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By Electronic and United States Mail

Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Dear Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities (the "Committee") of the Section of Business Law (the "Section") of the American Bar Association (the "ABA") in response to a request for comments by the Securities and Exchange Commission (the "SEC" or "Commission") on proposed amendments to the SEC's financial responsibilities contained in Release No. 34-55431, 72 FR 12862 (Mar. 19, 2007) (the "Proposal" or the "Release").

The comments expressed in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section, nor does it necessarily reflect the view of all members of the Committee.

I. INTRODUCTION AND GENERAL COMMENTS

The Committee congratulates the Commission and its staff on publication of the important amendments to and interpretations of the Commission's financial responsibility rules,

particularly the net capital rule, Rule 15c3-1, and the customer protection rule, Rule 15c3-3, under the Securities Exchange Act of 1934 ("Exchange Act"). Given the complexity of the financial responsibility rules, the Committee believes that it is particularly important for the industry and the bar to have an opportunity to comment on changes to and interpretations of these rules.

The Committee further believes, however, that a unified and centralized approach to the financial responsibility rules is important, and is concerned that not only did NASD Regulation, Inc. ("NASD") issue interpretative guidance on financial as well as operation rules [1] during the comment period for the Release, but so did the New York Stock Exchange, Inc. (the "NYSE"),[2] despite promises by these self-regulatory organizations to harmonize their rulebooks. The Committee continues to urge the Commission to take steps to create uniform rules and interpretations.

Our specific comments are discussed below, but, among other things, the Committee agrees with the Commission that the purposes for which Exchange Act Rule 15c3-2 was adopted are now addressed by Rule 15c3-3 and supports the elimination of this rule.

II. DISCUSSION OF THE SPECIFIC PROPOSALS

A. Disparate Treatment of Affiliates for Purposes of Reserve Accounts and Issuers of Money Market Funds

In its Proposal, the Commission expresses concern that the sanctity of special reserve deposits may be threatened if the customer reserve account is maintained at a bank affiliated with the broker-dealer. Similarly, while the Commission proposes to expand the definition of "qualified security" for purposes of Rule 15c3-3 to include money market funds, it requires that the issuers of the funds be unaffiliated with the broker-dealer. The Commission, however, offers no factual support for prohibiting broker-dealers from depositing customer reserves in affiliated banks or investing funds in affiliated money market funds. We believe that such disparate treatment between affiliates and non-affiliates should be supported by more than theoretical concerns, particularly in the case of highly regulated broker-dealer affiliates, such as national banks, and, particularly, issuers of money market funds that are regulated by the Commission itself. Rather than a blanket prohibition on broker-dealers using affiliated banks to maintain customer reserve accounts, or treating money market funds issued by affiliates as qualified securities, the Committee respectfully suggests that the Commission use objective standards, such as adequacy

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1 *See* NASD Notice to Members 07-16 (Frequently Asked NASD Financial and Operational Questions) (Apr. 2007) (available at http://www.nasd.com/RulesRegulation/NoticestoMembers/2007NoticestoMembers/NASDW_018898).

2 *See, e.g.,* Exch. Act Rel. No. 55555, 72 FR 16839 (Apr. 5, 2007).

of regulation and oversight, management independence, the affiliate's creditworthiness, and the rating assigned to money market fund by a nationally recognized statistical rating organization.

C. Treatment of Free Credit Balances

The Proposal addresses the treatment of customer free credit balances, specifically the practice of sweeping free credit balances to money market funds and bank deposit accounts. It is of course appropriate for the Commission to provide guidance on the effect such sweep programs have on the calculation of a broker-dealer's customer reserve calculation. However, the majority of the Commission's proposed amendments to Rule 15c3-3 with respect to the treatment of customer free credit balances relate to broker-dealers' sales practices, rather than the reserve calculation implications of sweep programs.[3] In particular, proposed new paragraphs (j)(2)(ii) and (iii) almost exclusively deal with customer communications and a requirement to follow self-regulatory organization ("SRO") disclosures.[4] Given the very narrow focus and technical requirements of Rule 15c3-3, we believe that it would be more appropriate for the Commission to reflect the sales practice requirements related to sweep accounts in a separate rule, or, ideally, to ask that the NASD (and subsequently the Securities Industry Regulatory Authority) address sweep accounts through its sales practice rules.

