

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–55431; File No. S7–08–07]

RIN 3235–AJ85

Amendments to Financial Responsibility Rules for Broker-Dealers

AGENCY: Securities and Exchange Commission (the “Commission”).

ACTION: Proposed rule.

SUMMARY: The Commission is proposing for comment amendments to its net capital, customer protection, books and records, and notification rules for broker-dealers under the Securities Exchange Act of 1934 (“Exchange Act”). The proposed amendments would address several emerging areas of concern regarding the financial requirements for broker-dealers. They also would update the financial responsibility rules and make certain technical amendments.

DATES: Comments should be received on or before May 18, 2007.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7–08–07 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–08–07. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site (<http://www.sec.gov/rules/proposed>). Comments will also be available for public inspection and copying in the Commission’s Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from

submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT:

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

SUPPLEMENTARY INFORMATION:

I. Background

We are proposing for comment amendments to the broker-dealer net capital rule (Rule 15c3–1),¹ customer protection rule (Rule 15c3–3),² books and records rules (Rules 17a–3 and 17a–4),³ and notification rule (Rule 17a–11).⁴

II. Proposed Amendments

A. Amendments to the Customer Protection Rule

The Commission adopted the customer protection rule (Rule 15c3–3) in 1972 in response to a congressional directive to strengthen the financial responsibility requirements for broker-dealers that carry customer assets.⁵ The rule requires a broker-dealer to take certain steps to protect the credit balances and securities it holds for customers. Under the rule, a broker-dealer must, in essence, segregate customer funds and fully paid and excess margin securities held by the firm for the accounts of customers.⁶ The intent of the rule is to require a broker-dealer to hold customer assets in a manner that enables their prompt return in the event of an insolvency, which, in turn, increases the ability of the firm to wind down in an orderly self-liquidation and, thereby avoid the need for a proceeding under the Securities Investor Protection Act of 1970 (“SIPA”).⁷

The required amount of customer funds to be segregated is calculated pursuant to a formula set forth in Exhibit A to Rule 15c3–3.⁸ 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. Generally, a broker-dealer with a deposit requirement of \$1 million or more computes its reserve requirement on a weekly basis as of the close of the last business day of the week (usually Friday).⁹ The weekly calculation determines the required minimum balance the broker-dealer must maintain in the reserve account.

As noted, Rule 15c3–3 also requires a broker-dealer to maintain physical possession or control of all fully paid and excess margin securities carried for customers.¹⁰ This means the broker-dealer cannot lend or hypothecate these securities and must hold them itself or, as is more common, in a satisfactory control location. Under the rule, satisfactory control locations include regulated securities clearing agencies, U.S. banks, and, with the approval of the Commission, certain foreign financial institutions.¹¹ In order to meet the possession or control requirement, a broker-dealer must determine on a daily basis the amount of customer fully paid and excess margin securities (by issuer and class) it holds for customers.¹² It then compares that amount with the amount of securities it holds free of lien in its own possession or at one of the satisfactory control locations. If a shortfall exists, the firm must take certain actions under the rule.¹³ The actions include: removing liens on securities collateralizing a bank loan; recalling securities loaned to a bank or clearing corporation; buying-in securities that have been failed to receive over thirty days; or buying-in securities receivable as a result of dividends, stock splits or similar

¹ 17 CFR 240.15c3–1.

² 17 CFR 240.15c3–3.

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

⁴ 17 CFR 240.17a–11.

⁵ See Exchange Act Release No. 9856 (November 10, 1972), 1972 SEC LEXIS 189.

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. Subparagraph (a)(5) defines “excess margin securities” as securities having a market value in excess of 140% of the amount the customer owes the broker-dealer and which the broker-dealer has designated as not constituting margin securities.

⁷ 15 U.S.C. 78aaa *et seq.*

⁸ 17 CFR 240.15c3–3a.

⁹ 17 CFR 240.15c3–3(e)(3).

¹⁰ 17 CFR 240.15c3–3(b)(1).

¹¹ 17 CFR 240.15c3–3(c).

¹² 17 CFR 240.15c3–3(d).

¹³ *Id.*

distributions that are outstanding over forty-five days.¹⁴

1. Proprietary Accounts of Broker-Dealers

We are proposing an amendment to Rule 15c3-3 that would require broker-dealers to treat accounts they carry for domestic and foreign broker-dealers in the same manner generally as “customer” accounts for the purposes of the reserve formula of Rule 15c3-3.¹⁵ The amendment is intended to address an inconsistency between the way these proprietary accounts of broker-dealers are protected under Rule 15c3-3 and the SIPA.

Specifically, because broker-dealers are not “customers” for purposes of Rule 15c3-3, a broker-dealer that carries the proprietary accounts of other broker-dealers is not required to include credit and debit items associated with those accounts in the customer reserve formula. Conversely, under SIPA, broker-dealers are considered “customers” and, consequently, entitled to certain protections. When a broker-dealer is liquidated under SIPA, an estate of customer property is created.¹⁶ Customers of the failed broker-dealer, including customers that are broker-dealers, are entitled to a *pro rata* share of the estate of customer property. Thus, while broker-dealers need not reserve for accounts carried for other broker-dealers under Rule 15c3-3, in a SIPA liquidation, broker-dealer accountholders may share in the fund of

customer property. This disparity increases the risk that, in the event a clearing broker is liquidated under SIPA, customer claims will exceed the amount of customer property.

In order to correct the gap between Rule 15c3-3 and SIPA, we are proposing amendments to Rules 15c3-1, 15c3-3 and 15c3-3a that would require carrying broker-dealers to perform a separate reserve computation for proprietary accounts of other domestic and foreign broker-dealers in addition to the reserve computation currently required for “customer” accounts, and establish and fund a separate reserve account for the benefit of these domestic and foreign broker-dealers.¹⁷ This added protection also would mitigate potential contagion that might arise in the event of a failure of a broker-dealer with a large number of broker-dealer customers.

The proposed amendments, in many respects, would codify a no-action letter regarding proprietary accounts of introducing brokers (“PAIB Letter”) previously issued by Commission staff.¹⁸ One significant difference is that the amendments would have a broader scope by including proprietary accounts of foreign brokers-dealers and banks acting as broker-dealers. In the PAIB Letter, the staff stated it would not recommend any action to the Commission if an introducing broker-dealer did not take a net capital deduction under Rule 15c3-1 for cash held in a securities account at another broker-dealer, provided the other broker-dealer agreed to (1) perform a reserve computation for broker-dealer accounts, (2) establish a separate special reserve bank account, and (3) maintain cash or qualified securities in the reserve account equal to the computed reserve requirement (“PAIB agreement”).¹⁹ The PAIB Letter,

however, did not completely address the disparity between Rule 15c3-3 and SIPA, because the procedures set forth in the letter are voluntary and foreign broker-dealers are not subject to Rule 15c3-1 and, consequently, have no incentive to enter into PAIB agreements. Therefore, carrying firms do not include the accounts of foreign broker-dealers in either the Rule 15c3-3 or PAIB computations. However, these entities may be customers for the purposes of SIPA.

The proposed amendments—like the PAIB Letter—would establish reserve requirements for a carrying broker with respect to proprietary accounts it carries for other broker-dealers. Paragraph (e) of Rule 15c3-3 would be amended to require the carrying broker to perform a reserve computation for a proprietary account of another broker-dealer (referred to as a “PAB account”) and to establish and maintain a reserve account at a bank for these PAB accounts.²⁰ A new paragraph (a)(16) would be added to define “PAB account,” paragraph (f) would be amended to require the carrying broker-dealer to notify the bank about the status of the PAB reserve account and obtain an agreement and notification from the bank that the PAB reserve account will be maintained for the benefit of the PAB accountholders. In addition, paragraph (g) would be amended to specify when the carrying broker-dealer could make withdrawals from a PAB reserve account. The carrying broker would have to maintain cash or qualified securities in the PAB reserve account in an amount equal to the PAB reserve requirement. Consistent with the no-action relief provided in the PAIB Letter, if the PAB reserve computation results in a deposit

another broker-dealer outstanding 30 days or less. This exception is limited to receivables from a clearing broker-dealer related to transactions in accounts introduced by the broker-dealer. Frequently, introducing broker-dealers as well as other broker-dealers will have receivables from another broker-dealer arising from proprietary transactions in an account at the other broker-dealer. There is no exception in Rule 15c3-1 permitting these receivables to be included in a broker-dealer's net capital amount. However, under the terms of the PAIB Letter, a broker-dealer could include them.

²⁰ Under paragraph (e), broker-dealers are required to perform the customer reserve computation as of the close of business on the last business day of the week or, in some cases, the month. Broker-dealers from time to time may perform a mid-week computation if it would permit them to make a withdrawal. Under the proposed amendments, a broker-dealer would need to compute both the customer and PAB reserve requirements simultaneously before making a withdrawal from either account based on a mid-week computation. Moreover, a withdrawal could not be made from one account if the mid-week computation demonstrated an increased requirement in the other account.

¹⁴ *Id.*

¹⁵ See 17 CFR 240.15c3-3(a)(1). This paragraph defines “customer” for the purposes of Rule 15c3-3. Broker-dealers, both domestic and foreign, are excluded from the definition and, consequently, are not treated as “customers” for the purposes of the rule's reserve and possession and control requirements. Some foreign broker-dealers also operate as banks. These firms are not deemed “customers” to the extent that their accounts at the U.S. broker-dealer involve proprietary broker-dealer activities.

¹⁶ In particular, under SIPA, the pool of “customer property” is established using assets recovered from the failed broker-dealer. The statute determines the assets that become a part of the pool of customer property. 15 U.S.C. 78lll(4). Customer property includes “cash and securities * * * at any time received, acquired, or held by or for the account of the debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted.” Therefore, “customer property” includes those securities positions that are held for customers and the cash that is owed to customers. After being established, customer property is distributed to customers *pro rata* based on the amounts of their claims (*i.e.*, their net equity). While broker-dealers are not entitled to advances from the SIPC fund to make up for shortfalls in the fund of customer property (*see* 15 U.S.C. 78fff-3(a)(5)), they may be “customers” as that term is defined in SIPA and, therefore, entitled to a *pro rata* distribution from the fund of customer property.

¹⁷ The amendment would exclude from the broker-dealer reserve computation accounts established by a broker-dealer that fully guarantees the obligations of, or whose accounts are fully guaranteed by, the clearing broker. In these circumstances, the guarantor must take deductions under Rule 15c3-1 for guaranteed obligations of the other firm. In addition, the amendment would exclude delivery-versus-payment and receipt-versus-payment accounts. These types of accounts pose little risk of reducing the estate of customer property in a SIPA liquidation since they only hold assets for short periods of time.

¹⁸ See Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Raymond J. Hennessy, Vice President, NYSE, and Thomas Cassella, Vice President, NASD Regulation, Inc. (Nov. 10, 1998).

¹⁹ Under Rule 15c3-1, broker-dealers generally are required to deduct unsecured receivables from their net worth when computing their net capital. Paragraph (c) of the rule contains certain exceptions to this requirement. Among the enumerated exceptions are commissions receivable from

requirement, the proposed amendment would allow the requirement to be offset to the extent there are excess debits in the customer reserve computation of the same date. However, in order to provide greater protection to customers that are not broker-dealers, a deposit requirement resulting from the customer reserve computation would not be able to be offset by excess debits in the PAB reserve computation. This means the carrying broker-dealer could use PAB credits to finance "customer" debits, but not the other way around. Thus, "customers" (which include retail investors but exclude broker-dealers) would receive greater protection.

Paragraph (b) of Rule 15c3-3 would be amended to provide that a broker-dealer carrying PAB accounts would not be required to maintain physical possession or control of fully paid and excess margin securities carried for PAB accounts, provided it obtains the written permission of the PAB accountholder to use such securities in the ordinary course of its securities business. This provision would be consistent with Rule 15c3-3, which is intended to provide greater protection to customers that are not broker-dealers customers. It also would accommodate industry practice of carrying broker-dealers using the securities of their broker-dealer accountholders, which contributes to the liquidity of the securities markets.

Finally, paragraph (c)(2)(iv)(E) of Rule 15c3-1 would be amended to require a broker-dealer to deduct from net worth when calculating net capital the amount of its cash in a proprietary account at another broker-dealer where the other broker-dealer is not treating the cash in compliance with the proposed requirements described above. This would prevent broker-dealers from including assets in their net capital amounts that may not be readily available. We would not expect broker-dealers to audit or examine their carrying broker-dealers to determine whether the carrying broker-dealer is in compliance with the proposed rules.

We request comment on all aspects of these proposed amendments, including whether the accounts of other non-customers under Rule 15c3-3 (*e.g.*, principal officers of the broker-dealer) should be included in the PAB computation.

2. Banks Where Special Reserve Deposits May Be Held

Broker-dealers must deposit cash or "qualified securities" into the customer reserve account maintained at a "bank"

under Rule 15c3-3(e).²¹ Rule 15c3-3(f) further requires the broker-dealer to obtain a written contract from the bank in which the bank agrees not to re-lend or hypothecate securities deposited into the reserve account.²² Consequently, the securities should be readily available to the broker-dealer. Cash deposits, however, are fungible with other deposits carried by the bank and may be freely used in the course of the bank's commercial lending activities. Therefore, to the extent a broker-dealer deposits cash in a reserve bank account, there is a risk the cash could be lost or inaccessible for a period if the bank experiences financial difficulties. This could adversely impact the broker-dealer and its customers if the balance of the reserve deposit is concentrated at one bank in the form of cash.

This risk may be heightened when the deposit is held at an affiliated bank in that the broker-dealer may not exercise due diligence with the same degree of impartiality when assessing the financial soundness of an affiliate bank as it would with a non-affiliate bank. Moreover, the broker-dealer's customers may not derive any significant protection from the reserve requirement in the event of the parent's insolvency.

To address these risks, we are proposing an amendment to Rule 15c3-3 that would exclude cash deposits at affiliate banks for the purposes of meeting customer or PAB reserve requirements and place limitations on the amount of cash a broker-dealer could maintain in a customer or PAB special reserve bank account at one unaffiliated bank. The exclusion and limitations would not apply to deposits of securities since these assets do not become a part of a bank's working capital. As discussed below, the limitations would prevent a broker-dealer from maintaining a reserve deposit in the form of cash at a single unaffiliated bank that exceeds a percentage of the broker-dealer's or the bank's capital. This is designed to mitigate the risk that an impairment of the reserve deposit at an unaffiliated single bank will have a material negative impact on the broker-dealer's ability to meet its obligations to customers and PAB accountholders.²³

²¹ The term "qualified securities" is defined in paragraph (a)(6) of Rule 15c3-3 to mean a securities issued by the United States or guaranteed by the United States with respect to principal and interest. 17 CFR 240.15c3-3(a)(6). The term "bank" is defined in paragraph (a)(7) of Rule 15c3-3.

²² See 17 CFR 240.15c3-3(f).

²³ These amendments are not intended to affect the practice whereby customer free credit balances are swept into a bank deposit account and the customer receives Federal Deposit Insurance Protection.

Under the proposal, a paragraph (e)(5) would be added to Rule 15c3-3. This new paragraph would provide that—in determining whether the broker-dealer maintains the minimum reserve deposits required (customer and PAB)—the broker-dealer would be required to exclude a cash deposit at an affiliated bank. With respect to unaffiliated banks, the broker-dealer would be required to exclude the deposit to the extent that it exceeded (1) 50% of the broker-dealer's excess net capital (based on the most recently filed FOCUS Report),²⁴ or (2) 10% of the bank's equity capital (based on the bank's most recently filed Call Report or Thrift Financial Report).²⁵ The goal is to limit cash reserve account deposits to reasonably safe amounts as measured against the capitalization of the broker-dealer and the bank. Excess net capital is the amount that a broker-dealer's net capital exceeds its minimum requirement and, therefore, constitutes a cushion to absorb unexpected losses. We believe limiting a cash deposit in one bank to 50% of excess net capital means the broker-dealer has a reserve to absorb the loss or impairment of the deposit plus an additional amount to absorb other losses. The amount of a bank's equity capital is a measure of its financial solvency. We believe limiting the cash deposit to 10% of the bank's equity capital means the broker-dealer would not commit customer cash to an institution in an amount that is out of proportion to the bank's capital base.

We request comment on all aspects of these proposed amendments, including whether the proposed reserve deposit limitations of 50% of excess net capital or 10% of the bank's equity capital adequately address the risks of concentrating cash deposits at any one bank or whether other thresholds should apply.

