of information requirements as defined by the Paperwork Reduction Act of 1995 as amended. In addition, it will not impose any costs on the public.

VII. Statutory Authority

The amendments are made pursuant to authority conferred on the Commission by the Exchange Act, including sections 15(c)(3), 23(a) and 36.

List of Subjects

17 CFR Part 200

Administrative practice and procedure, Authority delegations (government agencies), Organization and functions (government agencies).

17 CFR Part 240

Broker-dealers, Reporting and recordkeeping requirements, Securities.

Text of Rule Amendments

In accordance with the foregoing, the Commission amends title 17, chapter II of the *Code of Federal Regulations* as follows:

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[23] *Id.*

[24] 5 U.S.C. 603(a).

[25] 5 U.S.C. 605(b).

[26] *See* Proposing Release, 67 FR 39643, Appendix A.

[27] 17 CFR 200.30–3.

[28] 17 CFR 240.15c3–3.

PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

Subpart A—Organization and Program Management

1. The authority section for Part 200, subpart A, continues to read, in part, as follows:

Authority: 15 U.S.C. 77s, 78d–1, 78d–2, 78w, 78*ll*(d), 78mm, 79t, 77sss, 80a–37, 80b–11, unless otherwise noted.

2. Section 200.30–3 is amended by revising paragraph (a)(10) to read as follows:

§ 200.30–3 Delegation of authority to Director of Division of Market Regulation.

* * * * *

(a) * * *

(10) (i) Pursuant to Rule 15c3–3 (§ 240.15c3–3 of this chapter) to find and designate as control locations for purposes of Rule 15c3–3(c)(7) (§ 240.15c3–3(c)(7) of this chapter) certain broker-dealer accounts which are adequate for the protection of customer securities.

(ii) Pursuant to section 36(a) of the Act (15 U.S.C. 78mm(a)) to review and, either unconditionally or on specified terms and conditions, grant or deny exemptions from the collateral requirements of paragraph (b)(3) of Rule 15c3–3 of the Act (§ 240.15c3–3 of this chapter) for a type of collateral after concluding that the characteristics of such collateral are substantially comparable to the characteristics of a type of collateral previously exempted by the Commission.

* * * * *

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

3. The authority citation for Part 240 continues 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–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, and 80b–11, unless otherwise noted.

* * * * *

4. Section 240.15c3–3 is amended by removing the authority citation following § 240.15c3–3 and revising paragraph (b)(3)(iii) to read as follows:

§ 240.15c3–3 Customer protection—reserves and custody of securities.

* * * * *

(b) *Physical possession or control of securities.* * * *

(3) * * *

(iii) Specifies that the broker or dealer:

(A) Must provide to the lender, upon the execution of the agreement or by the close of the business day of the loan if the loan occurs subsequent to the execution of the agreement, collateral, which fully secures the loan of securities, consisting exclusively of cash or United States Treasury bills and Treasury notes or an irrevocable letter of credit issued by a bank as defined in section 3(a)(6)(A)–(C) of the Act (15 U.S.C. 78c(a)(6)(A)–(C)) or such other collateral as the Commission designates 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; and

(B) Must mark the loan to the market not less than daily and, in the event that the market value of all the outstanding securities loaned at the close of trading at the end of the business day exceeds 100 percent of the collateral then held by the lender, the borrowing broker or dealer must provide additional collateral of the type described in paragraph (b)(3)(iii)(A) of this section to the lender by the close of the next business day as necessary to equal, together with the collateral then held by the lender, not less than 100 percent of the market value of the securities loaned; and

* * * * *

By the Commission.

Dated: March 11, 2003.

Margaret H. McFarland,

Deputy Secretary.

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meeting sessions will begin at 8 a.m. on both days.

On Tuesday, the meeting will focus on the DOE's planned repository design and operating mode for Yucca Mountain. The Board has invited the DOE to describe clearly the thermal aspects of the repository design and operating mode, how the thermal aspects of the design and operating mode were analyzed for waste isolation, and the results of the analyses.

The half-day meeting on Wednesday will include discussions of other scientific issues related to a Yucca Mountain repository, including a presentation on corrosion research by a representative of the Center for Nuclear Waste Regulatory Analyses; a presentation on geophysical and hydrogeologic investigations by a representative of Inyo County, California; an update on the Yucca Mountain science and technology program; and a presentation by a representative of the Igneous Consequences Peer Review Panel. The session also will include a discussion of the DOE's performance confirmation plans.