The new language of (j)(2)(ii) and (iii) does not address the safety of the sweeps or the custody or control broker-dealers have over the free credits. Rather, (j)(2)(ii)(A) discusses obtaining a customer's consent after disclosing the terms and conditions of the potential products. We concur that customers should receive this information, but do not believe this is an activity that rises to the level of an amendment to the customer protection rule. Moreover, the requirement in (j)(2)(ii)(B) that broker-dealers comply with SRO disclosure and notice requirements regarding sweeps of free credit balances is redundant.[5] Broker-dealers are already required to comply with SRO rules, and indeed the Commission already can enforce SRO rules under Section 21(d) of the Exchange Act. We note that the Commission and SRO staffs have been discussing with the industry a 16-point proposal concerning free-credit balance sweep programs, but only a few of

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3 The Committee notes and supports the SEC's proposal to recognize that proprietary accounts of futures commission merchants under the Commodity Exchange Act are not free credit balances.

4 The first sentence of proposed (j)(2)(iii) adds the words "or will accumulate" to "A broker or dealer is permitted to transfer free credit balances that are held or will accumulate in the account of a customer . . . ." It is unclear what distinction the SEC is making by adding "or will accumulate" and we request clarification.

5 The most relevant SRO notice is NYSE Information Memo 05-11 (Feb. 15, 2005) (available at http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256F09007311B485256FAC0064B945/$FILE/Microsoft%20Word%20-%20Document%20in%2005-11.pdf), although this information memo is phrased in terms of industry best practices rather than as binding requirements, and the Information Memo was never filed with the Commission as a rule change as would be required for a binding SRO rule under Section 19(b) of the Exchange Act.

those points are addressed in the current proposal. As a result, it is unclear if there will be, in addition to these proposed amendments, another set of SRO disclosure requirements. Consistent with our comments above regarding uniformity, we believe that it would be best to have all sales practice requirements in one place, rather than having some in Rule 15c3-3 and others scattered in SRO rules or notices.

The proposed 30-day notice period and disclosures proposed in (j)(2)(ii)(D) and (iii)(C) also deal with customer communication rather than customer protection and would be better addressed as a sales practice issue by the SROs. The Commission's proposal does not address situations in which it is impractical for broker-dealers (through no fault of their own) to provide 30 days advance notice - a situation the SROs have already addressed.[6] In our view, this issue underscores our view that the more flexible ability of SROs to address sales practice issues makes sweep programs a more appropriate subject for SRO rulemaking than for SEC rulemaking.

We understand the Commission's intent is to permit broker-dealers to transfer customers among different cash alternatives (free credit balances, bank sweeps or money market mutual funds) subject only to the 30-day notice requirement, without requiring affirmative consent from each customer. NASD Rule 2510(d)(2) currently allows such "bulk transfers" among money market funds, but the NASD has interpreted this rule not to apply to transfers among other cash alternatives.[7] We agree that it is desirable to provide greater flexibility in providing cash management alternatives. However, we believe the language as proposed (which speaks entirely in terms of "free credit balances") does not clearly accomplish this intent, and should be rephrased in terms of broader cash management alternatives.

D. Holding Futures Positions in a Securities Portfolio Margining Account

The Commission notes in the Release that the Chicago Board Options Exchange ("CBOE") and the NYSE have amended their margin rules to permit member broker-dealers to compute margin requirements under a portfolio margin methodology.[8] These rules would permit the inclusion of certain futures and futures options contracts[9] in the portfolio margin accounts so that they may

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6 *See* Letter from Patricia Albrecht, NASD, to George Simon, Foley & Lardner, dated Jan. 26, 2005, Interpretative Guidance Relating to Rule 2510(d) (available at http://www.nasd.com/RulesRegulation/PublicationsGuidance/ InterpretiveLetters/ConductRules/NASDW_013714).

7 *See* Letter from Patricia Albrecht, NASD, to Marc A. Cohen, Metropolitan Life Insurance Company, dated Feb. 3, 2003, Interpretative Guidance Relating to Rule 2510(d) (available at http://www.nasd.com/RulesRegulation/PublicationsGuidance/InterpretiveLetters/ConductRules/NASDW_002634).

8 The NASD has also amended its margin rule to permit members to establish portfolio margin accounts. *See* Exch. Act Rel. No.55518, 72 FR 13149 (Mar. 20, 2007).