²⁴ Under Rule 17a-5 (17 CFR 240.17a-5) broker-dealers must file periodic reports on Form X-17a-5 (Financial and Operational Combined Uniform Single Reports ("FOCUS Reports")). The FOCUS Report form requires, among other financial information, a balance sheet, income statement, and net capital and customer reserve computations.

²⁵ Commercial banks insured by the Federal Deposit Insurance Corporation ("FDIC"), savings banks supervised by the FDIC, and non-insurance trust companies supervised by the Office of the Comptroller of the Currency file quarterly Call Reports. Savings Associations and non-insured trust companies supervised by the Office of Thrift Supervision file Thrift Financial Reports (TFRs). These reports include a line item for equity capital. A report for a specific institution can be obtained by accessing the following Web site: http://www2.fdic.gov/call_tfr_rpts/search.asp.

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

As noted above, a broker-dealer is limited to depositing cash or "qualified securities" into the bank account it maintains to meet the customer reserve deposit requirements under Rule 15c3-3. Paragraph (a)(6) of Rule 15c3-3 defines "qualified securities" as securities issued by the United States or guaranteed by the United States with respect to principal and interest ("U.S. Treasury securities").²⁶ These strict limitations on the types of assets that can be used to fund a broker-dealer's customer reserve account are designed to further the purpose of Rule 15c3-3; namely, that customer assets be segregated and held in a manner that makes them readily available to be returned to the customer. For example, paragraph (e)(2) of Rule 15c3-3 makes it unlawful for a broker-dealer to use customer credits (generally, cash balances in securities accounts) for any purpose other than financing customer debits (fully secured margin loans).²⁷ Under the rule, the amount of excess credits (*i.e.*, credits net of debits) must be held in the customer reserve account and, as noted, the account must be funded with either cash or U.S. Treasury securities.²⁸

Federated Investors, Inc. ("Federated") has filed a petition with the Commission requesting that Rule 15c3-3 be amended to include certain types of money market funds in the definition of qualified securities.²⁹ We believe expanding the definition to include money market funds that only invest in securities meeting the definition of "qualified security" in Rule 15c3-3 would be appropriate. The assets held by such a money market fund would be same as those a broker-dealer can hold directly in its customer reserve account. Consequently, 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.

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

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

For the foregoing reasons, we propose amending the definition of "qualified security" in paragraph (a)(6) of Rule 15c3-3 to include an unaffiliated money market fund that: (1) Is described in Rule 2a-7 of the Investment Company Act of 1940; (2) invests solely in securities issued by the United States or

guaranteed by the United States as to interest and principal; (3) agrees to redeem fund shares in cash no later than the business day following a redemption request by a shareholder; and (4) has an amount of net assets equal to at least 10 times the value of the shares deposited by the broker-dealer in its customer reserve account.

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.

4. Allocation of Customers' Fully Paid and Excess Margin Securities to Short Positions

Paragraph (d) of Rule 15c3-3 sets forth steps a broker-dealer must take to retrieve securities from non-control locations if there is a shortfall in the fully paid or excess margin securities it is required to hold. The rule does not require the broker-dealer to act when a short position on the broker-dealer's stock record allocates to a customer long position; for example, if the broker-dealer sells short a security to its customer. In such a circumstance, the broker-dealer would not be required to have possession or control of the security its customer has paid for in full. Instead, the broker-dealer would put the mark-to-market value of the security as a credit item in the reserve formula. The cash paid by the customer to purchase the security could be used by the broker-dealer to make any increased deposit requirement caused by the credit item. If the increase is less than the cash paid, the broker-dealer could use the excess funds in its own business operations. Moreover, if the value of the security decreases, the broker-dealer could withdraw funds out of the reserve account and use them as well. In effect, this permits the broker-dealer to monetize the customer's security. This is contrary to the customer protection goals of Rule 15c3-3, which seeks to ensure that broker-dealers do not use customer assets for proprietary purposes.

Accordingly, we are proposing to add a new paragraph (d)(4) to Rule 15c3-3, which would add an additional action with respect to retrieving securities from non-control positions when the broker-dealer needs to obtain possession or control over a specific issue and class of

²⁶ 17 CFR 240.15c3-3(a)(6).

²⁷ 17 CFR 240.15c3-3(e)(2).

²⁸ *Id.*

²⁹ See Public Petition for Rulemaking No. 4-478 (April 3, 2003), as amended (April 4, 2005), available at <http://www.sec.gov/rules/petitions/petn4-478.htm>.

securities.³⁰ Specifically, under the proposal, the broker-dealer would be required to take prompt steps to obtain physical possession or control over securities of the same issue and class as those included on the broker-dealer's books as a proprietary short position or as a short position for another person. By requiring the broker-dealer to obtain physical possession or control over the security, it would no longer be able to monetize the value of the security and use the cash for proprietary activities.

Under the proposal, the action would not be required until the short position had aged more than 10 business days (or more than 30 calendar days if the broker or dealer is a market maker in the securities).³¹ Allowing broker-dealers 10 business days before they must take action is consistent with paragraph (m) of Rule 15c3-3, which similarly allows a broker-dealer up to 10 business days after settlement date to purchase securities that a customer has sold through the broker-dealer but failed to deliver. As with the requirement in paragraph (m), the proposal's objective is to require a broker-dealer to close an open transaction but within a timeframe that permits a degree of flexibility. The longer 30 calendar day period for securities in which the broker-dealer makes a market is intended to accommodate the short-selling that is integral to market-making activities.

We request comment on all aspects of this proposed amendment, including whether the proposed time periods should be longer or shorter.

5. Treatment of Free Credit Balances and Importation of Rule 15c3-2 Requirements Into Rule 15c3-3

i. Treatment of Free Credit Balances

Free credit balances are funds payable by a broker-dealer to its customers on demand.³² They may result from cash deposited by the customer to purchase securities, proceeds from the sale of securities or other assets held in the customer's account, or earnings from dividends and interest on securities and other assets held in the customer's account. Broker-dealers may, among other things, pay interest to customers on their free credit balances, or offer to transfer (sweep) them into a specific

money market fund or interest bearing bank account. The customer earns dividends on the money market fund or interest on the bank account until such time as the customer chooses to liquidate the position in order to use the cash, for example, to purchase securities.

In recent years, broker-dealers have on occasion changed the product to which a customer's free credit balances are swept—most frequently from a money market fund product to an interest bearing bank account. There are differences in these two types of products, including the type of protection afforded the customer in the event of an insolvency. The money market shares—as securities—would receive up to \$500,000 in SIPA protection in the event the broker-dealer failed. The bank deposits—as cash—would receive \$100,000 in protection from the Federal Deposit Insurance Corporation ("FDIC") in the event the bank failed. On the other hand, the money market fund as a security theoretically could lose its principal; whereas the bank deposit would be guaranteed up to the FDIC's \$100,000 limit. There also may be differences in the amount of interest earned from the two products. In short, while not judging the appropriateness of either option, we note there may be consequences to changing options and believe that customers should have a sufficient opportunity to make an informed decision.³³

For these reasons, we are proposing to amend Rule 15c3-3 by adding a new paragraph (j) that would make it unlawful for a broker-dealer to convert, invest or otherwise transfer free credit balances except under three circumstances. The first circumstance, set forth in proposed paragraph (j)(2)(i) of Rule 15c3-3, would permit a broker-dealer to convert, invest, or otherwise transfer the free credit balances to any type of investment or other product, or to a different account within the broker-dealer or at another institution, or otherwise dispose of the free credit balances, but only upon a specific order, authorization, or draft from the

customer, and only under the terms and conditions specified by the customer in the order, authorization or draft. This proposal is not addressing free credit balance sweeps to money market funds and bank deposit accounts, but rather the use of customer free credit balances for other purposes (e.g., to purchase securities other than money market funds, or to transfer to a different account or financial institution). In these circumstances, the proposed paragraph would prohibit any investment, conversion, or other transfer of the free credit balances except on the customer's specific order, authorization, or draft.

The second and third circumstances, set forth in proposed paragraphs (j)(2)(ii) and (iii) of Rule 15c3-3, address the sweeping of free credit balances to either a money market fund or a bank deposit account. The former applies to new customers and the latter to existing customers as of the date the proposed amendments would become effective.

Proposed paragraph (j)(2)(ii) of Rule 15c3-3 would permit a broker-dealer to have the ability to change the sweep option of a new customer from a money market fund to a bank deposit account (and vice versa), provided certain specific conditions are met. First, the customer would need to agree prior to the change (e.g., in the account opening agreement) that the broker-dealer could switch the sweep option between those two types of products. Second, the broker-dealer would need to provide the customer with all notices and disclosures regarding the investment and deposit of free credit balances required by the self-regulatory organizations for which the broker-dealer is a member.³⁴ Third, the broker-dealer would need to provide the customer with notice in the customer's quarterly statement that the money market fund or bank deposit account can be liquidated on the customer's demand and converted back into free credit balances held in the customer's securities account. Fourth, the broker-dealer would need to provide the customer with notice at least 30 calendar days before changing the product (e.g., from one money market fund to another), the product type (e.g., from a money market fund to a bank account), or the terms and conditions under which the free credit balances are swept. The notice would need to describe the change and explain how the customer could opt out of it.

The third circumstance, set forth in proposed paragraph (j)(2)(iii) of Rule

³⁰ Current paragraph (d)(4) of Rule 15c3-3 would be re-designated as paragraph (d)(5).

³¹ The proposed amendment would not apply to securities that are sold for a customer but not obtained from the customer within 10 days after the settlement date. This circumstance is addressed by paragraph (m) of Rule 15c3-3, which requires the broker-dealer to close the transaction by purchasing securities of like kind and quantity. 17 CFR 240.15c3-3(m).

³² See 17 CFR 240.15c3-3(a)(8).

³³ In 2005, The New York Stock Exchange LLC ("NYSE") addressed the issue of disclosure. Specifically, the NYSE issued an information memo to its members discussing, among other things, the disclosure responsibilities of a broker-dealer offering a bank sweep program to its customers. See Information Memo 05-11 (February 15, 2005). The Memo stated that broker-dealers should disclose material differences in interest rates between the different products and, with respect to the bank sweep program, the terms and conditions, risks and features, conflicts of interest, current interest rates, the manner by which future interest rates will be determined, and the nature and extent of FDIC and SIPC protection. See *id.*

³⁴ See NYSE Information Memo 05-11 (February 15, 2005).

15c3-3, would apply to existing customers as of the effective date of the proposed rule. It would permit a broker-dealer to have the option to change an existing customer's sweep option from a money market fund to a bank deposit account (and vice versa), provided the second, third, and fourth conditions set forth in proposed paragraph (j)(2)(ii) discussed above were met. To minimize the burden on the broker-dealer, proposed paragraph (j)(2)(iii) would not require the broker-dealer to obtain the customer's previous agreement to permit the broker-dealer to switch the sweep option between money market fund products and bank deposit account products. This would avoid the necessity of having to amend each existing customer account agreement. Because all the other conditions in proposed paragraph (j)(2)(ii) would apply, the broker-dealer would be required to provide existing customers with the various notices and disclosures that must be made to new customers, including giving notice at least 30 calendar days before the sweep option was changed and in that notice explain the change and how the customer could opt out of it.

We request comment on all aspects of this proposed amendment, including: (1) Whether it would provide adequate protection to customers with respect to changes in the treatment of their free credit balances, (2) on the cost burdens (quantified to the extent possible) that would result if the condition in proposed paragraph (j)(2)(ii)(A) of Rule 15c3-3 to obtain a new customer's prior agreement were to be applied to existing customers, (3) whether there are other sweep products in addition to money market mutual funds and bank deposit accounts that could be contemplated in proposed paragraphs (j)(2)(ii) and (iii) of Rule 15c3-3, and (4) whether the treatment of free credit balances has already been adequately addressed by the self-regulatory organizations.

ii. Importation of Rule 15c3-2

Rule 15c3-2 requires a broker-dealer holding free credit balances to provide its customers (defined as any person other than a broker-dealer) at least once every three months with a statement of the amount due the customer and a notice that (1) the funds are not being segregated, but rather are being used in the broker-dealer's business, and (2) that the funds are payable on demand. The rule was adopted in 1964 before the adoption of Rule 15c3-3.³⁵ Since the adoption of Rule 15c3-3, a broker-

dealer, as noted above, has been limited in how it may use customer free credit balances. While the reserve account required under Rule 15c3-3 is in the name of the broker-dealer and the assets therein remain a part of its capital, the assets in the account are held for the exclusive benefit of the broker-dealer's customers. In a liquidation of the broker-dealer, the assets in the account will be available to satisfy customer claims ahead of all other creditors.

We believe the adoption of Rule 15c3-3 has eliminated the need to have a separate Rule 15c3-2. At the same time, we believe certain of the requirements in Rule 15c3-2 should be imported into Rule 15c3-3; namely, the requirements that broker-dealers inform customers of the amounts due to them and that such amounts are payable on demand.³⁶ Accordingly, we are proposing to eliminate Rule 15c3-2 and amend Rule 15c3-3 to include these latter requirements.

We request comment on all aspects of this proposed amendment. Commenters are encouraged to provide data to support their views.

6. Aggregate Debit Items Charge

Note E(3) to the customer reserve formula (Rule 15c3-3a) requires a broker-dealer using the "basic method" of computing net capital under Rule 15c3-1 to reduce by 1% the total debits in Item 10 of the formula (*i.e.*, debit balances in customer's cash and margin accounts).³⁷ This 1% reduction in Item 10 debits lowers the amount of total debit items in the formula. Because the debits offset aggregate credits in determining customer reserve requirements, the reduction has the potential to increase the amount a broker-dealer must maintain in the reserve account. Under paragraph (a)(1)(ii)(A) of Rule 15c3-1 however, broker-dealers using the "alternative standard" ³⁸ to compute their minimum net capital requirement must reduce aggregate debit items by 3% in lieu of

the 1% reduction required by Note E(3).³⁹ Thus, the deduction applicable to alternative standard firms can result in an even larger reserve deposit requirement.

The Commission adopted the alternative standard as part of the 1975 amendments to Rule 15c3-1, which expanded the rule's scope to apply to all broker-dealers.⁴⁰ The alternative standard constituted a new way of providing for the capital adequacy of a broker-dealer in that it diverged from the traditional notion of limiting a firm's leverage.⁴¹ The alternative standard instead imposes a capital requirement based on the size of the broker-dealer's commitments to its customers through margin lending and other transactions. Thus, it requires a broker-dealer to hold net capital equal to a percentage of its customer commitments. The alternative standard was designed to integrate a broker-dealer's capital requirement under Rule 15c3-1 with the customer protection requirements in Rule 15c3-3; hence it uses the aggregate debit computation required by Rule 15c3-3 to determine a broker-dealer's net capital requirement under Rule 15c3-1.⁴²

As part of the amendments adopting the alternative standard, the Commission lowered the haircut on equity securities from 30% to 15% for a broker-dealer using the standard.⁴³ At the same time, it amended Rule 15c3-1 to require alternative standard firms to employ the greater 3% reduction of debit items.⁴⁴ The Commission explained the greater requirement as providing, "in the event of a liquidation [of the broker-dealer], an additional cushion of secured debit items which will be available to satisfy customers with whom the broker or dealer effects transactions."⁴⁵

Originally, the alternative standard required a broker-dealer to hold net capital equal to 4% of its customer debits.⁴⁶ The Commission lowered this requirement to 2% in 1982.⁴⁷ It explained its decision as being based on broker-dealers' improved back-office systems and increased use of clearing

³⁵ Rule 15c3-2 contains an exemption for broker-dealers that also are banking institutions supervised by a Federal authority. This exemption would not be imported into Rule 15c3-3 because there are no broker-dealers left that fit within the exemption. Further, under the proposed amendment, the definition of "customer" for purposes of the imported 15c3-2 requirements would be the definition of "customer" in Rule 15c3-3, which is somewhat narrower than the definition in Rule 15c3-2.

³⁷ Under the "basic method," a broker-dealer cannot permit its aggregate indebtedness (generally total money liabilities) to exceed 1500% of its net capital. 17 CFR 15c3-1(a)(1)(i).

³⁸ Under the "alternative standard," a broker-dealer's minimum net capital requirement is equal to 2% of the firm's aggregate debit items. 17 CFR 240.15c3-1(a)(1)(ii).

³⁹ 17 CFR 240.15c3-1(a)(1)(ii)(A).

⁴⁰ See Exchange Act Release No. 11497 (June 26, 1975). Prior to 1975, the rule only applied to broker-dealers that were not a member of a securities exchange, since exchange members were subject to capital rules promulgated by the exchanges. *Id.*

⁴¹ See *id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ Exchange Act Release 18417 (January 13, 1982), 47 FR 3512 (January 25, 1982).

