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Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303
Rule-comments@sec.gov

File Number S7-08-07

Dear Ms. Morris:

Here are my comments on File S7-08-07, on the Financial Responsibility Rules for Broker Dealers.

In brief:

- The well-meaning restrictions in Rule 15c3-3 make it unduly burdensome to lend fully paid securities. These rules should be streamlined to make it easier to lend fully paid securities with the consent of the accountholders.

- The new proposed definition of fully paid securities unduly expands the universe of fully paid securities.

- The proposing release does not fully comply with the Regulatory Flexibility Act. In particular, the proposal does not show that the Commission has considered as an alternative the methods used by foreign jurisdictions to deal with these issues.

Rule 15c3-3 imposes excessive burdens on lending fully paid securities.

There is nothing in the Exchange Act or SIPA which indicates any congressional intent to ban the lending of securities from cash accounts or excess margin securities from margin accounts. Nevertheless, the implementation of 15c3-3 has resulted in a *de facto* ban on such lending. As long as appropriate controls are in place, stock lending is an important part of the functioning of modern capital markets. Currently, rule 15c3-3 requires the following before securities can be loaned out of cash accounts or “excess margin” securities can be loaned out of margin accounts:

> 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;
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> ii. Provides that the lender will be given a schedule of the securities actually borrowed at the time of the borrowing of the securities;
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> iii. Specifies that the broker or dealer:
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> 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 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
>
> 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.

Back office personnel have told me that, as a practical matter, securities cannot be borrowed from cash accounts. The administrative expenses involved with collateral, letters of credit, and marking to market make it impractical to borrow small quantities of shares from individual cash accounts. I have personally contacted one of my brokers about lending stock held in my IRA, and I was informed that they were only interested if I had $100,000 worth of a particular hard-to-borrow stock to lend.

These bureaucratic restrictions on lending fully paid shares make it sometimes much more difficult to borrow shares. This exacerbates the problems associated with failures to deliver in the U.S. markets. Making it easier for firms to lend fully paid securities will reduce failures to deliver.

The rules can and should be streamlined to reduce the administrative costs of lending from cash accounts. Brokerage firms routinely lend stock from margin accounts with few if any problems. The same safeguards that protect margin account customers are probably adequate to protect cash account customers. However, care should be taken to make sure that such customers are aware of the consequences of lending securities, including loss of voting rights and potential tax problems with substitute payments in lieu of dividends. The current margin account disclosures required by NASD Rule 2341 are woefully inadequate in this respect, as they say nothing about potential loss of voting rights or tax complications. Customers should be able to opt out of lending their fully paid securities without any penalty from the brokerage firm.

The proposed definition of fully paid securities is overly broad.

The proposed definition for fully paid securities states:

> *The term fully paid securities shall include all securities carried for the account of a customer unless such securities are purchased in a transaction for which the customer has not made full payment.*

This definition is inadequate as indicated in the following example. Suppose that a customer purchases securities in a margin account and pays for them in full. They now qualify as fully paid securities under the proposed definition, because the customer has made full payment. Several days or weeks or years later, the customer then borrows against the securities in the account. Under a strict reading of the proposed definition, these securities would qualify as fully paid securities, because the customer made full payment for the original purchase transaction. However, these securities have been used as collateral for a loan from the brokerage firm, so they should not be treated as fully paid for the purposes of rule 15c3-3.

The Regulatory Flexibility Act analysis is insufficient because the Commission has not investigated the alternatives used by other jurisdictions.

§603(c) of the Regulatory Flexibility Act requires:

Each initial regulatory flexibility analysis shall also contain a description of any significant alternatives to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the proposed rule on small entities.

The SEC is not the only regulator that has dealt with the financial responsibility requirements for broker dealers. Most other developed and even emerging capital markets have rules dealing with the capital requirements for financial institutions. However, the proposing release does not indicate whether the Commission has seriously investigated how these other regulatory agencies have addressed these issues. In this and other rule filings the SEC should examine what these other regulators are doing.

In particular, many jurisdictions in smaller countries deal mainly with smaller firms. Although the quality of investor protection in some of these jurisdictions leaves a lot to be desired, others have leapfrogged to world class levels by learning from the best practices (and avoiding the worst mistakes) of other countries.

Even though we love to beat our chests and brag about how great our markets are, we can still learn from the experience (both good and bad) of other jurisdictions. Paying explicit attention to regulatory trends in the rest of the world benefits not only small entities (by reducing their regulatory burden) but all entities, as the larger entities can experience more consistent regulatory procedures around the world. The comment letter from JP Morgan Chase references the UK's FSA rules in this area. As the world contemplates Basel II, the SEC should also consider a Basel II type approach to net capital requirements.

Indeed, in every rulemaking action, the Commission should explicitly examine the alternatives used by regulators in other jurisdictions. Failure to do so puts U.S. entities at a disadvantage.

Respectfully submitted,

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