9 Under the portfolio margin rules, the only futures and futures options contracts permitted are those on broad-based equity securities indices.

be combined with securities in the account to compute the required margin. The Commission states in its Release that under the Securities Investor Protection Act of 1970, as amended ("SIPA"), only claims for securities and cash are protected, thereby raising the question of how futures position in a portfolio margining account should be treated in a SIPA liquidation. The Commission proposes to clarify this question by amending Rule 15c3-3 and Rule 15c3-3a to provide the protection of those rules to futures positions in the portfolio margin account.

Specifically, the definition of "free credit balances" in paragraph (a)(8) of Rule 15c3-3 would be amended to include margin deposits and daily marks-to-market related to, and the proceeds from, the liquidation of futures and options on futures carried in a portfolio margin account established under SRO rules. A broker-dealer would have to treat these balances as credit items under the reserve formula. The market value of futures options would only become a credit in the formula as of the "filing date", as that term is defined in SIPA with respect to a SIPA liquidation proceeding. This treatment of futures options is considered necessary because the broker-dealer does not hold cash balances in respect of such options, provided that they have a market value. Treating options as a credit in the formula is designed to ensure that their market value will be taken into account in the computation of the customer's "net equity" claim in the SIPA liquidation.

On the debit side of the customer reserve formula, the Commission proposes to amend Rule 15c3-3a Item 14 to permit the broker-dealer to include the amount of customer margin required and on deposit at a derivatives clearing organization related to the futures positions carried in the portfolio margin account. Item 14 is also proposed to be amended to extend the requirements that must be met by a derivatives clearing organization with respect to such debit items. The purpose of including margin balances for futures maintained at a derivatives clearing organization is to make such deposits "customer property" under SIPA.

The Commission has requested comment on whether this approach represents "a workable solution" to providing SIPA protection to portfolio margin accountholders and whether there may be other approaches the Commission may pursue to provide such protection.

Before responding to the request, the Committee would first like to applaud the Commission for addressing this topic. Authorization to compute margin on a portfolio basis, *i.e.*, computing the amount of collateral required to secure an extension of credit to a customer, should be based on measurement of the market risk to the broker-dealer of positions carried in the account (including offsets or hedges), was adopted by the Board of Governors of the Federal Reserve System in amendments to Regulation T that became effective in January, 1998.

Since then, the use of futures and futures options by sophisticated investors and traders to augment or offset their positions in securities has become commonplace. Therefore, any portfolio margin rule, to be efficient, must take into account related derivatives. The portfolio margin rules adopted by the CBOE and the NYSE do this by allowing the inclusion not only of futures and futures options on related products, but also of so-called "OTC "(or, over-the-counter)

derivatives, that is, privately negotiated transactions that include security-based options, swaps and forward contracts. Clarification of the treatment of futures and options in the portfolio margin account is an essential step to assure that there is roadmap in the unfortunate event of a broker-dealer liquidation.

The Committee also notes that the use of portfolio margining is widespread in financial markets outside of the United States, particularly in Europe. The lack of a comprehensive portfolio margin regime in the United States has driven some securities financing by major investors and traders abroad. The incremental steps taken by the CBOE and the NYSE to establish portfolio margining for equity products is an important first step not only for reasons of efficient use of capital, but also for enhancing the competitive position of the U.S. financial markets. Therefore the Committee supports the Commission's efforts to facilitate the cross-margining of futures and securities in the portfolio margining account by clarifying the treatment of futures and options positions under SIPA. The Committee also urges the Commission to continue to support SRO initiatives that will expand the products that can be carried in a portfolio margin account to include debt securities, foreign currencies and credit derivatives.

An additional measure that we urge the Commission to consider relates to the limitations on rehypothecation of customer collateral. Generally, a broker-dealer is limited in the amount of customer collateral that it may rehypothecate as collateral to finance the credit it extends to a customer by the provisions of Section 8 of the Exchange Act and Rule 8c-1 thereunder, and by Rule 15c2-1 (prohibiting rehypothecation in excess of customers' aggregate indebtedness), and Rule 15c3-3 (effectively limiting the value of a customer's securities that may not be rehypothecated to 140% of the customer's debit balance).