³⁵ See Exchange Act Release No. 7266 (March 12, 1964).

agencies.⁴⁸ These developments made it possible for the firms to handle large volumes of trading without experiencing operational and bookkeeping problems.⁴⁹ The Commission also noted that the SROs had upgraded their surveillance programs and that the early warning rules of both the Commission and the SROs remained significantly higher than the 2% minimum requirement.⁵⁰

In recent years, the amount of debit items carried by broker-dealers has increased substantially. Consequently, the 3% reduction in debit items has required many broker-dealers using the alternative standard to increase their reserve deposits by additional amounts that are far in excess of the additional cushion envisioned when the amendment was adopted in 1975. Furthermore, the level of risk assumed by broker-dealers does not increase proportionately as the aggregate amount of debits increases; due, in part, to an increase in diversity among the debits. The proportional 3% reduction of debit items does not recognize this diversification benefit.

Moreover, in 1992, the Commission amended Rule 15c3-1 to lower the haircut for broker-dealers using the basic method to 15%, which brought their requirement in line with the alternative standard firms.⁵¹ The 15% haircut for equity securities has proven sufficient to cover most market moves and, therefore, we believe the increased level of protection derived from the greater 3% debit item reduction likely would not provide a benefit justified by the costs.

For these reasons, we believe it is now appropriate to treat broker-dealers using the alternative standard on a par with firms using the basic method and, therefore, propose lowering the debit reduction applicable to alternative standard firms. We would apply a 1% reduction, rather than a 3% reduction, for alternative standard firms. The 1% reduction should provide an adequate cushion, given these firms' current levels of debit items, which—as noted—are far greater than existed when the rule was adopted in 1975 or amended in 1982. Our proposal would amend paragraph (a)(1)(ii)(A) of Rule 15c3-1 by removing the provision requiring the 3% reduction. This would make alternative standard firms subject to the 1% reduction in debit items as required in Note E(3) of Rule 15c3-3a.

We request comment on all aspects of this proposed amendment, including whether the benefits of the 3% reduction outweigh any costs that might arise from the proposal. Commenters are requested to identify potential costs and provide data to support their views.

7. "Proprietary Accounts" Under the Commodity Exchange Act

Certain broker-dealers also are registered as futures commission merchants under the Commodity Exchange Act ("CEA"). These firms carry both securities and commodities accounts for customers. The definition of "free credit balances" in paragraph (a)(8) of Rule 15c3-3 excludes funds that are carried in commodities accounts that are segregated in accordance with the requirements of the CEA.⁵² However, regulations promulgated under the CEA exclude certain types of accounts ("proprietary accounts") from the segregation requirement.⁵³ The question has arisen as to whether a broker-dealer holding these types of accounts must include funds in them as "free credit balances" when performing a customer reserve computation.

These funds likely would not be protected in a SIPA proceeding because they are related to commodities transactions.⁵⁴ The purpose behind the cash reserve requirements in Rule 15c3-3 is to require broker-dealers to hold sufficient funds with which to satisfy customer claims arising from securities (not commodities) transactions and, thereby, to minimize the need for a SIPA liquidation. This purpose would not be served by treating funds held in commodities accounts (that are not segregated under CEA regulations) as "free credit balances." Accordingly, we are proposing an amendment to

paragraph (a)(8) of Rule 15c3-3, which would clarify that funds held in a commodity account meeting the definition of a "proprietary account" under CEA regulations are not to be included as "free credit balances" in the customer reserve formula.

We request comment on all aspects of this proposed amendment. Commenters are encouraged to provide data to support their views.

B. Holding Futures Positions in a Securities Portfolio Margin Account

The Chicago Board of Options Exchange, Incorporated ("CBOE") and the NYSE have amended their margin rules to permit broker-dealer members to compute customer margin requirements using a portfolio margin methodology ("Portfolio Margin Rules").⁵⁵ A portfolio margining methodology computes margin requirements based on the net market risk of all positions in an account assuming certain potential market movements. Under the Portfolio Margin Rules, a broker-dealer can combine securities and futures positions into the portfolio margin account. SIPA, however, only protects customer claims for securities and cash and specifically excludes from protection futures contracts that are not also securities.⁵⁶ This raises a question as to how futures positions in a portfolio margin account would be treated in a SIPA liquidation. Consequently, we are proposing amendments to Rules 15c3-3 and 15c3-3a that are designed to provide the protections of Rule 15c3-3 and SIPA to futures positions in a securities account under the Portfolio Margin Rules.

First, we propose amending the definition of "free credit balances" in paragraph (a)(8) of Rule 15c3-3 to include funds resulting from margin deposits and daily marks to market related to, and proceeds from the liquidation of, futures on stock indices and options thereon carried in a securities account pursuant to a portfolio margining rule of an SRO. Under this amendment, a broker-dealer holding such funds would have to treat them as "credit items" for purposes of the customer reserve computation. Consequently, the futures-related funds

⁵² 17 CFR 240.15c3-3(a)(8).

⁵³ Rule 1.20 (17 CFR 1.20) requires a futures commission merchant to segregate "customer" funds. Rule 1.3(k) (17 CFR 1.3(k)) defines the term "customer" for this purpose. The definition of "customer" excludes persons who own or hold a "proprietary account" as that term is defined in Rule 1.3(y) (17 CFR 1.3(y)). Generally, the definition of "proprietary account" refers to persons who have an ownership interest in the futures commission merchant. See 17 CFR 1.3(y).

⁵⁴ To receive protection under SIPA, a claimant must first qualify as a "customer" as that term is defined in the statute. Generally, a "customer" is any person who has (1) "a claim on account of securities received, acquired, or held by the [broker-dealer]," (2) "a claim against the [broker-dealer] arising out of sales or conversions of such securities" or (3) "deposited cash with the debtor for the purposes of purchasing securities." 15 U.S.C. 7811(2). The definition of "security" in SIPA specifically excludes commodities and non-securities futures contracts (see 15 U.S.C. 7811(14)) and, thus, a person with a claim for such assets would not meet the definition of "customer."

⁵⁵ Exchange Act Release No. 54918 (December 12, 2006), 72 FR 1044 (January 9, 2007) (SR-NYSE-2006-13); Exchange Act Release No. 54919 (December 12, 2006), (SR-CBOE 2006-14); Exchange Act Release No. 52031 (July 14, 2005), 70 FR 42130 (July 21, 2005) (SR-NYSE-2002-19); Exchange Act Release No. 52032 (July 14, 2005), 70 FR 42118 (July 21, 2005) (SR-CBOE-2002-03).

⁵⁶ The definition of "security" in SIPA includes a futures contract that also is a security; namely, a "security future" as defined in section 3(a)(55)(A) of the Exchange Act. See 15 U.S.C. 7811(14).

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ Exchange Act Release No. 31511 (November 24, 1992), 57 FR 56973 (December 2, 1992).

in a portfolio margin account would need to be included with all other credit items when a broker-dealer computed its customer reserve requirement under Rule 15c3-3. Further, because free credit balances constitute “cash” in a customer’s account, they are “cash” for purposes of determining a customer’s “net equity” in a SIPA liquidation.⁵⁷

Our proposed amendment to the definition of “free credit balances” also would bring within the definition’s scope the market value of futures options in a portfolio margin account as of the SIPA “filing date.”⁵⁸ Unlike futures contracts, futures options do not take the form of cash balances in the account (*i.e.*, they have market value at the end of a trading day). Since the broker-dealer is not holding cash for the customer there is not the need to treat the futures options as a “free credit balance” and require a credit in the reserve formula. However, if the broker-dealer is liquidated under SIPA, the unrealized gains or losses of the futures options should be included in calculating the customer’s net equity in the account (along with the cash balances related to the futures contracts and the securities positions and related cash balances). The proposed amendment is designed to provide for this outcome by defining the market value of the futures options as a free credit balance in the event the broker-dealer becomes subject to a SIPA proceeding. As “free credit balances,” funds resulting from margin deposits and daily marks to market related to futures and the market value of futures options as of the SIPA filing date would constitute claims for cash in a SIPA proceeding and, therefore, become a part of a customer’s “net equity” claim and be entitled to up to \$100,000 in advances to make up for shortfalls.⁵⁹

On the debit side of the customer reserve formula, we are proposing an amendment to Rule 15c3-3a Item 14

that would permit the broker-dealer to include as a debit item the amount of customer margin required and on deposit at a futures clearing organization related to futures positions carried in a securities account pursuant to an SRO portfolio margin rule. Under SIPA, the term “customer property” includes “resources provided through the use or realization of customers’ debit cash balances and other customer-related debit items as the Commission defines by rule.”⁶⁰ Under this provision of SIPA, this proposed amendment to Rule 15c3-3a would make the margin required and on deposit at a futures clearing organization part of the “customer property” in the event the broker-dealer is placed in a SIPA liquidation.⁶¹ Thus, it would be available to the liquidation trustee for distribution to the failed firm’s customers.

We believe our proposed amendments designed to provide the protections of Rule 15c3-3 and SIPA to all positions in a securities account established under an SRO portfolio margin rule are warranted given that the futures positions in the account serve as hedges for the securities positions and, therefore, reduce the risk of the securities positions. The intermingled nature of the positions, margin or deposit, and the fact that the futures positions reduce the amount of margin necessary to carry the securities positions makes it highly practical to treat all the positions in accordance with the requirements of Rule 15c3-3 and, as part of the customer’s “net equity” in a SIPA liquidation.

We solicit comment on whether this approach represents a workable solution to providing SIPA protection to portfolio margin account holders. In particular, we request comment as to whether there are other approaches the Commission may pursue that are designed to provide SIPA protection to futures related cash and futures options in portfolio margin accounts.

C. Amendments With Respect to Securities Lending and Borrowing and Repurchase/Reverse Repurchase Transactions

Securities lending and repurchase transactions by institutions are an important element of the financial markets. In a typical securities lending transaction, the parties agree that the owner of the securities (*e.g.*, a pension fund, institutional investor, bank, or

broker-dealer) will lend securities to a borrower, and the borrower will be required to return securities of like kind and quantity to the lender. To protect the lender’s interest, the borrower typically will provide cash or other securities as collateral in excess of the market value of the securities loaned.⁶² In the typical securities repurchase/ reverse repurchase transaction (“repo transactions”), a buyer agrees to purchase securities from a seller and the seller agrees to repurchase them at some time in the future at the sale price plus some additional consideration. Thus, if the securities increase in value, the seller is at risk that the buyer will default on its obligation to resell them at the original contract price. Conversely, if the securities decrease in value, the buyer is at risk that the seller will default on its obligation to repurchase them at the original contract price. To address these risks, the securities underlying the agreement are marked to market daily and, if their value rises above the contract price, the buyer provides margin to the seller to secure the buyer’s obligation to resell the securities at a price lower than market value. Alternatively, if the value of the securities falls below the contract price, the seller provides margin to the buyer to secure the seller’s obligation to repurchase the securities at a price above the market value.

In addition to participating in securities lending transactions, broker-dealers provide a variety of services to other borrowers and lenders, including counterparty credit evaluation, collateral management, and administration of distributions and corporate actions. Moreover, a broker-dealer may negotiate the loan as agent for both parties (divulging their identities just prior to the transaction) or by interposing itself as principal between two undisclosed counterparties as a conduit lender.

The failure of MJK Clearing, Inc. (“MJK”)—the largest SIPA liquidation to date—raised several concerns regarding securities lending transactions. The

⁵⁷ If a person qualifies as a “customer” under SIPA, the next inquiry is to value the amount of the customer’s claim. This step is accomplished by reference to the definition of “net equity” in SIPA. 15 U.S.C. 78lll(11). Generally, “net equity” is the “dollar amount of the [customer’s] account” as determined by calculating the sum that would have been owed the customer had the securities in the customer’s account been liquidated on the date the SIPA proceeding was commenced minus any amounts owed by the customer to the broker-dealer.

⁵⁸ The term “filing date” is defined in SIPA as, generally, being the date a SIPA proceeding is commenced. See 15 U.S.C. 78lll(7).

⁵⁹ Generally, futures and futures options in a portfolio margin account would be transferred to a solvent broker-dealer or liquidated before the initiation of a SIPA proceeding. Consequently, these proposals are highly cautionary as it is unlikely that a broker-dealer would be placed in a SIPA liquidation while still holding these types of positions in customer accounts.

⁶⁰ 15 U.S.C. 78lll(4)(B).

⁶¹ Margin posted at a futures clearing organization for securities futures products currently is treated in this manner. See 17 CFR 240.15c3-3a.

⁶² In computing net capital under Rule 15c3-1, a broker-dealer generally must make a deduction in the amount that the market value of securities loaned exceeds the value of collateral received. 17 CFR 240.15c3-1(c)(2)(iv)(B). Likewise, a broker-dealer must make a deduction in the amount the value of collateral posted exceeds the value of securities borrowed to the extent the excess is greater than certain percentages. This permits the broker-dealer to provide excess collateral in conformance with industry standards without taking the deduction. In either case, the broker-dealer is not required to take the deduction, provided it issues a mark-to-market call and collects payment the same day.

Commission, in two civil complaints,⁶³ alleged that MJK engaged in conduit securities lending transactions involving shares of a company called GenesisIntermedia, Inc. According to the complaints, MJK borrowed shares of GenesisIntermedia from one broker-dealer, providing cash collateral equal to the market value of the borrowed shares. MJK then re-lent the GenesisIntermedia shares to other broker-dealers that provided cash collateral in return. As indicated in the complaints, after the transactions, the market value of the GenesisIntermedia shares declined dramatically. The complaints also describe how MJK returned cash collateral to the borrowing broker-dealers as the shares declined in value but did not collect excess cash collateral provided to the broker-dealer that lent the shares to MJK. Eventually, MJK went out of business. At the time of its failure, MJK still owed cash collateral to several of the borrowing broker-dealers.⁶⁴

MJK's failure caused losses to the borrowing broker-dealers and to other firms to whom those broker-dealers re-lent the borrowed securities.⁶⁵ In subsequent litigation, disputes have arisen as to whether certain of these broker-dealers were acting as principals or agents.⁶⁶ Uncertainty as to whether broker-dealers are acting as principal or agent in a securities loan transaction raises concerns as to whether firms are taking required net capital charges related to their securities lending activities.⁶⁷ A broker-dealer might not take the required charges on the theory that it was arranging the loans as agent,

rather than principal, notwithstanding the fact that there was no express disclaimer of principal liability.

We are proposing two amendments designed to improve regulatory oversight of securities lending and repo transactions. The first proposal would amend subparagraph (c)(2)(iv)(B) to Rule 15c3-1 to clarify that broker-dealers providing securities lending and borrowing settlement services are assumed, for purposes of the rule, to be acting as principals and are subject to applicable capital deductions. Under the proposed amendment, these deductions could be avoided if a broker-dealer takes certain steps to disclaim principal liability. Namely, the broker-dealer would be required to disclose the identities of the borrower and lender to each other and obtain written agreements from the borrower and lender stating that the broker-dealer is acting exclusively as agent and assumes no principal liability in connection with the transaction.⁶⁸

The second proposal would add a paragraph (c)(5) to Rule 17a-11, which would require broker-dealers to notify the Commission whenever the total amount of money payable against all securities loaned or subject to a repurchase agreement, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement exceeds 2,500 percent of tentative net capital; provided that, for purposes of this leverage threshold, transactions involving "government securities" as defined in Section 3(a)(42) of the Exchange Act, are excluded from the calculation.⁶⁹ Based on FOCUS report data, we estimate that a leverage threshold of 25 times tentative net capital would be triggered by 21 broker-dealers on a regular basis. We believe that this indicates the proposed threshold is high enough to only capture on a regular basis those few firms highly active in securities lending and repos. Accordingly, it is an appropriate notice trigger for a firm that historically has not been as active in these transactions but rapidly leverages up its positions.

We believe that receiving notice when this threshold is exceeded would help identify broker-dealers with highly

leveraged non-government securities lending and borrowing and repo operations and make it easier for regulators to respond more quickly and protect customers in the event a firm is approaching insolvency. To avoid frequent filing by firms that engage predominantly in securities lending and repo transactions, the proposal would give a broker-dealer the option of submitting monthly reports regarding its securities lending and repo activities to its designated examining authority.

We request comment on all aspects of these proposed amendments, including whether there are other steps the Commission should take to reduce the risk that a broker-dealer will fail as a consequence of a breakdown in its securities lending or repurchase activities. We also seek comment on the appropriateness of the 2,500% of tentative net capital early warning trigger and whether a smaller or larger leverage test should be employed.