Opportunities for public comment will be provided before adjournment on both days. Those wanting to speak during the public comment periods are encouraged to sign the "Public Comment Register" at the check-in table. A time limit may have to be set on individual remarks, but written comments of any length may be submitted for the record. Interested parties also will have the opportunity to submit questions in writing to the Board. If time permits, the questions will be addressed during the meeting.

A detailed agenda will be available approximately one week before the meeting. Copies of the agenda can be requested by telephone or obtained from the Board's Web site at *http://www.nwtrb.gov*. Beginning on June 16, 2003, transcripts of the meeting will be available on the Board's Web site, via e-mail, on computer disk, and on a library-loan basis in paper format from Davonya Barnes of the Board staff.

A block of rooms has been reserved at the Watergate Hotel. A meeting rate is available for reservations made by April 21, 2003. When making a reservation, please state that you are attending the Nuclear Waste Technical Review Board meeting. For more information, contact the NWTRB; Karyn Severson, External Affairs; 2300 Clarendon Boulevard, Suite 1300; Arlington, VA 22201-3367; (tel) 703-235-4473; (fax) 703-235-4495.

Dated: April 17, 2003.

William D. Barnard,

Executive Director, Nuclear Waste Technical Review Board.

[FR Doc. 03-9908 Filed 4-21-03; 8:45 am]

BILLING CODE 6820-AM-M

SECURITIES AND EXCHANGE COMMISSION

[Securities Exchange Act of 1934: Release No. 47683 and International Series Release No. 1268]

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

April 16, 2003.

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] and excess margin [2] securities from customers to pledge a wider range of collateral than is currently permitted under paragraph (b)(3) of rule 15c3-3 (17 CFR 240.15c3-3). Most of the categories of permissible collateral added by this Order were selected based on their high quality and liquidity. The remaining categories, certain sovereign debt securities and foreign currencies, are being added because they may be pledged only when borrowing non-equity securities issued by entities (including the sovereign entity) from the same sovereign jurisdiction or denominated in the same currency, respectively. In these cases, market declines affecting the pledged collateral should be expected to have a related affect on the borrowed securities. By adding only highly liquid collateral or, with respect to two categories, collateral that is restricted in its use, the Order is consistent with the objectives of paragraph (b)(3) of rule 15c3-3, which is designed to ensure borrowings from customers remain fully collateralized.

The Commission took into account several considerations in deciding whether to provide this exemptive relief and designate additional categories 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 the additional kinds of collateral will provide. Those benefits include 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.

The rule 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. The Order requires, in addition to the rule's requirements, over-collateralization when the collateral is denominated in a different currency than the borrowed securities. The daily marking to market and over-collateralization should serve to buffer fluctuations in value.

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 types 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:[3]

1. "Government securities" as defined in section 3(a)(42)(A) and (B) of the Exchange Act may be pledged when borrowing any securities.

2. "Government securities" as defined in section 3(a)(42)(C) of the Exchange Act issued or guaranteed as to principal or interest by the following corporations may be pledged when borrowing any

[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] All prior staff interpretations and no-action positions concerning the types of collateral that may be pledged under paragraph (b)(3) of rule 15c3-3 are herewith withdrawn.

securities: (i) The Federal Home Loan Mortgage Corporation, (ii) the Federal National Mortgage Association, (iii) the Student Loan Marketing Association, and (iv) the Financing Corporation.

3. Securities issued by, or guaranteed as to principal and interest by, the following Multilateral Development Banks—the obligations of which are backed by the participating countries, including the U.S.—may be pledged when borrowing any securities: (i) The International Bank for Reconstruction and Development, (ii) the Inter-American Development Bank, (iii) the Asian Development Bank, (iv) the African Development Bank, (v) the European Bank for Reconstruction and Development, and (vi) the International Finance Corporation.

4. Mortgage-backed securities meeting the definition of a "mortgage related security" set forth in section 3(a)(41) of the Exchange Act may be pledged when borrowing any securities.