The basic problem is that customers who sell listed options or engage in other OTC derivatives transactions may generate a margin requirement, but incur no debit and hence there is no increase in "aggregate indebtedness" that would allow the firm to use the customer's assets to fund the cost of those positions. For example, a broker-dealer carrying the account of a portfolio margin customer may face the following situation: a customer with $5 million in equity (who is therefore qualified to include OTC derivatives in the account) is short $10 million in value of an exchange-traded fund ("ETF") linked to a broad-based equity index and is long an OTC derivative on the same value of the same index. In addition, the customer has deposited $10 million of treasury bonds in the account. The customer has a portfolio margin requirement but does not have a debit in the account. Nevertheless, to hedge its exposure to the customer under the OTC derivative (since the customer is "long" and the firm is "short) the firm is long a basket of equity securities, an ETF or a futures contract, or a combination thereof. Although the broker-dealer has not extended credit to the customer, the broker-dealer is using its own resources to fund the cost to carry the customer's position in the portfolio margin account. Under the current rules, the broker-dealer is not entitled to rehypothecate the customer's treasury securities to finance the hedging transaction.

If, on the other hand, the customer had purchased an underlying basket of securities or an ETF funded by the firm creating a debit in the account of, say, $8,500,000, the firm would be able to rehypothecate (perhaps by a repurchase ("repo") transaction) a like amount of the customer's treasury securities to generate the cash needed to finance the customer's debit.

The asymmetry of result in what are economically similar positions is a substantial limitation on the ability of the broker-dealer to offer the customer the most cost-efficient financial terms. The result is that U.S. broker-dealers are not competitive with foreign competitors who have no such limitation.

In adopting the amendments that permitted firms to establish OTC derivatives dealers, the Commission recognized this issue and amended Rules 8c-1, 15c2-1 and 15c3-3 to exempt OTC derivatives dealers from the rehypothecation rules in transactions with counterparties. The result of these amendments was that customers of the OTC derivatives dealers did not have the protection of SIPA. We urge the Commission to consider amending Rules 8c-1, 15c2-1 and 15c3-3 to provide that the provisions thereof are inapplicable to customers that are entitled to engage in derivatives transactions in a portfolio margin account (this would include both listed and unlisted derivatives), provided that such customers agree in writing that they will not have the protection of SIPA and may be deemed to be general creditors of the broker-dealer in regard to claims arising from their portfolio margin accounts.

We appreciate that this result is contrary to what the Commission seeks to achieve by the proposed amendments; that is, that SIPA protection will be increased by extension to futures and options in the account. We believe, however, that in view of the precedent established in the OTC derivatives dealer rules, and the fact that the amendments would only apply to large and sophisticated customers entitled to engage in OTC derivatives transactions, such amendments are warranted.

Alternatively, the Commission could seek to craft amendments to these rules that expand the definition of aggregate indebtedness to include, in addition to credit actually extended by the broker-dealer, a percentage of the market value of the derivative in the portfolio margin account or some similar measure of the broker-dealer's cost to carry the customer's positions. The disadvantage of this approach is that the amount or value could fluctuate substantially with market changes and could require additional systems and procedures to measure and monitor compliance.

With regard to the specific request for comments, the Committee supports the proposed amendments because the Commission has correctly analyzed the economic characteristics of futures and options. Based on this analysis, the treatment of these instruments in the customer reserve formula would be necessary even if the Commission did not also wish to assure that SIPA protection was being extended to portfolio margin accountholders. That is, even if SIPA were not an issue, broker-dealers would need guidance regarding the treatment of these positions under Rule 15c3-3.

The Committee, however, is not convinced that these amendments assure certainty of application under SIPA. In this regard, the Committee notes that the proposed amendments attempt to deal with three areas that are potentially problematic under SIPA: (i) the definition of "customer" under section 16(2), (ii) the definition of "security" in Section 16(14), and (iii) the definition of "customer property" in section 16(4). In our view, legal certainty under SIPA is best achieved by amendment of these sections of SIPA. The Committee has reviewed the proposed amendments of SIPA that the Commission has proposed to Congress and believes that these amendments would best assure the treatment of futures and options positions carried in a portfolio margin account.

E. Broker-Dealer Solvency Requirements

The Commission is proposing an amendment to the net capital rule that would require a broker-dealer to cease its securities business activities in the event of certain "insolvency events", including "the inability to make computations necessary to establish compliance with Rule 15c3-1." The Committee respectfully requests that the Commission clarify this definition of "insolvency events" to carve out market-wide disruptions that prevent the computation of net capital, but are unrelated to the solvency of the broker-dealer.