D. Documentation of Risk Management Procedures

The failure of MJK highlights the importance of broker-dealers documenting their implemented controls for managing the material risk exposures that arise from their business activities. For example, a broker-dealer active in securities lending is exposed to a variety of risks, including market risk,⁷⁰ credit risk,⁷¹ liquidity risk⁷² and operational risk.⁷³ Other broker-dealer activities give rise to these risks as well, including managing a repo book, dealing in OTC derivatives, trading proprietary positions and lending on margin. A well-documented system of internal controls designed to manage material risk exposures enables a broker-dealer's management to identify, analyze, and manage the risks inherent in the firm's business activities with a view to preventing significant losses. The need for such controls is particularly urgent with respect to the

⁶³ See SEC Litigation Release No. 18641, 2004 LEXIS 706 (March 26, 2004); SEC Complaint, *SEC v. Thomas G. Brooks*, Civil Action No. CV 03-3319 ADM/AJB, United States District Court (D. Minn. June 2, 2003); *SEC v. Thomas G. Brooks*, SEC Litigation Release No. 18168, 2003 SEC LEXIS 1321 (June 3, 2003); SEC Complaint, *SEC v. Kenneth P. D'Angelo et al.*, Case No. LACV 03-6499 CAS (VBKx), United States District Court (C.D. Cal. September 11, 2003); SEC Litigation Release No. 18344, 2003 SEC LEXIS 2173 (September 11, 2003).

⁶⁴ *Id.*; See also, *In re MJK Clearing, Inc.*, 2003 U.S. Dist. LEXIS 5954 (D. Minn. 2003).

⁶⁵ See, e.g., *Nomura v. E*Trade*, 280 F.Supp. 2d 184 (S.D.N.Y. 2003).

⁶⁶ See *id.*

⁶⁷ Under paragraph (c)(2)(iv)(B) of Rule 15c3-1, broker-dealers are required to deduct from net worth most unsecured receivables, including the amount that the market value of a securities loan exceeds the value of collateral obtained for the loan. Similarly, with respect to repo transactions, a broker-dealer obligated to resell securities must, in computing net capital, deduct the amount that the market value of the securities is less than the resale price. 17 CFR 240.15c3-1(c)(2)(iv)(F). A broker-dealer obligated to repurchase securities must, in computing net capital, deduct the amount that the market value of the securities is greater than the repurchase price to the extent the excess is greater than certain percentages. 17 CFR 240.15c3-1(c)(2)(iv)(F).

⁶⁸ Standard master securities loan agreements (including the annexes thereto) commonly used by the parties to a securities lending transaction contain similar provisions for establishing agent (as opposed to principal) status in a securities lending and borrowing transaction. See, e.g., 2000 Master Securities Loan Agreement, Annex I, published by The Bond Market Association.

⁶⁹ 15 U.S.C. 78c(a)(42). "Government securities" generally present less market risk than other types of securities used in securities lending and repo transactions. Consequently, they are excluded from the scope of this proposed rule.

⁷⁰ Market risk involves the risk that prices or rates will adversely change due to economic forces. Such risks include adverse effects of movements in equity and interest rate markets, currency exchange rates, and commodity prices. Market risk can also include the risks associated with the cost of borrowing securities, dividend risk, and correlation risk.

⁷¹ Credit risk comprises risk of loss resulting from counterparty default on loans, swaps, options, and during settlement.

⁷² Liquidity risk includes the risk that a firm will not be able to unwind or hedge a position or meet cash demands as they become due.

⁷³ Operational risk encompasses the risk of loss due to the breakdown of controls within the firm including, but not limited to, unidentified limit excesses, unauthorized trading, fraud in trading or in back office functions, inexperienced personnel, and unstable and easily accessed computer systems.

largest broker-dealers, which generally engage in a wide range of highly complex businesses across many different markets and geographical locations.

We believe that, for the most part, these firms as a matter of business practice already have well-documented procedures and controls for managing risks. Moreover, many are part of a public company subject to the requirements of section 404 of the Sarbanes-Oxley Act of 2002,⁷⁴ and the Commission's rules thereunder,⁷⁵ which require the company to include in its annual report a report of management on the company's internal control over financial reporting. Notwithstanding the fact that many broker-dealers already have documented their implemented internal controls as a matter of business practice or because they are part of public companies subject to the requirements under Sarbanes-Oxley, we believe it is important to reinforce the practice, particularly for broker-dealers that are not part of public companies, and make it easier for regulators to access a broker-dealer's procedures and controls. Consequently, we are proposing amendments to the books and records rules that would require certain broker-dealers to make and keep current records documenting their implemented systems of internal risk management control.

The proposal would add a paragraph (a)(23) to Rule 17a-3, which would require certain large broker-dealers to document any implemented internal risk management control designed to assist in analyzing and managing the risks (e.g., market, credit, liquidity, operational) arising from the business activities it engages in, including, for example, securities lending and repo transactions, OTC derivative transactions, proprietary trading and margin lending. The requirement only would apply to broker-dealers that have more than (1) \$1,000,000 in aggregate credit items as computed under the customer reserve formula of Rule 15c3-3, or (2) \$20,000,000 in total capital including debt subordinated in accordance with Appendix D to Rule 15c3-1. This would limit the proposed rule's application to the broker-dealers that, because of their complexity and size, are subject to the greatest risks and whose failure to adequately manage the risks could have the largest systemic

impact. We estimate there are approximately 500 such firms.

The proposal also would add a paragraph (e)(9) to Rule 17a-4, which would require a broker-dealer to maintain these records for three years after the date the broker-dealer ceases to use the system of controls. We believe that the additional three years creates an audit trail between former and current procedures and provides regulators with sufficient opportunity to review the records during the broker-dealer's normal exam cycle.

We are not proposing any minimum elements that would be required to be included in a firm's internal controls or specifying issues that should be addressed. Rather, the amendment is designed to ensure that broker-dealers clearly identify the procedures, if any, they use to manage the risks in their business. We believe the proposed documentation requirement would help firms and their designated examining authorities identify gaps in their internal procedures. Moreover, broker-dealers that have already documented their internal controls would not be required to take any further steps other than to retain the written procedures for three years after new controls were put in place and maintain the procedures in a manner that makes them readily available to the Commission and other securities regulators (to the extent they were not already readily available).

We request comment on all aspects of these amendments, including whether either of the criteria as to which broker-dealers would be subject to the proposed requirement should be lower or higher, or whether we should consider some other criteria for application of the proposed requirement.

E. Amendments to the Net Capital Rule

1. Requirement To Subtract From Net Worth Certain Liabilities or Expenses Assumed by Third Parties and Non-Permanent Capital Contributions

Under Rule 15c3-1, broker-dealers are required to maintain, at all times, a minimum amount of net capital. The rule generally defines "net capital" as a broker-dealer's net worth (assets minus liabilities), plus certain subordinated liabilities, less certain assets that are not readily convertible into cash (e.g., fixed assets), and less a percentage (haircut) of certain other liquid assets (e.g., securities).⁷⁶ Broker-dealers are required to calculate net worth using generally accepted accounting principles.

Based on our experience, we are concerned that some broker-dealers may be excluding from their calculations of net worth certain liabilities that relate directly to expenses or debts incurred by the broker-dealer. The accounting justification for the exclusion is that a third-party (usually a parent or affiliate) has assumed responsibility for these expenses and debts through an expense sharing agreement. In some cases, however, the third-party does not have the resources—independent of the broker-dealer's revenues and assets—to assume these liabilities. Thus, the third-party is dependent on the resources of the broker-dealer to pay the expenses and debts. Excluding liabilities from the broker-dealer's net worth calculation in these situations may misrepresent the firm's actual financial condition, deceive the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition.

For these reasons, we are proposing an amendment to Rule 15c3-1 that would add a new paragraph (c)(2)(i)(F) requiring a broker-dealer to adjust its net worth when calculating net capital by including any liabilities that are assumed by a third-party if the broker-dealer cannot demonstrate that the third-party has the resources independent of the broker-dealer's income and assets to pay the liabilities. To evidence a third-party's financial capacity, the broker-dealer could maintain as a record the third party's most recent and current (*i.e.*, as of a date within the previous twelve months) audited financial statements, tax return or regulatory filing containing financial reports.

Based on our experience, we also are concerned that broker-dealers may be receiving capital contributions from individual investors that are subsequently withdrawn after a short period of time (often less than a year). In some cases, the capital may be contributed under an agreement giving the investor the option to withdraw the capital at the investor's discretion. In the past, the Commission has emphasized that capital contributions to broker-dealers should not be temporary⁷⁷ and the Commission staff has explained that a capital contribution should be treated as a liability if it is made with the understanding that the contribution can be withdrawn at the option of the investor.⁷⁸ We are

⁷⁷ See *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).

⁷⁸ Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation,

⁷⁴ Pub. L. 107-204, 116 Stat. 745 (2002).

⁷⁵ See Securities Act Release No. 8238, Exchange Act Release No. 47986; Investment Company Act Release No. 26068 (June 5, 2003), 68 FR 36635 (June 18, 2003).

⁷⁶ See 17 CFR 240.15c3-1(c)(2).

proposing to codify these views by amending Rule 15c3-1 to add a paragraph (c)(2)(i)(G), which would require a broker-dealer to treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it. The provision also would require a broker-dealer to treat as a liability any capital contribution that is intended to be withdrawn within a year unless the broker-dealer receives permission in writing from its designated examining authority.⁷⁹ Under paragraph (c)(2)(i)(G)(2) of the proposed rule, a withdrawal made within one year of the contribution is presumed to have been intended to be withdrawn within a year and, therefore, presumed to be subject to the deduction.

We request comment on all aspects of these proposed amendments, including suggestions for records (in addition to audited financial statements, tax returns and regulatory filings) by which a broker-dealer could demonstrate a third-party's current financial capacity. We also request comment on potential metrics for measuring whether the third-party has sufficient financial resources to assume the broker-dealer's expenses for the purposes of calculating net capital under Rule 15c3-1. For example, would it be sufficient if the third-party's most recent financial statement, tax return or filing showed an amount of annual net revenue, excluding income derived from the broker-dealer (e.g., from management fees or dividends) that equaled or exceeded the broker-dealer's annual expenses assumed by the third-party? Would it be sufficient if a financial statement or filing showed the third-party had an amount of equity capital that, at a minimum, equaled 100%, 150%, 200%, 1000% or some other percentage of the broker-dealer's annual expenses assumed by the third-party?

With respect to the proposal on capital contributions and withdrawals, we request comment on whether the time period within which withdrawn and intended to be withdrawn contributions must be treated as liabilities should be longer than one year.

Commission, to Raymond J. Hennessy, Vice President, NYSE, and Susan DeMando, Vice President, NASD Regulation, Inc. (February 23, 2000).

⁷⁹ These requirements would not apply to withdrawals covered by paragraph (e) (4)(iii) of Rule 15c3-1, namely, withdrawals used to make tax payments or to pay reasonable compensation to partners. These types of payments are ordinary business expenditures and do not raise the types of concerns the proposed rule is designed to address.

2. Requirement To Deduct the Amount a Fidelity Bond Deductible Exceeds SRO Limits

Under SRO rules, certain broker-dealers that do business with the public or are required to become members of the Securities Investor Protection Corporation ("SIPC") must comply with mandatory fidelity bonding requirements.⁸⁰ While the form and amounts of the bonding requirements vary based on the nature of a broker-dealer's business, the SRO rules typically permit a broker-dealer to have a deductible provision included in the bond. However, the rules provide that the deductible may not exceed certain amounts.⁸¹ With regard to firms that maintain deductible amounts over the maximum amount permitted, a number of SRO rules provide that the broker-dealer must deduct this excess amount from net worth when calculating net capital under Rule 15c3-1.⁸²

Rule 15c3-1, however, does not specifically reference the SRO deductible requirements as a charge to capital. Accordingly, while the SROs require that the excess fidelity bond be deducted from net capital, the Commission's rule does not specify such a deduction. This means that a broker-dealer would not be required for the purposes of Commission rules to show the impact of the deduction in the net capital computation on the FOCUS report it is required to periodically file.⁸³ To address this gap, we are proposing to amend Rule 15c3-1 by adding a paragraph (c)(2)(xiv) that would require a broker-dealer to deduct, with regard to fidelity bonding requirements prescribed by a broker-dealer's examining authority, the excess of any deductible amount over the maximum deductible amount permitted. We believe the fidelity bonding requirement is an important prudential

⁸⁰ See, e.g., NYSE Rule 319, NASD Rule 3020, CBOE Rule 9.22, and Amex Rule 330. SRO fidelity bonding requirements typically contain agreements covering the following areas: A "Fidelity" insuring clause to indemnify against loss of property through dishonest or fraudulent acts of employees; an "On Premises" agreement insuring against losses resulting from crimes such as burglary and theft and from misplacement of property of the insured; an "In Transit" clause indemnifying against losses occurring while property is in transit; a "Forgery and Alteration" agreement insuring against loss due to forgery or alteration of various kinds of negotiable instruments; and a "Securities Loss" clause protecting against losses incurred through forgery and alteration of securities. *Id.*

⁸¹ See, e.g., NYSE Rule 319(b), which permits NYSE members and member organizations to self-insure to the extent of \$10,000 or 10% of the minimum insurance requirement as prescribed by the NYSE.

⁸² See, e.g., NYSE Rule 319(b); NASD Rule 3020(b)(2).

⁸³ See 17 CFR 240.17a-5.

safeguard because it serves as a measure to protect the broker-dealer's capital from unforeseen losses arising from, among other events, improper activity by an employee.⁸⁴

We request comment on all aspects of this proposed amendment.

3. Broker-Dealer Solvency Requirement

We are proposing an amendment to Rule 15c3-1 that would require a broker-dealer to cease its securities business activities if certain insolvency events occur. The proposed amendment would prevent a broker-dealer from continuing to conduct a securities business while it is seeking protection in a bankruptcy proceeding. A broker-dealer that has made an admission of insolvency, or is otherwise deemed insolvent or entitled to protection from creditors, does not possess the financial resources necessary to operate a securities business. Continuing to operate in such circumstances poses a significant credit risk to counterparties and to the clearance and settlement system, and, in the event the firm ends up in a liquidation proceeding under SIPA, may impair the ability of the SIPA trustee to make customers of the broker-dealer whole and satisfy claims of other creditors out of the assets of the general estate.

We are proposing to amend paragraph (a) of Rule 15c3-1 to provide that a broker-dealer shall not be in compliance with the rule if the firm is "insolvent" as that term is defined in the rule. "Insolvent" would be defined in a new paragraph (c)(16) as, among other things, a broker-dealer's placement in a voluntary or involuntary bankruptcy or similar proceeding; the appointment of a trustee, receiver or similar official; a general assignment by the broker-dealer for the benefit of its creditors; an admission of insolvency; or the inability to make computations necessary to establish compliance with Rule 15c3-1. The proposed definition of "insolvent" is intended to be broad enough to encompass any type of insolvency proceeding or condition of insolvency.⁸⁵ By making solvency a requirement of Rule 15c3-1, a broker-dealer that is insolvent would have to cease conducting business because section 15(c)(3) of the Exchange Act generally prohibits a broker-dealer from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any security in contravention of

⁸⁴ See, e.g., NYSE Rule 319, which specifies the type of coverage the bond must provide.

⁸⁵ For example, the proposed definition incorporates concepts of insolvency in the U.S. Bankruptcy Code and SIPA. See 11 U.S.C. 101; 15 U.S.C. 78eee(b)(1).

the Commission's financial responsibility rules (which include Rule 15c3-1).⁸⁶

We also are proposing an amendment to the first sentence of paragraph (b)(1) of Rule 17a-11 that would require a broker-dealer meeting the definition of "insolvent" to provide immediate notice to the Commission, the firm's designated examining authority and, if applicable, the CFTC. This notice would assist regulators in taking steps to protect the insolvent firm's customers, including, if appropriate, notifying SIPC of the need to commence an SIPA liquidation.

We request comment on all aspects of these proposed amendments, including whether there are other insolvency events that should be captured in the definition.