5. Negotiable certificates of deposit and bankers acceptances issued by a "bank" as that term is defined in section 3(a)(6) of the Exchange Act, and which are payable in the United States and deemed to have a "ready market" as that term is defined in 17 CFR 240.15c3–1 ("rule 15c3–1"),[4] may be pledged when borrowing any securities.

6. Foreign sovereign debt securities may be pledged when borrowing any securities, *provided* that, (i) at least one nationally recognized statistical rating organization ("NRSRO") has rated in one of its two highest rating categories either the issue, the issuer or guarantor, or other outstanding unsecured long-term debt securities issued or guaranteed by the issuer or guarantor; and (ii) if the securities pledged are denominated in a different currency than those borrowed,[5] the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of rule 15c3–3 (100%) by 1% when the collateral is denominated in the Euro, British pound, Swiss franc, Canadian dollar or Japanese yen, or by 5% when it is denominated in another currency.

7. Foreign sovereign debt securities that do not meet the NRSRO rating condition set forth in item 6 above may be pledged only when borrowing non-equity securities issued by a person organized or incorporated in the same jurisdiction (including other debt securities issued by the foreign sovereign); *provided* that, if such foreign sovereign debt securities have been assigned a rating lower than the securities borrowed, such foreign sovereign debt securities must be rated in one of the four highest rating categories by at least one NRSRO. If the securities pledged are denominated in a different currency than those borrowed, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of rule 15c3–3 by 1% when the collateral is denominated in the Euro, British pound, Swiss franc, Canadian dollar or Japanese yen, or by 5% when it is denominated in another currency.

8. The Euro, British pound, Swiss franc, Canadian dollar or Japanese yen may be pledged when borrowing any securities, *provided* that, when the securities borrowed are denominated in a different currency than that pledged, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of rule 15c3–3 by 1%. Any other foreign currency may be pledged when borrowing any non-equity securities denominated in the same currency.

9. Non-governmental debt securities may be pledged when borrowing any securities, *provided* that, in the relevant cash market they are not traded flat or in default as to principal or interest, and are rated in one of the two highest rating categories by at least one NRSRO. If such securities are not denominated in U.S. dollars or in the currency of the securities being borrowed, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of rule 15c3–3 by 1% when the securities pledged are denominated in the Euro, British pound, Swiss franc, Canadian dollar or Japanese yen, or by 5% when they are denominated in any other currency.

The categories of permissible collateral identified above do not include securities that (i) have no principal component, or (ii) accrue interest at the time of the pledge at a stated rate equal to or greater than 100% per annum (expressed as a percentage of the actual principal amount of the security).

Broker-dealers pledging any of the securities set forth above must, in addition to satisfying the notice requirements already contained in paragraph (b)(3) of rule 15c3–3, include in the written agreement with the customer a notice that some of the securities being provided by the borrower as collateral under the agreement may not be guaranteed by the United States.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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[4] Certificates of deposit and bankers acceptances are deemed to have a "ready market" under rule 15c3–1 if, among other things, they are issued by a bank as defined in section 3(a)(6) of the Exchange Act that is (i) subject to supervision by a federal banking authority, and (ii) rated investment grade by at least two nationally recognized statistical rating organizations or, if not so rated, has shareholders' equity of at least $400 million.

[5] For the purposes of this Order, equity securities will be deemed to be denominated in the currency of the jurisdiction in which the issuer of such securities has its principal place of business.

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–47676; File No. SR–CBOE–2002–05]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, 3, and 4 Thereto by the Chicago Board Options Exchange, Incorporated Relating to the Introduction of the CBOE Hybrid System

April 14, 2003

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 18, 2002, April 2, 2002, May 17, 2002, January 16, 2003, and April 7, 2003, respectively, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change, and Amendments No. 1, 2, 3, and 4 to the proposed rule change,[3] as described in Items I, II, and III below, which Items have been prepared by the CBOE. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The CBOE proposes to implement the CBOE Hybrid System, a revolutionary options trading platform that combines the best features of both open outcry and electronic trading systems. When operational, the CBOE Hybrid System will offer automatic executions of eligible electronic orders and still provide an open-outcry trading

[1] 15 U.S.C. 78(b)(1).

[2] 17 CFR 240.19b–4.

[3] Amendment No. 4 supersedes the original filing and Amendments No. 1, 2, and 3 in their entirety.