F. Proposals Relating to Certain Deductions from Net Worth

Pursuant to proposed paragraph (c)(2)(i)(G) of Rule 15c3-1, a broker-dealer would be required to subtract from net worth, in the determination of its regulatory net capital, any contribution of capital to the broker-dealer under an agreement that provides the investor with the option to withdraw the capital, or that is intended to be withdrawn within a period of one year unless the withdrawal has been approved in writing by the broker-dealer's designated examining authority.[10]

With respect to proposed paragraph (c)(2)(i)(G)(1), we submit that such proposal should be amended to exclude a redemption right – a form of option - provided to the investor in connection with the investor's capital contribution to the broker-dealer, where (i) the redemption right may only be exercised by the investor commencing more than one year following the date of the capital contribution to the broker-dealer and (ii) the redemption right would not be mandatorily redeemable within the meaning of Financial Accounting Standards Board ("FASB") No. 150.[11] Because the redemption right would not be mandatorily redeemable and the investor

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[10] Pursuant to Rule 15c3-1(c)(2)(i)(G)(2), any withdrawal of capital made within one year of its contribution to the broker-dealer is presumed to be subject to this deduction.

[11] For the purposes of FASB 150, a redemption right would deemed to be mandatorily redeemable if such right would require the issuer to redeem the instrument by transferring its cash, assets, or other equity interests to the holder of the right at a specified or determinable date (or dates), or upon an event certain to occur.

would not be able to exercise the redemption right until the passage of at least one year following the date of the capital contribution by the investor to the broker-dealer, there would not be any intent by the investor to withdraw the capital within a period of one year after the date of the contribution thereof and, thus, such capital contribution should not be required to be subtracted from the broker-dealer's net worth – in conformity with proposed paragraph (c)(2)(i)(G)(2). In this regard, we would expect the Commission to employ a first in/first out approach in connection with the determination of the commencement of the aforesaid one-year period.

With respect to the presumption set forth in proposed paragraph (c)(2)(i)(G)(2) (*i.e.,* that any withdrawal of capital made within one year of its contribution to the broker-dealer is presumed to be subject to this deduction), we note that this proposal would codify into Rule 15c3-1 an interpretive letter issued by the Commission's staff in 2000.[12] Pursuant to such interpretive letter, however, the Commission noted that any withdrawal of capital as to that investor within a period of one year would be required to be recharacterized as a liability "other than a withdrawal described in paragraph (e)(4)(iii) of Rule 15c3-1."[13] We submit that proposed paragraph (c)(2)(i)(G)(2) should be amended to also exclude from the presumption therein any withdrawal described in paragraph (e)(4)(iii) of Rule 15c3-1.

G. Documentation of Risk Management Procedures

1. Summary of the Proposal

The SEC is proposing to amend its books and records rules to require certain large broker-dealers to document any implemented internal risk management controls designed to assist in analyzing and managing the risks arising from its business activities. By way of example, the SEC had identified market, credit, liquidity or operational risk arising from the securities lending, repurchase, OTC derivative, proprietary trading or margin lending business as risks to which the proposed rule would apply. The SEC is also proposing to amend its record retention rule to require that the broker-dealer maintain records of risk management controls for three years after ceasing to use such controls.[14] The proposed rule would apply to broker-dealers with more than $1,000,000 in aggregate credit items as computed under the Rule 15c3-3's customer reserve formula, or $20,000,000 in total capital including debt subordinated in accordance with Appendix D to Rule 15c3-1.

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12 See letter to the NYSE dated March 6, 2000 (NO-ACT, WSB File No. 0320200047).

13 Paragraph (e)(4)(iii) of Rule 15c3-1 permits a broker-dealer to make required tax payments and pay reasonable compensation to partners without the restrictions of paragraphs (e)(1) and (e)(2) of the Rule and without considering them to be part of the calculation of withdrawals, advances and loans under those paragraphs.

14 The SEC is proposing to add new subsection (a)(23) to SEC Rule 17a-3 (Records to be made by certain exchange members, brokers and dealers) and new subsection (e)(9) to rule 17a-4 (Records to be preserved by certain exchange members, brokers and dealers).

2. Relationship to Existing Rules

Various rules require broker-dealers to create or maintain risk management controls. As the Commission notes in the Proposal, many broker-dealers operate within public companies subject to the requirements of section 404 of the Sarbanes-Oxley Act of 2002.[15] Such companies are required to include in management reports an annual assessment of the company's internal control over financial reporting.