4. Amendment To Rule Governing Orders Restricting Withdrawal of Capital From a Broker-Dealer

Paragraph (e) of Rule 15c3-1 places certain conditions on a broker-dealer when withdrawing capital.⁸⁷ For example, a broker-dealer must give the Commission two days notice before a withdrawal that would exceed 30% of the firm's excess net capital and two days notice after a withdrawal that exceeded 20% of that measure.⁸⁸ Paragraph (e) also restricts capital withdrawals that would have certain financial impacts on a broker-dealer such as lowering net capital below certain levels.⁸⁹ Finally, under the rule, the Commission may issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under certain circumstances.⁹⁰ The rule, however, limits such orders to withdrawals, advances, or loans that, when aggregated with all other withdrawals, advances, or loans on a net basis during a thirty calendar day period, exceed thirty percent of the firm's excess net capital.⁹¹ The rule also requires that the Commission conclude, based on the facts and information available that a withdrawal, advance, or loan in excess of thirty percent of the broker-dealer's excess net capital may be detrimental to the financial integrity of the firm, or may unduly jeopardize the firm's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the

customers or creditors of the firm to loss without taking into account the application of the SIPA.⁹² The order may restrict such withdrawals, advances, or loans for a period of up to twenty business days.⁹³

Paragraph (e) of Rule 15c3-1 was adopted in the aftermath of the failure of the investment bank holding company Drexel Burnham Lambert, Inc. ("Drexel").⁹⁴ At the time of its adoption, the Commission pointed out that Drexel, prior to its failure, withdrew substantial capital from its regulated broker-dealer subsidiary over a period of three weeks in the form of short term loans.⁹⁵ The withdrawals were made without notifying the Commission or the broker-dealer's designated examining authority.⁹⁶ Moreover, part of the broker-dealer's capital consisted of hard to price high yield bonds.⁹⁷ This made it difficult to determine the firm's actual net capital amount and, consequently, whether it was in capital compliance.⁹⁸

Since the adoption of Rule 15c3-1(e) in 1991, the Commission only once has issued an order restricting a broker-dealer from withdrawing capital.⁹⁹ Specifically, on October 13, 2005, the Commission ordered the two broker-dealer subsidiaries of REFCO, Inc.—REFCO Securities, LLC and REFCO Clearing, LLC—to restrict capital withdrawals, advances, and loans.¹⁰⁰ The Commission issued the order after REFCO, Inc. announced that its financial statements for 2002 through 2005 should not be relied on and that a material unregulated subsidiary (REFCO Capital Markets, Ltd.) had ceased all activities for a 15-day period.¹⁰¹

As required under Rule 15c3-1(e), the Commission's order with respect to REFCO's broker-dealer subsidiaries only restricted capital withdrawals, loans and advances to the extent they would exceed 30% of the broker-dealer's excess net capital when aggregated with other such transactions over a 30-day period. The Commission and other securities regulators often discover that the books and records of a troubled broker-dealer are incomplete or inaccurate. This can make it difficult to determine the firm's actual net capital

and excess net capital amounts. In such a case, an order that limits withdrawals to a percentage of excess net capital would be difficult to enforce as it would not be clear when that threshold had been reached. Given the circumstances, we believe the better approach is to remove the 30% of excess net capital limitation. This would simplify the orders by allowing the Commission to restrict all withdrawals, advances, and loans. All the other conditions in the rule would be preserved.

We request comment on all aspects of this proposed amendment.

5. Adjusted Net Capital Requirements

i. Amendment to Appendix A of Rule 15c3-1

We are proposing an amendment to Appendix A of Rule 15c3-1, which permits broker-dealers to employ theoretical option pricing models to calculate haircuts for listed options and related positions that hedge those options.¹⁰² Non-clearing option specialists and market makers need not apply haircuts to their proprietary listed options positions, provided the broker-dealer carrying their account takes a charge to its own net capital based on the charge computed using the theoretical pricing model.¹⁰³ In 1997, the Commission adopted a temporary amendment to Appendix A that, by virtue of decreasing the range of pricing inputs to the model, effectively reduced the haircuts applied by the carrying firm with respect to non-clearing option specialist and market maker accounts.¹⁰⁴ The temporary amendment, which only applied to these types of accounts, was limited to major market foreign currencies and diversified indexes. The Commission made this relief—which is contained in paragraph (b)(1)(iv) of Appendix A¹⁰⁵—temporary so the Commission could evaluate the effects of the reduced capital charges, particularly under

¹⁰² 17 CFR 240.15c3-1a.

¹⁰³ 17 CFR 240.15c3-1(c)(2)(x).

¹⁰⁴ See Exchange Act Release No. 38248 (February 6, 1997), 62 FR 6474 (February 12, 1997). Under Appendix A to Rule 15c3-1, a broker-dealer calculating net capital charges for its options portfolios shocks the products in each portfolio (grouped by underlying instrument) at ten equidistant points along a potential market move range. The market move ranges for major market foreign currencies, high-capitalization diversified indexes, and non-high-capitalization diversified indexes are, respectively: +(-) 6%, +(-) 10% and +(-) 15%. The temporary rule lowered these market move ranges to respectively: +(-) 4½%, + 6% (-) 8% and +(-) 10% in terms of calculating haircuts for positions of non-clearing options specialists and market makers. See *id.*

¹⁰⁵ 17 CFR 240.15c3-1a(b)(1)(iv)(B).

⁸⁶ 15 U.S.C. 78o.

⁸⁷ See 17 CFR 240.15c3-1(e).

⁸⁸ 17 CFR 240.15c3-1(e)(1).

⁸⁹ 17 CFR 240.15c3-1(e)(2).

⁹⁰ 17 CFR 240.15c3-1(e)(3).

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.*

⁹⁴ See Exchange Act Release No. 28927 (February 28, 1991), 56 FR 9124 (March 5, 1991).

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ See Exchange Act Release No. 52606 (October 13, 2005).

¹⁰⁰ See *id.*

¹⁰¹ *Id.*

conditions involving high levels of market volatility.

The relief expired two years from its effective date. The Commission staff subsequently issued a no-action letter on January 13, 2000 continuing the relief.¹⁰⁶ Since the no-action letter was issued, there have been periods of significant volatility in the securities markets, including the markets for major market foreign currencies and high-capitalization and non-high-capitalization diversified indexes. These periods of volatility include the Russian debt crisis in 1998, the internet bubble and the September 11, 2001 terrorist attacks. Despite periods of substantial volatility, there have been no significant increases in the number of deficits in non-clearing option specialist and market-maker accounts, nor did the lower capital charges under paragraph (b)(1)(iv) result in excessive leverage. Consequently, we are proposing to amend paragraph (b)(1)(iv) of Appendix A to Rule 15c3-1 to make permanent the previously granted relief. We believe permitting the lower requirement with respect to these types of positions carried in non-clearing option specialist and market-maker accounts better aligns the capital requirements in Rule 15c3-1 with the risks associated with these positions and accounts.

We request comment on all aspects of this proposed amendment, including whether the lower market move ranges for positions held by non-clearing options specialists and market makers are appropriate and whether data or other information suggests that these lower ranges did result in an increase in the number of deficits in non-clearing option specialist and market-maker accounts or in excessive leverage on the part of these firms. Commenters are encouraged to provide data to support their views.

ii. Money Market Funds

We are proposing an amendment that would reduce the "haircut" broker-dealers apply under Rule 15c3-1 for money market funds from 2% to 1% when computing net capital. In 1982, the Commission adopted a 2% haircut requirement for redeemable securities of an investment company registered under the Investment Company Act of 1940 that holds assets consisting exclusively of cash or money market instruments and which is known as a

"money market fund."¹⁰⁷ The 2% haircut was adopted before the Commission adopted certain amendments to Rule 2a-7 under the Investment Company Act of 1940 (17 CFR 270.2a-7) that strengthened the risk limiting investment restrictions for money market funds.¹⁰⁸ Rule 2a-7 defines a money market fund generally as an investment company limited to investing in U.S. dollar denominated securities that present minimal credit risks and that are, at the time of acquisition, "eligible securities."¹⁰⁹ In particular, the rule requires that the securities purchased by a money market fund be short-term instruments of issuers that are deemed a low credit risk.¹¹⁰ The rule also requires the fund to diversify its portfolio of securities.¹¹¹ Based on the enhancements to Rule 2a-7, as well as the historical stability of money market funds as investments, we are proposing to amend paragraph (c)(2)(vi)(D)(1) of Rule 15c3-1 to reduce the haircut on such funds from 2% to 1%. This amendment is designed to better align the net capital charge with the risk associated with holding a money market fund. A further amendment would clarify that a money market fund, for the purposes of paragraph (c)(2)(vi)(D)(1), is a fund described in Rule 2a-7.

We 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.¹¹² Commenters are encouraged to provide data to support their views.

F. Technical Amendments

Finally, we are proposing a number of technical amendments to these rules in order to, for example, update or correct citations to other regulations. These technical amendments include proposed amendments to the definitions of "fully paid securities," "margin securities," and "bank" in Rule 15c3-3.¹¹³ Our proposed amendments are not

intended to substantively change the meanings of these defined terms but, rather, to remove text that is superfluous or redundant. Consequently, we specifically seek comment on whether our proposed amendments to these definitions would substantively alter the meaning of "fully paid securities," "margin securities," and "bank" as those terms are defined in Rule 15c3-3. Commenters should describe how the amendment would result in a substantive change.

III. Further Requests for Comment

A. In General

We invite interested persons to submit written comments on any aspect of the proposed amendments, in addition to the specific requests for comments. Further, we invite comment on other matters that might have an effect on the proposals contained in the release, including any competitive impact.

B. Requests for Comment on Certain Specific Matters

1. Early Warning Levels

The Capital Committee of the Securities Industry Association ("SIA") has proposed lowering the Rule 17a-11 early warning level for broker-dealers that carry over \$10 billion in debits. Currently, under Rule 17a-11, a broker-dealer that computes its net capital requirement using the alternative standard must provide regulators with notice if their net capital level falls below 5% of aggregate debit items. The SIA contends that a broker-dealer with aggregate debit items exceeding \$10 billion would not be approaching financial difficulty simply because its net capital falls to the 5% early warning threshold. The broker-dealer, because of the large amount of debits and corresponding capital requirement, would continue to hold sufficient net capital in the SIA's estimation. The SIA has suggested using a tiered approach in which the early warning level would be calculated by adding: (5% of the first \$10 billion in debits) + (4% of the next \$5 billion) + (3% of the next \$5 billion) + (2.5% of all remaining debits).

We request comment on this proposal and note that the SROs would need to alter their early warning levels as well to make any such proposed amendment effective.

2. Harmonize Securities Lending and Repo Capital Charges

We also are considering whether to harmonize the net capital deductions required under paragraph (c)(2)(iv)(B) of Rule 15c3-1 for securities lending and

¹⁰⁶ Letter from Michael Macchiaroli, Associate Director, Division of Market Regulation, Commission, to Richard Lewandowski, Vice President, Regulatory Division, The Chicago Board Options Exchange, Inc. (Jan. 13, 2000).

¹⁰⁷ Exchange Act Release No. 18737 (May 13, 1982), 47 FR 21759 (May 20, 1982). See 17 CFR 240.15c3-1(c)(2)(vi)(D)(1).

¹⁰⁸ Investment Company Act Release No. 18005 (February 20, 1991), 56 FR 8113 (February 27, 1991).

¹⁰⁹ 17 CFR 270.2a-7.

¹¹⁰ See *id.*

¹¹¹ *Id.*

¹¹² See Public Petition for Rulemaking No. 4-478 (April 3, 2003), as amended (April 4, 2005), available at <http://www.sec.gov/rules/petitions/petn4-478.htm>.

¹¹³ 17 CFR 240.15c3-3(a)(3), (4), and (7) respectively.

borrowing transactions with the deductions required under paragraph (c)(2)(iv)(F) for securities repo transactions. Securities lending and borrowing transactions are economically similar to repo transactions. However, the need to take a deduction (or the size of the deduction) under Rule 15c3-1 may depend on whether the broker-dealer executes the transaction as a securities loan/borrow or repo transaction.¹¹⁴ We are concerned that this has created an opportunity for regulatory arbitrage.

In order to eliminate this mismatch, we could make identical the securities loaned and repurchase agreement deductions and, similarly, the securities borrowed and reverse repurchase agreement deductions. We seek comment on the feasibility of such a proposal and on how it should be implemented.

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

Under Rule 15c3-3, a broker-dealer is required to include as a "credit" item in the customer reserve formula the amount of any loan it receives that is collateralized by securities carried for the accounts of customers.¹¹⁵ The credit item is intended to ensure that funds obtained through the use of customer securities are deployed to support customer transactions (e.g., to make margin loans) and not used in the broker-dealer's proprietary business.

In some cases, the customer's securities may be subject to a lien arising from a third-party loan that is not made to the broker-dealer (e.g., the loan is made directly to the customer). If the customer's securities are not moved to a pledge account in the name of the third-party lender, then the broker-dealer will continue to hold them in the name of the customer. As between the broker-dealer and the customer, the securities may be fully paid for and, consequently, subject to the physical possession or control requirement of Rule 15c3-3. Moreover, if the broker-dealer became insolvent and was liquidated in a SIPA

proceeding, the trustee could be placed in the situation of owing the securities both to the customer and to the third-party holding the lien. This could increase the costs of a SIPA liquidation, which is underwritten by the fund administered by SIPC.

The situation becomes even more complicated when the securities are subject to liens held by multiple creditors. The amount of the obligation to each creditor may change daily depending on market movements or other factors. In a SIPA proceeding, this could increase the number of parties with potentially competing claims for the securities, and thereby increase the complexity and costs of the liquidation.

For these reasons, we request comment on how third-party liens against customer fully paid securities carried by a broker-dealer should be treated under the financial responsibility rules, including Rule 15c3-3, Rule 17a-3 and Rule 17a-4. For example, should the broker-dealer be required to: (1) Include the amount of the customer's obligation to the third-party as a credit item in the reserve formula; (2) move the securities subject to the lien into a separate pledge account in the name of the pledgee or pledges; or (3) record on its books and records and disclose to the customer the existence of the lien, identity of the pledgee(s), obligation of the customer, and amount of securities subject to the lien?

IV. Paperwork Reduction Act

Certain provisions of the proposed amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA"). We have submitted the proposed amendments to the Office of Management and Budget ("OMB") for review in accordance with the PRA.¹¹⁶ An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The rules being amended—Rule 15c3-1, Rule 15c3-3, Rule 17a-3, Rule 17a-4 and Rule 17a-11—contain currently approved collections of information under, respectively, OMB control numbers 3235-0200, 3235-0078, 3235-0033, 3235-0279 and 3235-0085.

A. Collections of Information Under the Proposed Amendments

The proposed rule amendments contain recordkeeping and disclosure requirements that are subject to the PRA. In summary, the amendments

would require a broker-dealer, under certain circumstances, to (1) disclose the principals and obtain certain agreements from the principals in a securities lending transaction where it performs settlement services if it wants to be considered an agent (as opposed to a principal) for the purposes of the net capital rule,¹¹⁷ (2) obtain written permission from broker-dealer ("PAB") account holders to use their fully paid and excess margin securities,¹¹⁸ (3) perform a PAB reserve computation,¹¹⁹ (4) obtain written notification from a bank holding its PAB Special Reserve Account that the bank has received notice that the assets in the account are being held for the benefit of PAB account holders,¹²⁰ (5) enter into a written contract with a bank holding its PAB Special Reserve Accounts in which the bank agrees the assets in the account would not be used as security for a loan to the broker-dealer and would not be subject to a right, charge, security interest, lien, or claim of any kind in favor of the bank,¹²¹ (6) obtain the affirmative consent of a customer before changing the terms under which the customer's free credit balances are invested,¹²² (7) make and maintain records documenting internal controls to assist the broker-dealer in analyzing and managing market, risks arising from business activities,¹²³ (8) provide notice to the Commission and other regulatory authorities if the broker-dealer becomes insolvent,¹²⁴ and (9) provide notice to the Commission and other regulatory authorities if the broker-dealer's securities borrowed and loan or securities repurchase/reverse repurchase activity reaches a certain threshold or, alternatively, provide regulatory authorities with a monthly report of the broker-dealer's securities borrowed and loan or securities repurchase/reverse repurchase activity.¹²⁵

¹¹⁷ Proposed amendment revising paragraph (c)(2)(iv)(B) of Rule 15c3-1.

¹¹⁸ Proposed amendment adding paragraph (b)(5) to Rule 15c3-3.

¹¹⁹ Proposed amendment revising paragraph (e)(1) of Rule 15c3-3.

¹²⁰ Proposed amendment revising paragraph (f) of Rule 15c3-3.

¹²¹ *Id.*

¹²² Proposed amendment adding paragraph (j) to Rule 15c3-3.

¹²³ Proposed amendments adding paragraph (a)(24) to Rule 17a-3 and revising paragraph (e)(9) of Rule 17a-4.

¹²⁴ Proposed amendment revising paragraph (b)(1) of Rule 17a-11.

¹²⁵ Proposed amendment adding paragraph (c)(5) to Rule 17a-11.

