



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF COMPLIANCE
INSPECTIONS AND
EXAMINATIONS

February 6, 2014

Peter Schwartz
[REDACTED]
[REDACTED]

Dear Mr. Schwartz:

I received your January 27, 2014 letter to Chair Mary Jo White, in which you suggest that one way to mitigate the lack of broker-dealer examination coverage identified in the Securities and Exchange Commission's fiscal year 2014 Congressional Budget Request would be to create a new technological system to calculate broker-dealer net capital and customer reserve requirements.

As identified in our FY 2014 Budget Request, the Office of Compliance Inspections and Examinations ("OCIE") will continue to focus on new technological investments and initiatives, to the extent permitted by the SEC's annual funding level. For example, OCIE plans to acquire additional data sets and information that can be utilized in risk assessment efforts and examinations. By using this enhanced technology, our staff will continue to focus examinations on high risk entities and to improve OCIE's risk assessment and surveillance functions. OCIE also will invest in tools and resources that will permit more efficient analysis and synthesis of data.

Regarding the technology you suggest that would create a single, real time system to calculate a broker-dealer's net capital and customer reserve requirements, we appreciate the ideas you shared and will consider your recommendations. We agree that increased use of new technology in our regulatory oversight is important, particularly, as noted above, where it allows us to more efficiently analyze data and thereby ensure compliance. I will also share your thoughts with other relevant staff within the Commission. Thank you for taking the time to share your thoughts about this issue.

If you have any questions, please do not hesitate to call. I can be reached at [REDACTED] or [REDACTED]

Sincerely,

Kevin W. Goodman
Associate Director
Office of Compliance Inspections and Examinations

cc: Office of the Chairman

January 27, 2014

Securities and Exchange Commission
SEC Headquarters
100 F Street NE
Washington DC 20549
Attention Commissioner Mary Jo White

RE: Simultaneously Eliminating Budget and Regulatory Gaps

Dear Commissioner Mary Jo White

According to the SEC's FY 2014 Congressional Budget Justification regarding the Office of Compliance Inspections and Examinations:

“Exam Coverage of the Securities Market Remains Limited: ... With respect to broker-dealers, the program is supplemented by SRO oversight, and together the SEC and SROs examined close to 50 percent of broker-dealers in some manner during FY 2012. However, the program has examined less than one percent of the approximately 160,000 branch offices in the previous 10 years. Even considering the aggregate branch office exams of the SEC and the SROs, regulators are still examining well below one percent of broker-dealer branch offices annually.”

As the transfer of data from the broker-dealer to the examiner is less costly than the transfer of examiners to each physical location, then the data should be moved. This would be consistent with the goal 2014 Budget Justification Strategic Goal 4: Maximizing the use of SEC Resources and Executive Order 13589 Section 3 (Promoting Efficient Spending *Travel*) which states “agencies are encouraged to devise strategic alternatives to Government travel”

An ideal state of regulation can exist the raw data of the regulated is transmitted to an independent entity to process that information into a format which is useful to the regulator. In an ideal state of regulation violations are non-existent as preventative systems are in place to block such violations.

Integral to protection of the customers of broker-dealers are two mathematical equations: The Computation of Net Capital (SEC Rule 15c3-1) and the Customer Reserve Calculation (SEC Rule 15c3-3) . Though the numbers vary from firm to firm, there is only one correct way of performing each equation as prescribed by the Securities & Exchange Commission.

If the SEC or FINRA had to examine one single system which calculates broker-dealer net capital, then the SEC and FINRA would not have to examine net capital calculations of each and every broker-dealer. If the Broker-Dealers were to disseminate their raw data to one common system independent of the broker-dealers, then the costs to the regulators would be minimized, and the costs to the regulated would be shared. There is not a lack of examiners, there is an excess of calculations. Standardized data should ideally flow into a single system for standardized calculations.

How would the costs to the regulator be minimized? The regulators would just need to be involved with initial design of the system and then have control over any changes in the program code going forward. The program code would always be transparent to, and under the control of the regulator.

Why would the regulated broker-dealers want independent net capital calculations?