Moreover, several of the largest broker-dealers operate as consolidated supervised entities ("CSEs") under Appendix E of Rule 15c3-1.[16] A broker-dealer operating under Appendix E of Rule 15c3-1 is required to establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.[17]

In addition, a broker-dealer operating within a holding company structure is subject to Section 17(h) of the Exchange Act and Rules 17h-1T and 17h-2T thereunder. These rules require broker-dealers to maintain, preserve and file with the SEC written policies, procedures or systems concerning the broker-dealer's: (i) methods for monitoring and controlling its financial and operational risks resulting from the activities of any of its associated persons, other than natural persons; (ii) financing and capital adequacy, and (iii) trading positions and risks.[18]

The SEC has not discussed how these existing requirements are meant to relate to the proposed rules or why the existing rules are not adequate for accomplishing the goal of providing for appropriate risk management policies and procedures. In addition, the SEC has not specified the number of broker-dealers that would be covered by the proposed rules that are not covered by the existing rules, making it difficult to assess the costs and benefits of the proposed rules. Accordingly, the Committee does not believe that the risk management proposal is explained adequately and cannot support this proposal until the Commission provides more detail about what is contemplated.

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15 Proposing Release at 37.

16 Currently, five broker-dealers have been approved by the SEC to operated under Appendix E of Rule 15c3-1. A broker-dealer calculating net capital adequacy using Appendix E must maintain tentative net capital of at least $1 billion and net capital of at least $500 million.

17 Rule 15c3-1e(a)(1)(ii).

18 Section 17(h) and Rule 17h-1T do not compel broker-dealers to create policies and procedures when none exist; however, these provisions do require broker-dealers that operate under informal or oral policies or procedures to summarize these policies in written form, and to file them with the SEC. Additionally, a broker-dealer that operates without the policies referred to in these rules is required to document, in writing, the absence of such policies. Letter from Michael A. Macchiaroli, Associate Director, SEC Division of Market Regulation, to Securities Industry Association, September 20, 1993.

3. Importation of Content Requirements

a. Source of Content Requirement

While the proposal is not explicit, the proposed requirement to document risk management procedures appears to contain within it a substantive requirement with respect to the content of those procedures. In this regard, the proposing release states that the Commission believes the "requirement would help firms and their designated examining authorities identify gaps in their internal procedures." The SEC points to the failure of MJK Clearing as highlighting the importance of adequate risk management. A study conducted of the failure of MJK Clearing recommended that the SEC propose rules to require clearing broker-dealers to maintain written risk management procedures, covering market, credit, funding, legal, and operational risks.[19] Part of the reason that the MJK Study recommended that the SEC institute such a rule was to provide a framework from which regulatory examiners can base their examinations.[20] In particular, the MJK Study states, "[s]ecurities industry regulatory examiners have been instructed to examine and comment on the internal controls and the risk management procedures of the securities firms that they are examining, but they have little formal guidance with which to based their review on. [sic]" [21] As such, it would appear that a purpose of the SEC in proposing these rules is to create a requirement for broker-dealers to maintain risk policies that meet certain content standards, against which the broker-dealers may then be examined. However, the content standards themselves are left unstated.

b. Effect of the Lack of Content Standards

The proposed rules do not specify content standards for the documented risk management procedures. As such, each broker-dealer subject to the proposed rule must, based on its own views of risks, costs, and benefits, determine the procedures it believes are necessary and appropriate for its business. This is a flexible approach that may result in a range of outcomes. The proposal in this respect may be analogized to the CSE regime, which, as discussed above, requires broker-dealers opting into that regime to document their risk management procedures. The CSE has been described as "the adoption of a prudential regulatory approach."[22]

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19 Study of the Failure of MJK Clearing, the Securities Lending Business and the Related Ramifications on the Securities Investor Protection Corp. (MJK Study) at 2 and 31-32. Note that the proposed rule goes beyond the recommendation in the MJK report, as it would cover broker-dealers that meet the specified financial criteria, but that are not clearing brokers.

20 *Id.* MJK Study at 32.

21 *Id.* MJK Study at 31.