¹¹⁴ Specifically, with respect to repurchase agreement and securities borrowed transactions, the required deductions are triggered only when the deficits exceed certain percentages. See 17 CFR 240.15c3-1(c)(2)(iv)(B) and (F). Conversely, with reverse repurchase agreement and securities loaned transactions, the deductions are triggered without regard to the size of the deficit.

¹¹⁵ 17 CFR 240.15c3-3a, Item 2. A broker-dealer may finance margin loans to its customers by obtaining a bank loan that is secured by the customers' securities, which—because they are not "excess margin securities"—do not have to be in the control of the broker-dealer under Rule 15c3-3(b).

¹¹⁶ 44 U.S.C. 3507(d); 5 CFR 1320.11

B. Proposed Use of Information

The Commission and other regulatory authorities would use the information collected under the proposed amendment to Rule 15c3-1 and Rule 15c3-3 to determine whether the broker-dealer is in compliance with each rule. In particular, the record with respect to acting as agent in a securities loan transaction would assist examiners in verifying that the broker-dealer is properly accounting for securities loan deficits under Rule 15c3-1. The records with respect to the PAB accounts would assist examiners in verifying that the PAB accountholders had agreed to permit the broker-dealer to use their securities, the broker-dealer had performed the PAB reserve computation and the bank holding the PAB Special Reserve Account had agreed to do so free of lien.

The Commission and other regulatory authorities would use the information collected under the proposed amendments to Rules 17a-3 and 17a-4 to determine whether the broker-dealer is operating in a manner that mitigates the risk it will fail as a result of failing to document internal controls.

The Commission and other regulatory authorities would use the information collected under the proposed amendments to Rule 17a-11 to identify a broker-dealer experiencing financial difficulty. This information would assist the Commission and other regulators in promptly taking appropriate steps to protect customers, creditors, and counterparties. In particular, a notice of insolvency would assist regulators in responding more quickly to a failing institution. The notices and reports with respect to securities lending and repos would assist regulators in identifying broker-dealers that are active in these transactions or suddenly take on large positions. This would assist in monitoring the systemic risk in the markets.

C. Respondents

The amendment to Rule 15c3-1 requiring a broker-dealer to make disclosures to, and obtain certain agreements from, securities lending principals only would apply to those firms that participate in the settlement of securities lending transactions as agents. We estimate that approximately 170 broker-dealers would be affected by this requirement.¹²⁶

The amendments to Rule 15c3-3 requiring a broker-dealer to perform a PAB reserve computation and to obtain

certain agreements and notices related to its PAB accounts only would affect those firms that carry such accounts. We estimate that approximately 75 broker-dealers would carry such accounts.¹²⁷

The amendment to Rule 15c3-3 requiring a broker-dealer to obtain the affirmative consent of a customer before changing the terms under which the customer's free credit balances are maintained only would apply to firms that carry free credit balances for customers. We estimate that approximately 256 broker-dealers carry customer accounts.¹²⁸

The amendments to Rules 17a-3 and 17a-4 requiring a broker-dealer to make and maintain records documenting internal controls for analyzing and managing risks only would apply to firms that have more than \$1,000,000 in aggregate credit items, or \$20,000,000 in capital. Thus, its impact would be limited to the largest broker-dealers. Generally, the broker-dealers that would be required to document internal controls are exposed to all the risks identified in the proposed amendment. Accordingly, the number of respondents would equal the number of broker-dealers meeting the thresholds set forth in the amendment. We estimate that approximately 517 broker-dealers would meet at least one of these thresholds.¹²⁹

The amendment to Rule 17a-11 would require a broker-dealer to provide the Commission with notice if it becomes subject to certain insolvency events only would affect a limited number of firms per year. We estimate that approximately six broker-dealers would become subject to one of these events in a given year.¹³⁰

The amendment to Rule 17a-11 would require a broker-dealer to provide notice to the Commission if its securities borrowed or loan or securities repurchase or reverse repurchase activity reaches a certain threshold or, alternatively, provide monthly reports to securities regulators about such activities only would affect a limited number of firms per year. We estimate that approximately 11 broker-dealers would provide the notice and that 21 broker-dealers would opt to send the monthly reports in a given year.¹³¹

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ This estimate is based on the Annual Report of the Securities Investor Protection Corporation ("SIPC"), which indicates that in recent years an average of six customer protection proceedings per year have been initiated with respect to SIPC members. A copy of the 2005 Annual Report can be obtained at: <http://www.sipc.org/pdf/2005AnnualReport.pdf>.

¹³¹ These estimates are derived from information filed by broker-dealers in FOCUS Report filings.

D. Total Annual Reporting and Recordkeeping Burden

As discussed in further detail below, we estimate the total recordkeeping burden resulting from these amendments would be approximately 373,938 annual hours,¹³² 105,900 one-time hours,¹³³ and a one-time cost of \$1,000,000 arising from the retention of outside counsel.

1. Securities Lending Agreements and Disclosures

The proposed amendment to Rule 15c3-1 would require a broker-dealer to make disclosures to, and obtain certain agreements from, securities lending principals in situations where the firm participates in the settlement of a securities lending transaction but wants to be deemed an agent for purposes of Rule 15c3-1. We understand that most existing standard securities lending master agreements in use today already contain language requiring agent lenders to disclose principals and principals to agree not to hold the agents liable for a counterparty default and, consequently, the proposed amendment would be codifying industry practice. Thus, the standard agreement used by the vast majority of broker-dealers should contain the representations and disclosures required by the proposed amendment. However, a small percentage of broker-dealers may need to modify their standard agreements.

We estimate that 5% of the approximately 170 firms engaged in this business, or 9 firms, would not have used the standard agreements. We further estimate each of these firms would spend approximately 20 hours of employee resources updating their standard agreement template. Therefore, we estimate that the total one-time burden to the industry as a result of this proposed requirement would be approximately 180 hours.¹³⁴ We do not believe firms would incur costs arising from updating systems, purchasing software, or engaging outside counsel in meeting this proposed requirement but seek comment on that estimate.

2. PAB Customer Reserve Account Recordkeeping Requirements

This proposed amendment to Rule 15c3-3 would require a broker-dealer to perform a PAB reserve computation and obtain certain agreements and notices related to PAB accounts and, therefore,

¹³² 9,350 hours + 364,333 hours + 255 hours = 373,938 hours.

¹³³ 180 hours + 26,830 hours + 2,250 hours + 10,000 hours + 2,500 hours + 62,040 hours + 2,100 hours = 105,900 hours.

¹³⁴ 9 broker-dealers × 20 hours per firm = 180 hours.

¹²⁶ This estimate is derived from FOCUS Reports filed by broker-dealers pursuant to Section 17 of the Exchange Act and Rule 17a-5 (17 CFR 240.17a-5).

would impose recordkeeping burdens on a broker-dealer to the extent it: (1) Has to perform a PAB computation; (2) chooses to use PAB securities and, therefore, needs to obtain agreements from PAB accountholders; and (3) opens a PAB reserve account at a new bank. The customer agreement requirement would be a one-time burden. It is standard for a broker-dealer to enter into a written agreement with an accountholder concerning the terms and conditions under which the account would be maintained. Therefore, requiring a written agreement would not result in additional burden. Rather, additional burdens would arise from the need to amend existing agreements and the standard agreement template that would be used for future customers.

Based on FOCUS Report filings, we estimate that there are approximately 2,533 existing PAB customers and, therefore, broker-dealers would have to amend approximately 2,533 existing PAB agreements. We further estimate that, on average, a firm would spend approximately 10 hours of employee resources amending each agreement. We also estimate, based on FOCUS Reports, that approximately 75 broker-dealers carry PAB accounts and, therefore, these 75 firms would have to amend their standard PAB agreement template. We estimate a firm would spend, on average, approximately 20 hours of employee resources on this task. Therefore, we estimate the total one-time burden to the industry from these requirements would be approximately 26,830 total hours.¹³⁵ We do not believe firms would incur costs arising from updating systems, purchasing software, or engaging outside counsel in meeting these proposed requirements but seek comment on that estimate.

The proposed requirements to perform a PAB computation and obtain agreements and notices from banks holding PAB accounts would result in annual burdens based on the number of broker-dealers that hold PAB accounts and the number of times per year these broker-dealers open new PAB bank accounts. Currently, to obtain the relief provided in the PAIB Letter, broker-dealers are required to obtain the agreements and notices from the banks. We understand that broker-dealers generally already obtain these agreements and notices. Therefore, we estimate there would be no additional burden imposed by this requirement but seek comment on this estimate.

The proposed amendment requiring a PAB computation would produce a one-time burden. Based on FOCUS Report filings, we estimate that approximately 75 broker-dealers would perform a PAB computation. These firms already perform a reserve computation for domestic broker-dealer customers under the PAIB letter. Nonetheless, we estimate these firms would spend, on average, approximately 30 hours of employee resources per firm updating their systems to implement changes that would be necessitated by our proposed amendment. Therefore, we estimate that the total one-time burden to the industry arising from this proposed requirement would be approximately 2,250 hours.¹³⁶

The proposed amendment requiring a PAB computation also would produce an annual burden. Based on FOCUS Report filings, we estimate that approximately 71 broker-dealers would perform the PAB computation on a weekly basis and four broker-dealers would perform it on a monthly basis. We further estimate that a broker-dealer would spend, on average, approximately 2.5 additional hours to complete the Rule 15c3-3 reserve computation as a result of our proposed amendment. Therefore, we estimate that the total annual burden to the industry from this proposed requirement would be approximately 9,350 hours.¹³⁷ We do not believe firms would incur costs arising from purchasing software or engaging outside counsel in meeting these proposed requirements but seek comment on that estimate.

3. Affirmative Consent

This proposed amendment to Rule 15c3-3 would require a broker-dealer to obtain the affirmative consent of a new customer before changing the terms under which the customer's free credit balances are treated and provide notice to existing customers prior to changing how their free credit balances are treated. The broker-dealer also would be required to make certain disclosures.

This proposed requirement would result in one-time and annual burdens to the broker-dealer industry. We note, however, that the requirement only would apply to a firm that carries customer free credit balances and opts to have the ability to change how its customers' free credit balances are treated.

Based on staff experience, we estimate that 50 broker-dealers would choose to provide existing and new customers with the disclosures and notices required under the proposed amendment in order to have the ability to change how their customers' free credit balances are treated. We further estimate these firms would spend, on average, approximately 200 hours of employee resources per firm updating their systems (including processes for generating customer account statements) to incorporate changes that would be necessitated by our proposed amendment. Therefore, we estimate that the total one-time burden to the industry arising from this proposed requirement would be approximately 10,000 hours.¹³⁸

We also estimate that these firms would consult with outside counsel in making these systems changes, particularly with respect to the language in the disclosures and notices. The Commission estimates that, on average, an outside counsel would spend, on average, approximately 50 hours assisting a broker-dealer in updating its systems for a one-time aggregate burden to the industry of 2,500 hours.¹³⁹ The Commission further estimates that this work would be split between a partner and associate, with an associate performing a majority of the work. Therefore, the Commission estimates that the average hourly cost for an outside counsel would be approximately \$400 per hour. For these reasons, the Commission estimates that the average one-time cost to a broker-dealer would be approximately \$20,000¹⁴⁰ and the one-time cost to the industry would be approximately \$1,000,000.¹⁴¹

As for annual burden, we estimate these proposed requirements would impact 5% of the total broker-dealer customer accounts per year. Based on FOCUS Report filings, we estimate there are approximately 109,300,000 customer accounts and, consequently, 5% of the accounts (5,465,000 accounts per year) would be impacted. We further estimate that a broker-dealer would spend, on average, four minutes of employee resources to process an affirmative consent for new customers and a disclosure for existing customers. Therefore, we estimate that the annual burden to the industry arising from the

¹³⁶ 75 broker-dealers × 30 hours per firm = 2,250 hours.

¹³⁷ [(71 weekly filers) × [52 weeks] × [2.5 hours per computation]] + [(4 monthly filers) × [12 months] × [2.5 hours per computation]] = 9,350 total hours.

¹³⁸ 50 broker-dealers × 200 hours per firm = 2,250.

¹³⁹ 50 broker-dealers × 50 hours per firm = 2,500 hours.

¹⁴⁰ \$400 per hour × 50 hours = \$20,000.

¹⁴¹ 50 broker-dealers × \$20,000 = \$1,000,000.

¹³⁵ (2,533 PAB customers × 10 hours per customer) + (75 firms × 20 hours per firm) = 26,830 hours.

requirement would be approximately 364,333 hours.¹⁴²

4. Internal Control Recordkeeping Requirements

These proposed amendments to Rules 17a-3 and 17a-4 would require certain large broker-dealers to make and maintain records documenting internal controls that assist in analyzing and managing risks. The requirement would apply to broker-dealers that have more than \$1,000,000 in customer credits or \$20,000,000 in capital. This requirement would result in a one-time burden to the industry.

Based on FOCUS Report filings, we estimate there are approximately 517 broker-dealers that meet the applicability threshold of this amendment (\$1,000,000 in credits or \$20,000,000 in capital). Based on staff experience, we estimate that these larger broker-dealers generally already have documented the procedures and controls they have established to manage the risks arising from their business activities. Moreover, among these firms, the time per firm likely would vary depending on the size and complexity of the firm. For some firms, the burden may be close to 0 hours and for others it may be hundreds of hours. Taking this into account, we estimate that a broker-dealer would spend, on average, approximately 120 hours of employee resources augmenting its documented procedures to come into compliance with this proposed amendment. Therefore, we estimate the total one-time burden to the industry would be approximately 62,040 hours.¹⁴³

We do not believe broker-dealers would incur costs arising from updating systems, purchasing software, or engaging outside counsel in meeting this proposed requirement but seek comment on that estimate.

5. Notice Requirements

The proposed amendments to Rule 17a-11 would require a broker-dealer to provide notice to the Commission and other regulatory authorities if the broker-dealer becomes subject to certain insolvency events, and notice to the Commission and other regulatory authorities if the broker-dealer's securities borrowed and loan or securities repurchase/reverse repurchase activity reaches a certain threshold or, alternatively, provide regulatory authorities with a monthly report of the broker-dealer's securities

borrowed and loan or securities repurchase/reverse repurchase activity.

The notice requirements would result in irregular filings from a small number of broker-dealers. As noted above, SIPC's 2005 annual report indicates that in recent years an average of six broker-dealers per year have become subject to a liquidation proceeding under the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa *et seq.*) ("SIPA"). Accordingly, we estimate that approximately six insolvency notices would be sent per year and that a broker-dealer would spend, on average, approximately ten minutes of employee resources to prepare and send the notice. Therefore, we estimate that the total annual burden to the industry arising from this proposal would be approximately one hour.¹⁴⁴ Based on FOCUS Report filings, we estimate that approximately twelve stock loan/borrow notices would be sent per year. We further estimate that a broker-dealer would spend, on average, approximately ten minutes of employee resources to prepare and send the notice. Therefore, we estimate that the total annual burden to the industry arising from this proposal would be approximately two hours.¹⁴⁵

Based on FOCUS Report filings, we estimate that 21 broker-dealers per year would submit the monthly stock loan/borrow report. We estimate each firm would spend, on average, approximately 100 hours of employee resources updating its systems to generate the report. Therefore, we estimate that the total one-time burden to the industry arising from this proposed requirement would be approximately 2,100 hours.¹⁴⁶ As for annual burden, we estimate each firm would spend, on average, approximately one hour per month (or twelve hours per year) of employee resources to prepare and send the report. Therefore, we estimate the total annual burden arising from this proposal would be approximately 255 hours.¹⁴⁷

We do not believe firms would incur costs arising from purchasing software or engaging outside counsel in meeting these proposed requirements but seek comment on this estimate.

E. Collection of Information Is Mandatory

These recordkeeping and notice requirements are mandatory with the exception of the option for a broker-

dealer to provide a monthly notice of its securities lending activities to its designated examining authority in lieu of filing the notice required under the proposed amendment to Rule 17a-11.

F. Confidentiality

The information collected under the amendments to Rules 15c3-1, 15c3-3, 17a-3 and 17a-4 would be stored by the broker-dealers and made available to the various regulatory authorities as required in connection with examinations, investigations, and enforcement proceedings.

The information collected under the amendments to Rule 17a-11 would be generated from the internal records of the broker-dealers. It would be provided to the Commission and other regulatory agencies but not on a regular basis (except for the optional monthly reports). The information provided to the Commission would be kept confidential to the extent permitted by law.

G. Record Retention Period

The proposed amendment to Rule 15c3-1 would require broker-dealers to make disclosures to principals and obtain agreements from principals with respect to securities lending transactions where the broker-dealer acts as agent. These records would have to be maintained for at least three years under paragraph (b)(7) of Rule 17a-4.¹⁴⁸ The retention period for the agreements also would depend on the length of time the relationship between the broker-dealer and the principal lasts.