- Enhanced Control over Firm Positions and Risk Exposures.
- Reallocation of Resources away from preparation and audits to new areas of regulation.
- Elimination of Examinations of such calculations if done independently
- Reduced SIPC Fees and Borrowing Costs.
- Increased Customer Assets as a result of Transparency
- Confidence of Customers and Investors

Are there benefits other than cost savings to the Regulators with this distinct structure?

- Independent Calculations remove the ability for the Broker-dealer to manipulate the reporting. Madoff Securities exemplifies the need of an outside party with no affiliation with the broker-dealer to be at the heart of the reporting.
- Raw Data insures comprehensive reporting. JPM Chase's Whale of London slipped through the regulatory net because the CFTC requires participants to voluntarily submit required positions. If figures do not lie, then simply submit the raw trial balance and stock record data.
- Real-Time Transparency enables visibility to intraday solvency levels of broker-dealers to the regulator. Examinations of end of day positions does nothing to circumvent intraday gambling.
- If trades can be compared to a firm's net-capital in real time, and trades beyond position limit could be flagged as no good for trade comparison, then systemic risk could be mitigated. As ambitious as it seems it is less expensive to design and implement than the interest on \$700 billion in TARP.
- The Long and Short Positions used for Haircuts for SEC Rule 15c3-1 are the result of firm proprietary trading. The positions which arise from trading firm accounts would serve as a system of checks and balances for enforcement of the Volcker Rule.
- Reduced Travel for the examiners can make the job more appreciable for examiners as well as the families of examiners. Independent Calculations which eliminates the conflict of interest enables a the natural order of family life as well as the natural structure of regulation.

The utilization of a real-time system by the broker-dealers would elevate compliance of 15c3-1 to the same level as what private institutional investors currently utilize for portfolio margin requirements for CFTC compliance. As Broker-Dealers hold customer accounts, they certainly should be under the same level of scrutiny as hedge funds. One may argue the broker-dealers do not take on as much risk, but how would one really know without looking at broker-dealer positions in real-time?

The same macro-prudential structure insures protection of customer cash for SEC Rule 15c3-3:

1. The Broker-Dealer transmits required data to an independent systems firm.
2. The Systems firm makes available the calculation to both the regulators and Broker-dealers.
3. The Broker-Dealer sends a screen shot of the new bank balance to the regulator.

If the CFTC had the details to customer account balances, the customer reserve calculation and a screen shot of the bank balance for exclusive benefit of customers, then all the customers of MF Global would have had access to their cash today. Customer reserves will perpetually be at risk as long as the player and the scorekeeper are the same party.

In 2001 I received a patent for a system which calculates SEC Rule 15c3-1 Haircuts in real-time. It enables broker-dealers to disclose their positions electronically, and enables the regulators to see the effects of basic securities such as stock and bonds on net capital in real-time. Similar systems calculate real-time haircuts on standardized derivatives for CFTC compliance. Consequently collective technology exists which can put the hand of the regulators on the pulse of broker-dealer solvency.

Initially a pilot program including just one self clearing entity willing to disseminate their data should be established as a foundation for the industry. Regulatory staff at the SEC and the SROs would be involved with systems requirements. Once up and running properly the street would be invited to participate. The Ryan-Murray Budget Agreement has only pushed back sequester cuts until 2016, it would be sensitive to fully implement now to ease future sequestration pain.

Executive Order 15576 Delivering Enabling, Effective and Accountable Government states “the Administration is committed to insuring that the Federal Government serves the American people with the utmost effectiveness and efficiency.” Independent Calculations which alert enforcement of insufficient broker-dealer capital in real-time is substantially more efficient as it eliminates the extra step of manually verifying broker-dealer solvency on a historical basis. Though efficiency is apparent and necessary for compliance there is something else of value other than bottom line savings:

Executive Order 15576 also states “The American People must be able to *trust their Government is doing everything* in their power to stop wasteful practices and earn a high return on every dollar spent” There is an opportunity to strengthen government credibility by tapping into synergies where both the public and private sector team up with a common goal in mind. If preventative systems are unveiled which can effectively protect customer assets, the financial services industry would likely attract such assets and government would receive heightened confidence in its ability to perform effectively.

Its a win-win for both the public and private sector. I look forward to hearing from you as implementation will yield profound effects on both budget and regulatory gaps in 2014

Sincerely

Peter Schwartz
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