22 Speech by SEC Commissioner Annette L. Nazareth, Remarks Before the SIFMA Compliance and Legal Conference (3/26/2007).

The Committee does not necessarily take issue with this flexible, prudential approach to regulation. However, the Committee believes that it is important that this aspect of the proposed rule also be reflected in SEC and SRO approaches to examinations of the content of broker-dealers' risk control procedures. The examinations will need to be conducted and supervised by personnel qualified to assess the content of the procedures in light of the subject broker-dealer's business, and not based on generic, "one size fits all" best practices. While a prudential approach to regulation requires broker-dealers to take on the responsibility of developing appropriate risk management controls without explicit guidelines, it also requires a more flexible approach from regulators in assessing the appropriateness of those controls. In this regard, in response to a recommendation from the U.S. Government Accountability Office, the SEC transferred the responsibilities for on-site testing of CSE holding company controls to the Division of Market Regulation so that "the expertise related to the prudential supervision of securities firms will be concentrated there."[23]

The Committee requests that in the context of the current rulemaking the SEC articulate the processes that examiners (whether SEC or SRO staff) will follow in inspecting the content of the documented risk management controls, including: (i) whether that review will be focused in the Division of Market Regulation; (ii) whether, or to what extent, the review will be informed by the staff's experience with CSE risk control procedures; and (iii) whether, or to what extent, examination staff will be instructed to review broker-dealer's risk management controls in a manner that is consistent with the flexible, prudential approach embodied in the proposed rule. We urge the Commission to make this process transparent so that the broker-dealers receive guidance about Commission views as to adequate risk management policies, which will serve to create consistent industry best practices. As stated above, however, the Committee believes that greater detail is needed bout the risk management proposal in a way that provides meaningful notice and comment, which we do not believe was provided through this proposal.

H. Accounting for Third-Party Liens on Customer Securities Held at a Broker-Dealer

The Proposal requests comments on how third-party liens on brokerage accounts should be treated. In the case where a customer's securities are subject to a lien arising from a third-party loan that is made to the customer and not to the broker-dealer, the broker-dealer should not be required to make a corresponding deposit in the customer reserve account to match the amount of the loan. The third-party loan is not a credit balance that the broker-dealer owes the customer or the third-party. By adding a credit to the customer reserve formula, the broker-dealer would effectively become a guarantor of the customer. This also raises the possibility of the securities

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23 GAO-07-154, Financial Market Regulation, Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration (Mar. 2007). The Committee notes that the risk management procedures adopted by CSE broker-dealers may not be appropriate for the broker-dealers that would be subject to the proposed rule.

becoming worthless, the broker-dealer failing, with a credit for the full loan amount remaining in the customer reserve account. A SIPC trustee would then have to determine who has the right to the credits in the customer reserve account held for a loan secured by now worthless securities. This could result in a windfall to the third-party lien holder by passing on the risk of the loan to the broker-dealer and its other customers and creditors.

The most effective way to avoid confusion regarding third-party liens in a SIPC liquidation would be to segregate securities subject to the lien into a separate pledge account in the name of the pledge or pledges. This should be notated in the appropriate books and records of the broker-dealer and disclosed in the account statements of the customer and possibly in an additional notice sent to the customer. Any adjustment in the amount of securities segregated to the pledge account due to market fluctuations should be the responsibility of the customer and the third-party pledges and not the broker-dealer. The broker-dealer should be allowed to pass on to the customer any expenses incurred from assuring the adequacy of the pledges' interest and in segregating the securities. The broker-dealer should also be allowed to make an assessment against the pledged securities to cover these related expenses. Any requirement to segregate a customer's securities to a pledge account should be restricted to instances where the customer acknowledges the third-party lien.

III. CONCLUSION

The Committee applauds the Commission's efforts on the Proposals and appreciates the opportunity to submit comments on this important initiative. As the Commission and staff prepare the adopting release, we respectfully request that they address the status of outstanding exemption, no-action, and interpretative letters. If the Committee can be of any assistance in this process, please let us know. We also are available to meet and discuss our comments with the Commission and its staff and to respond to any questions.

Respectfully submitted,

/s/ Keith F. Higgins

Keith F. Higgins
Chair, Committee on Federal Regulation of Securities

<u>Drafting Committee</u>
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H. Hardy Callcott
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David M. Katz
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Bruce Newman

cc: Hon. Christopher Cox, Chairman
Hon. Paul Atkins, Commissioner
Hon. Roel Campos, Commissioner
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Robert L.D. Colby, Deputy Director, Division of Market Regulation
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