The proposed amendments to Rule 15c3-3 would require broker-dealers to obtain written permission from a PAB customer if they want to use the customer's fully paid and excess margin securities and to obtain the affirmative consent of customers with respect to changing the terms under which free credit balances are maintained. These agreements would relate to the terms and conditions of the maintenance of the customer's account and, accordingly, fall within the record retention requirements of paragraph (c) of Rule 17a-4.¹⁴⁹ Under this paragraph, the records must be retained until six years after the closing of the customer's account. The amendments to Rule 15c3-3 also would require broker-dealers to obtain notices and contracts from the banks holding their PAB customer reserve accounts. In order to comply with Rule 15c3-3, broker-dealers would need to have these notices and contracts in place and documented. Accordingly,

¹⁴² 5,465,000 accounts × 4 minutes/account = 364,333 hours.

¹⁴³ 517 broker-dealers × 120 hours = 62,040 hours.

¹⁴⁴ 6 notices × 10 minutes per notice = 1 hour.

¹⁴⁵ 12 notices × 10 minutes per notice = 2 hours.

¹⁴⁶ 21 broker-dealers × 100 hours per firm = 2,100 hours.

¹⁴⁷ 21 broker-dealers × 12 hours per year or 252 hours.

¹⁴⁸ 17 CFR 240.17a-4(b)(7).

¹⁴⁹ 17 CFR 240.17a-4(c).

the retention period for these records is, at a minimum, equal to the life of the PAB customer reserve account for which they are obtained.

The proposed amendments to Rules 17a-3 and 17a-4 would require broker-dealers to document various internal control systems, policies and guidelines. The amendments to Rule 17a-4 include the establishment of a retention period for these records, which would be until three years after the termination of the use of such system, policy or guideline.

The proposed amendments to Rule 17a-11 would require broker-dealers to provide notice or monthly reports to the Commission and other regulatory authorities under certain circumstances. These notices and reports would constitute communications relating to a broker-dealer's "business as such" and, therefore, would need to be retained for three years.¹⁵⁰

H. Request for Comment

We request comment on the proposed collections of information in order to (1) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility, (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information, (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected, and (4) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology.

Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090, and refer to File No. S7-08-07. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this document in the **Federal Register**; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. The Commission has submitted the proposed collections of information to OMB for approval.

Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-08-07, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE., Washington, DC 20549.

V. Costs and Benefits of the Proposed Amendments

We are sensitive to the costs and benefits that result from Commission rules. We have identified certain costs and benefits of the proposed amendments and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in the analysis.¹⁵¹ We seek comment and data on the value of the benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this cost-benefit analysis, and request those commenters to provide data so we can improve these cost estimates.

We also seek estimates and views regarding these costs and benefits for particular types of market participants, as well as any other costs or benefits that may result from the adoption of these proposed rules.

A. Amendments to the Customer Protection Rule

1. Proprietary Accounts of Broker-Dealers

The proposed amendment to Rule 15c3-3 would require broker-dealers to perform a reserve calculation for the proprietary accounts ("PAB") of domestic and foreign broker-dealers and foreign banks acting as broker-dealers. It also would require them to obtain agreements from these broker-dealer customers with respect to the use of their fully paid and excess margin securities. Finally, it would require broker-dealers to obtain agreements and notices from the banks holding the PAB reserve deposits.

As discussed above, there is a disparity between the customer reserve

requirements in Rule 15c3-3 and the treatment of customers in a liquidation proceeding under the Securities Investor Protection Act of 1970 ("SIPA").¹⁵² Rule 15c3-3 requires broker-dealers to reserve the net amount of money they owe their customers. If the broker-dealer fails, this net amount is available to be returned to customers ahead of all other creditors. Moreover, if the failed broker-dealer is subject to a SIPA proceeding, this net amount becomes part of the estate of customer property, which is distributed *pro rata* to customers.

Foreign and domestic broker-dealers are not "customers" under Rule 15c3-3. Therefore, broker-dealers are not required to reserve the net amount of money owed to these entities. However, they are "customers" for the purposes of SIPA and, consequently, are entitled to a *pro rata* share of the estate of customer property. Thus, even if a failed broker-dealer properly reserved the net amount it owed its Rule 15c3-3 "customers," the estate of customer property nonetheless may be insufficient to return the money owed to these "customers" because broader definition of "customer" in SIPA entitles foreign and domestic broker-dealers to a *pro rata* share of the funds.

i. Benefits

Our proposed amendment would address this discrepancy by requiring broker-dealers to reserve for the net amount of money they owe other broker-dealers. This would benefit the other customers as well as the broker-dealer account holders by eliminating the inconsistency between Rule 15c3-3 and SIPA, which could decrease the estate of customer property in a SIPA liquidation. It also would minimize the risk that advances from the fund administered by the Securities Investor Protection Corporation ("SIPC") would be necessary to protect customer cash claims. We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

ii. Costs

The proposed requirements to perform a PAB computation and obtain agreements and notices from banks holding PAB accounts would result in one-time and annual costs to broker-dealers that hold PAB accounts. Under the no-action relief set forth in the PAIB Letter, these broker-dealers already are performing a reserve computation for

¹⁵¹ For the purposes of this cost/benefit analysis, we are using salaries for New York-based employees, which tend to be higher than the salaries for comparable positions located outside of New York. This conservative approach is intended to capture unforeseen costs and to account for the fact that a substantial portion of the work will be undertaken in New York. The salary information is derived from the *SIA Report on Management and Professional Earnings in the Securities Industry 2005* ("SIA Management Report 2005"). The hourly costs derived from the SIA Management Report 2005, and referenced in this cost benefit section, are modified to account for an 1800-hour work week and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

¹⁵² 15 U.S.C. 78aaa *et seq.*

¹⁵⁰ 17 CFR 240.17a-4(b)(4).

domestic broker-dealer accounts and have obtained the necessary agreements and notices from the banks holding their PAIB reserve deposits. Therefore, the proposed amendments would result in incremental costs.

The proposed requirement to obtain written agreements from PAB customers in order to use their fully paid and excess margin securities would result in a one-time cost to the industry. As discussed above with respect to the Paper Work Reduction Act of 1995 ("PRA"), it is standard for broker-dealers to enter into written agreements with their broker-dealer customers concerning the terms and conditions under which the customers' accounts will be maintained. Therefore, requiring a written agreement should not result in additional costs. Rather, the one-time costs would arise from the need to amend existing agreements and the standard agreement template that would be used for future customers.

As discussed with respect to the PRA, based on FOCUS Report filings, we estimate that there are approximately 2,533 existing PAB customers and, therefore, broker-dealers would have to amend approximately 2,533 existing PAB agreements. We further estimate that, on average, a firm would spend approximately 10 hours of employee resources amending each agreement. We also estimate, based on FOCUS Reports, that approximately 75 broker-dealers carry PAB accounts and, therefore, these 75 firms would have to amend their standard PAB agreement template. We estimate a firm would spend, on average, approximately 20 hours of employee resources on this task. Therefore, as noted with respect to the PRA, we estimate the total one-time hourly burden to the industry from these requirements would be approximately 26,830 hours.¹⁵³ For the purposes of this cost analysis, we estimate this work would be undertaken by a broker-dealer's in-house attorneys. The SIA Management Report 2005 indicates that the average hourly cost of an attorney is \$327. Therefore, we estimate that there would be a one-time cost to the industry from these proposed requirements of approximately \$8,773,410.¹⁵⁴

As discussed with respect to the PRA, the requirement to perform a PAB computation also would produce a one-time burden to the extent the system for performing the calculation would need to be updated. Based on FOCUS Report

filings, we estimate that approximately 75 broker-dealers would perform a PAB computation. These firms already perform a reserve computation for domestic broker-dealer customers under the PAIB letter. Nonetheless, we estimate these firms would spend, on average, approximately 30 hours of employee resources per firm updating their systems to implement changes that would be necessitated by our proposed amendment. With respect to the PRA, we estimate that the total one-time hourly burden to the industry arising from this proposed requirement would be approximately 2,250 hours.¹⁵⁵ For the purposes of the cost analysis, we estimate that this work would be undertaken by a Senior Programmer. The SIA Management Report 2005 indicates the average hourly cost of this position is approximately \$268. Therefore, we estimate that there would be a one-time cost to the industry from the proposed requirement of approximately \$603,000.¹⁵⁶

As noted with respect to the PRA, the proposed requirement to perform a PAB computation would result in an annual hourly burden to the extent the new requirement would lengthen the time needed to complete the computation. Based on FOCUS Report filings, we estimate that approximately 71 broker-dealers would perform the PAB computation on a weekly basis and four broker-dealers would perform it on a monthly basis. We further estimate that a broker-dealer would spend, on average, approximately 2.5 additional hours to complete the Rule 15c3-3 reserve computation as a result of our proposed amendment. Therefore, as noted with respect to the PRA, we estimate that the total annual hourly burden to the industry from this proposed requirement would be approximately 9,350 hours.¹⁵⁷ For purposes of this cost analysis, we estimate that the responsibility for performing the PAB computation would be undertaken by a financial reporting manager. As noted above, the SIA Management Report 2005 indicates that the average hourly cost for a financial reporting manager is \$278. Therefore, we estimate that the total annual cost to the industry resulting from these requirements would be approximately \$2,599,300.¹⁵⁸

As noted above, we request comment on these proposed cost estimates. In particular, we request comment on whether there would be additional costs to broker-dealers as a consequence of these proposals. For example, with respect to the PRA, we estimate that these requirements would not result in costs arising from purchasing software or engaging outside counsel. Therefore, we request comment on whether these requirements would result in such costs and, if so, how to quantify the costs. We also request comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

2. Banks Where Special Reserve Deposits May Be Held

The proposed amendment to Rule 15c3-3 would limit the amount of cash a broker-dealer could deposit at any one bank for the purposes of maintaining a required customer or PAB reserve requirement and exclude customer and PAB reserve cash deposits at affiliated banks from counting towards the broker-dealer's reserve requirement.

i. Benefits

The intent of this proposed amendment is to prevent broker-dealers from concentrating customer related deposits that are large relative to the broker-dealer or the bank in order to limit the risk arising from a financial collapse and to prevent such deposits from being lost in a group-wide financial collapse. Concentration poses a risk that some or all of the deposit may be lost. Depending on the size of the deposit and the broker-dealer, a lost deposit could cause the broker-dealer to fail. If the broker-dealer fails and the deposit is not recovered, the SIPC fund likely would not recover advances from the fund made for the purpose of returning customer assets. Moreover, to the extent that customer losses exceeded the SIPC advance limits, customers would suffer permanent losses. The benefits that would be derived from this proposed amendment are an increased safeguarding of SIPC funds and customer assets.

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

¹⁵³ (2,533 PAB customers × 10 hours per customer) + (75 broker-dealers × 20 hours per firm) = 26,830 hours.

¹⁵⁴ \$327 per hour × 26,830 hours = \$8,773,410.

¹⁵⁵ 75 broker-dealers × 30 hours per firm = 2,250 hours.

¹⁵⁶ \$268 per hour × 2,250 hours = \$603,000.

¹⁵⁷ [(71 weekly filers) × [52 weeks] × [2.5 hours per computation]] + [(4 monthly filers) × [12 months] × [2.5 hours per computation]] = 9,350 total hours.

¹⁵⁸ \$278 per hour × 9,350 hours = \$2,599,300.

ii. Costs

We estimate that the costs resulting from this proposed amendment would be incremental. Specifically, we estimate that approximately 216 broker-dealers would have reserve deposit requirements.¹⁵⁹ A majority of these firms meet a substantial portion of their deposit requirement using qualified government securities as opposed to cash and, therefore, would not be impacted by this proposal. Moreover, to the extent that a broker-dealer's cash deposits exceed the limits, it could open up one or more accounts at different banks or, alternatively, use qualified securities to meet part of its deposit requirement.

In terms of quantifying costs, we estimate that, of the 216 firms with reserve deposit requirements, only 5%, namely 11, would need to open new bank accounts or substitute qualified securities for cash in an existing reserve account. We estimate that the responsibility for opening a new reserve bank account or substituting qualified securities for cash in an existing account would be undertaken by a Senior Treasury/Cash Management Manager. The SIA Management Report 2005 indicates that the average hourly cost of this position is \$263. We estimate that the senior treasury/cash management manager would spend approximately 10 hours performing these changes. Therefore, we estimate that the average cost per firm to make these changes would be approximately \$2,630.¹⁶⁰ For these reasons, we estimate that the total one-time cost to the industry would be approximately \$28,930.¹⁶¹

As noted above, we request comment on these proposed cost estimates. In particular, we request comment on whether there would be additional costs to broker-dealers as a consequence of these proposals, such as costs arising from implementing systems changes, maintaining additional bank or securities accounts, and managing pools of qualified securities as opposed to a deposit of cash. We also request comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters should identify the metrics and sources of any empirical data that support their cost estimates.

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

The proposed amendment to Rule 15c3-3 would permit broker-dealers to deposit certain money market funds in the customer reserve account. This would benefit broker-dealers subject to the customer reserve requirements in Rule 15c3-3 by creating a deposit alternative to cash and United States Treasury securities. It would not result in any additional costs to broker-dealers.

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

In addition, while we do not believe the proposal would result in costs to broker-dealers, we request comment on whether it would result in costs to other market participants, including broker-dealer customers, and banks. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

4. Allocation of Customers' Fully Paid and Excess Margin Securities to Short Positions

The proposed amendment to Rule 15c3-3 would require broker-dealers to obtain possession or control over fully paid or excess margin securities that allocate to a proprietary or customer short position.

i. Benefits

This proposed amendment would protect broker-dealer customers by requiring broker-dealers to reduce long customer positions to possession and control even if the positions may allocate to a customer or proprietary short position. The possession or control requirement seeks to ensure that customer securities are available to be returned in the event the broker-dealer fails. Therefore, in addition to broker-dealer customers, the proposal would benefit the SIPC fund to the extent it mitigates outlays from the fund to make advances to customers of a failed broker-dealer that cannot return all customer securities.

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

ii. Costs

We estimate this proposed requirement would result in a one-time cost to firms that carry customer securities to update systems for complying with the possession and control requirements in Rule 15c3-3. Based on FOCUS Report filings, we estimate that approximately 350 broker-dealers carry customer securities. We further estimate these firms would spend, on average, approximately 40 hours of employee resources per firm updating their systems to implement changes that would be necessitated by our proposed amendment. For the purposes of this cost analysis, we estimate that this work would be undertaken by a Senior Programmer. The SIA Management Report 2005 indicates the average hourly cost of this position is approximately \$268. Therefore, we estimate that the average cost per firm to make these changes would be approximately \$10,720.¹⁶² For these reasons, we estimate that the total one-time cost to the industry would be approximately \$3,752,000.¹⁶³

We believe the annual costs resulting from this amendment would be *de minimis*. The proposal could result in some broker-dealers borrowing securities to cover proprietary short positions rather than using customer securities. However, currently when broker-dealers use customer securities they are required to put a credit in the Rule 15c3-3 reserve formula equal to the value of the securities. This credit item can result in higher reserve deposit requirements, which must be made using the broker-dealer's own capital. Thus, increased costs associated with having to borrow securities to cover a short position likely would be offset by decreased costs associated with devoting capital to customer reserve requirements.

As noted above, we request comment on these cost estimates. In particular, we request comment on whether there would be additional costs to broker-dealers as a consequence of these proposals. We also request comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

5. Requirement To Obtain Customers' Affirmative Consent

This proposed amendment to Rule 15c3-3 would require a broker-dealer to obtain the affirmative consent of a new

¹⁵⁹ This estimate is based on FOCUS Report filings.

¹⁶⁰ \$263 per hour × 10 hours = \$2,630.

¹⁶¹ 11 broker-dealers × \$2,630 = \$28,930.

¹⁶² \$268 per hour × 40 hours = \$10,720.

¹⁶³ 350 broker-dealers × \$10,720 = \$3,752,000.

customer in order to be able to change the terms under which the customer's free credit balances are treated and provide notice to existing customers prior to changing how their free credit balances are treated. The broker-dealer also would be required to make certain disclosures.

i. Benefits

Free credit balances constitute money that a broker-dealer owes its customers. Customers may maintain these balances at the broker-dealer in anticipation of future stock purchases. Generally, customer account agreements set forth how the broker-dealer will invest these balances. For example, the broker-dealer may sweep them into a money market fund or, alternatively, pay an amount of interest on the funds. This proposed amendment is designed to ensure that customers are provided meaningful notice if a broker-dealer seeks to change the terms under which their free credit balances are invested. This would provide the customers with an opportunity to opt out of the proposed change or re-direct their free credit balances.

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

ii. Costs

As discussed above with respect to the PRA, based on staff experience, we estimate that 50 broker-dealers would choose to provide existing and new customers with the disclosures and notices required under the proposed amendment in order to have the flexibility to change how their customers' free credit balances are treated. We further estimate these firms would spend, on average, approximately 200 hours of employee resources per firm updating their systems (including processes for generating customer account statements) to incorporate changes that would be necessitated by our proposed amendment. For the purposes of this cost analysis, we estimate that this work would be undertaken by a Senior Programmer. The SIA Management Report 2005 indicates the average hourly cost of this position is approximately \$268. Therefore, we estimate that the average cost per firm to make these changes would be approximately \$53,600.¹⁶⁴ For these reasons, we estimate that the total

one-time cost to the industry would be approximately \$2,680,000.¹⁶⁵

Also, as discussed above with respect to the PRA, we estimate that these firms would consult with outside counsel in making these systems changes, particularly with respect to the language in the disclosures and notices. The Commission estimates that, on average, an outside counsel would spend approximately 50 hours assisting a broker-dealer in updating its systems for a one-time aggregate burden to the industry of 2,500 hours.¹⁶⁶ The Commission further estimates that this work would be split between a partner and associate, with an associate performing a majority of the work. Therefore, the Commission estimates that the average hourly cost for an outside counsel would be approximately \$400 per hour. For these reasons, the Commission estimates that the average one-time cost to a broker-dealer for engaging outside counsel would be approximately \$20,000¹⁶⁷ and the one-time cost to the industry would be approximately \$1,000,000.¹⁶⁸

As for annual burden, as discussed above with respect to the PRA, we estimate that this requirement would impact approximately 5,465,000 customer accounts in a given year. We further estimate that a broker-dealer would spend, on average, four minutes of employee resources to process an affirmative consent for new customers and a disclosure for existing customers. For the purposes of this cost analysis, we estimate that the responsibility for processing the affirmative consents would be undertaken by a compliance clerk. The SIA Report on Office Salaries in the Securities Industry 2005 ("SIA Report on Office Salaries") indicates that the average hourly cost of this position is \$68. Additionally, we estimate the compliance clerk would spend approximately four minutes per consent and notice. Therefore, we estimate that the cost per account to process the affirmative consents and notices would be approximately \$4.50.¹⁶⁹ Therefore, the total annual cost to the industry would be approximately \$24.5 million.¹⁷⁰

As noted above, we request comment on these proposed cost estimates. In particular, we request comment on whether there would be additional costs to broker-dealers as a consequence of

these proposals. We also request comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

6. Eliminating the 3% Reduction for Aggregate Debit Items

The proposed amendment to paragraph (a)(1)(ii)(A) of Rule 15c3-1 would eliminate the requirement that broker-dealers using the alternative standard reduce their Exhibit A—Item 10 debits by 3% in lieu of the 1% reduction applicable to basic method firms. This would benefit broker-dealers subject to the 3% reduction by potentially reducing the amount of their reserve deposit requirements and, thereby, freeing up capital. Based on FOCUS data, we estimate that broker-dealers in the aggregate currently carry approximately \$550 billion in total credits and \$380 billion in total debits. Moreover, we further estimate that the amount of credits and debits held by firms that are subject to the 1% reduction is insignificant and, consequently, for purposes of this cost analysis, assume that the \$550 billion in credits and \$380 billion in debits are held by firms subject to the 3% reduction.

Under the current requirement to reduce total debits by 3%, broker-dealers, in the aggregate, reduce the approximately \$380 billion in total debits by \$11.4 billion.¹⁷¹ This decreases the amount of debits that can offset total credits from \$380 billion to \$368.6 billion. Based on our estimates, this potentially increases the industry-wide reserve requirement from approximately \$170 billion¹⁷² to \$181.4 billion.¹⁷³ Under the proposed 1% reduction, broker-dealers, in the aggregate, would reduce the approximately \$380 billion in total debits by \$3.8 billion.¹⁷⁴ This would decrease the amount of debits that can offset credits from \$380 billion to \$376.2 billion. Based on our estimates, this would potentially increase the industry-wide reserve requirement from \$170 billion¹⁷⁵ to \$173.8 billion (as opposed to \$181.4 billion).¹⁷⁶ Accordingly, our proposed amendment would result in a decrease in the industry-wide reserve requirement of approximately \$7.6

¹⁶⁵ 50 broker-dealers × \$53,600 = \$2,680,000.

¹⁶⁶ 50 broker-dealers × 50 hours per firm = 2,500 hours.

¹⁶⁷ \$400 per hour × 50 hours = \$20,000.

¹⁶⁸ 50 broker-dealers × \$20,000 = \$1,000,000.

¹⁶⁹ 4 minutes × \$68 per hour = \$4.50.

¹⁷⁰ 5,465,000 consents/notices × \$4.50 per consent/notice = \$24,592,500.

¹⁷¹ \$380 billion × 0.03% = \$11.4 billion.

¹⁷² \$550 billion – \$380 billion = \$170 billion.

¹⁷³ \$550 billion – \$368.6 billion = \$181.4 billion.

¹⁷⁴ \$380 billion × 0.01% = \$3.8 billion.

¹⁷⁵ \$550 billion – \$380 billion = \$170 billion.

¹⁷⁶ \$550 billion – \$376.2 billion = \$173.8 billion

¹⁶⁴ \$268 per hour × 200 hours = \$53,600.

billion, which broker-dealers could re-direct to other business activities.¹⁷⁷

We do not anticipate any net costs to broker-dealers that would result from the proposed amendment, given that the benefits from the freed-up capital of potentially \$7.6 billion would significantly offset any costs arising from making necessary systems changes to implement this proposed change to the customer reserve computation. However, it could result in costs to other market participants. Therefore, we request comment on whether it would result in such costs, including costs to broker-dealer customers and banks. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

7. Clarification Regarding Funds in Certain Commodity Accounts

The proposed amendment to paragraph (a)(8) of Rule 15c3-3 would clarify that broker-dealers need not treat funds in certain commodities accounts as “free credit balances” for purposes of the customer reserve formula. This would benefit broker-dealers that are registered as futures commission merchants by eliminating any ambiguity with respect to such accounts and avoiding situations where they unnecessarily increase reserve amounts. We do not anticipate the proposed amendment would result in any costs to broker-dealers and, as these funds are not protected under SIPA, would not expose the SIPC fund to increased liabilities.

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

In addition, while we do not believe the proposal would result in costs to broker-dealers, we request comment on whether it would result in costs to other market participants, including broker-dealer customers, and banks. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

B. Portfolio Margining

There are two proposed amendments to accommodate SRO rules that permit broker-dealers to determine customer margin requirements using a portfolio-margining methodology. The first amendment would revise the definition of “free credit balances” in paragraph (a)(8) of Rule 15c3-3. The revision would expand the definition to include

funds in a portfolio margin account relating to certain futures and futures options positions and the market value of futures options as of the filing date in a SIPA proceeding. The second amendment would add a debit line item to the customer reserve formula in Rule 15c3-3a consisting of margin posted by a broker-dealer to a futures clearing agency.

1. Benefits

The proposed amendments are designed to provide greater protection to customers with portfolio margin accounts. They would require broker-dealers to treat all cash balances in the accounts under the reserve computation provisions of Rule 15c3-3, which are designed to ensure that customer cash is available to be returned to customers in the event the broker-dealer fails. The proposed amendments also are designed to provide the protections of SIPA to these cash balances and to futures options in the accounts.

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify, including the identification of sources of empirical data that could be used for such metrics.

2. Costs

The requirements imposed by the proposed amendments would be elective. They only would apply to broker-dealers choosing to offer their customers portfolio margin accounts with a cross-margin feature (*i.e.*, the ability to hold futures and futures options in the account). We estimate that approximately thirty-three broker-dealers would elect to offer their customers portfolio margin accounts that would include futures and futures options.¹⁷⁸

The proposed amendment to the definition of “free credit balances” in Rule 15c3-3 would require broker-dealers to include in the customer reserve formula credit balances related to futures positions in a portfolio margin account. The proposed amendment to add a line item to the debits in the customer reserve formula of Rule 15c3-3a would require broker-dealers to include the amount of customer margin required and on deposit at a futures clearing organization as a “debit” in the reserve formula. Accordingly, these proposed amendments would require changes to the systems broker-dealers use to compute and account for their customer reserve requirements. We assume that the responsibility for

updating these systems will be undertaken by a Senior Programmer. The SIA Management Report 2005 indicates the average hourly cost of this position is approximately \$268. We estimate the senior programmer would spend approximately 130 hours to modify software to conform it to the requirements of the proposed amendments. Therefore, we estimate that the program and systems changes would result, on average, in a one-time cost of approximately \$34,840 on per broker-dealer.¹⁷⁹ For these reasons, we estimate the total one-time cost to the industry would be approximately \$1,149,720.¹⁸⁰

As noted above, we request comment on these proposed cost estimates. In particular, we request comment on additional costs to broker-dealers that would arise from these proposals, such as system costs in addition to those discussed above (*e.g.*, costs associated with purchasing new software and updates to existing software). We also request comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

C. Amendments With Respect to Securities Borrowed and Loaned and Repo Activities

We are proposing amendments to strengthen the financial responsibility of broker-dealers engaging in a securities lending business. The proposed amendments would require broker-dealers to (1) disclose the principals and obtain certain agreements from the principals in a transaction where they provide settlement services in order to be considered an agent (as opposed to a principal) for the purposes of the net capital rule, and (2) provide notice to the Commission and other regulatory authorities if the broker-dealer’s securities borrowed and loan or securities repurchase/reverse repurchase activity reaches a certain threshold or, alternatively, provide regulatory authorities with a monthly report of the broker-dealer’s securities borrowed and loan or securities repurchase/reverse repurchase activity.

1. Benefits

The proposed amendments are intended to strengthen the financial responsibility of broker-dealers engaged in a securities lending or repo business and to assist securities regulators in

¹⁷⁷ \$11.4 billion – \$3.8 billion = \$7.6 billion.

¹⁷⁸ This estimate is based on data from FOCUS Report filings.

¹⁷⁹ 130 hours × \$268 = \$34,840.

¹⁸⁰ 33 broker-dealers × \$34,840 = \$1,149,720.

monitoring such activities. This would assist securities regulators in responding to situations where a broker-dealer was in financial difficulty due to a large securities lending or repo position. This would help prevent significant losses to the firm's customers and other broker-dealers, and reduce financial system risk.

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

2. Costs

i. Requirements To Avoid Principal Liability

As discussed with respect to the PRA, we understand that most existing standard securities lending master agreements in use today already contain language requiring agent lenders to disclose principals and for principals to agree not to hold the agents liable for a counterparty default. Thus, the standard agreement used by the vast majority of broker-dealers should contain the representations and disclosures required by the proposed amendment. However, a small percentage of broker-dealers may need to modify their standard agreements. As discussed with respect to the PRA, we estimate that approximately nine broker-dealers would need to amend their securities lending agreements to include the required provision and that they would each spend, on average, approximately 20 hours in making the changes. We estimate that the responsibility for changing the language in the securities lending master agreement template would be undertaken collectively by an associate general counsel and attorney. The SIA Management Report 2005 indicates that the average hourly cost of these positions respectively is \$431 for the associate general counsel and \$327 for the attorney. We estimate that, on average, the attorney would spend 16 hours changing the template and the associate general counsel would spend four hours overseeing the project. Therefore, we estimate that the one-time cost to make these changes would be, on average, \$6,956 per firm.¹⁸¹ For these reasons, we estimate the total one-time cost to the industry would be approximately \$62,604.¹⁸²

As noted above, we request comment on these proposed cost estimates. In particular, we request comment on

additional costs to broker-dealers that would arise from these proposals, such as costs arising from making systems changes. We also request comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

ii. Notices or Monthly Reports

The proposed amendment to Rule 17a-11 would require broker-dealers engaged in securities lending or repurchase activities to either: (1) File a notice with the Commission and their designated examining authority whenever the total money payable against all securities loaned, subject to a reverse repurchase agreement or the contract value of all securities borrowed or subject to a repurchase agreement exceeds 2500% of tentative net capital; or, alternatively, (2) file a monthly report on their securities lending and repurchase activities with their designated examining authority.

As discussed with respect to the PRA, based on FOCUS Report filings, we estimate that approximately twelve notices per year would be sent pursuant to this proposed amendment. We further estimate that a broker-dealer would spend, on average, approximately ten minutes of employee resources to prepare and send the notice. Therefore, we estimate that the costs to the industry associated with this requirement would be de minimis.

As for the monthly reports, we estimated with respect to the PRA that approximately 21 broker-dealers would choose the option under the proposed rule of filing the reports. We also estimated with respect to the PRA that each firm would spend, on average, approximately 100 hours of employee resources updating its systems to generate the report. For the purposes of this cost analysis, we assume that the responsibility for updating these systems would be undertaken by a Senior Programmer. The SIA Management Report 2005 indicates the average hourly cost of this position is approximately \$268. Therefore, we estimate that the systems changes would result, on average, in a one-time cost of approximately \$26,800 per broker-dealer.¹⁸³ For these reasons, we estimate the total one-time cost to the industry would be approximately \$562,800.¹⁸⁴

As for the annual costs of generating and filing the monthly report, we estimated with respect to the PRA that

a broker-dealer would spend, on average, approximately one hour per month (or twelve hours per year) of employee resources to generate and send the report. We assume the responsibility for generating and filing the monthly report would be undertaken by a junior stock loan manager. The SIA Management Report 2005 indicates the average hourly cost for this position is \$208. We further estimate that a junior stock loan manager would spend, on average, approximately one hour per month compiling and filing this report for an average monthly cost of \$208. Therefore, we estimate the cost to file the reports would be approximately \$2,496 per firm.¹⁸⁵ For these reasons, we estimate the total annual cost to the industry would be approximately \$52,416.¹⁸⁶

As noted above, we request comment on these proposed cost estimates. In particular, we request comment on additional costs to broker-dealers that would arise from these proposals. We also request comment on whether these proposals would impose costs on other market participants, including persons active in the securities lending and repo markets. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

D. Documentation of Risk Management Procedures

We are proposing amendments to the broker-dealer books and records rules that would require certain large broker-dealers to document in writing the procedures and guidelines they use for managing risk. The proposed amendments do not require broker-dealers to implement procedures. Rather, they require the documentation of procedures that have been established by the broker-dealer.

1. Benefits

These proposed amendments would require large broker-dealers to document the controls they have implemented to address the risks they face as a result of their business activities. This would benefit the firms by mitigating the risk of financial loss or collapse and their customers by mitigating the risk of losses associated with a firm's failure or an employee's improper activities. Moreover, by strengthening the internal processes of the broker-dealers, these proposed amendments would benefit market participants and reduce systemic financial risk. In addition, by making the documented controls a required

¹⁸¹ $[(16 \text{ hours}) \times \$327 \text{ per hour}] + [(4 \text{ hours}) \times \$431 \text{ per hour}] = \$6,956$.

¹⁸² $9 \text{ broker-dealers} \times \$6,956 = \$62,604$.

¹⁸³ $100 \text{ hours} \times \$268 = \$26,800$.

¹⁸⁴ $21 \text{ broker-dealers} \times \$26,800 = \$562,800$.

¹⁸⁵ $[(1 \text{ hour}) \times \$208 \text{ per hour}] \times 12 \text{ months} = \$2,496$.

¹⁸⁶ $21 \text{ broker-dealers} \times \$2,496 = \$52,416$.

record, securities regulators would have better access to them. This would assist regulators in monitoring the risks faced by broker-dealers and understanding the controls they implement to address the risks.

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

2. Costs

These proposed amendments would apply to a limited number of broker-dealers, namely, those firms with more than \$1 million in customer credits or \$20 million in capital. This proposed requirement would result in a one-time cost to some of these firms to the extent they had established procedures that had not been documented. We believe, generally, that most of these firms have documented their established risk management controls and procedures. For these reasons, we estimated with respect to the PRA that the one-time hourly burden to meet the requirements of these proposed rules would range from 0 hours for some firms and to hundreds of hours for other firms. Taking this into account, we estimated with respect to the PRA that a broker-dealer would spend, on average, approximately 120 hours of employee resources augmenting its documented procedures to come into compliance with this proposed amendment.

For the purposes of this cost analysis, we estimate that the responsibility for documenting the risk management procedures and controls a broker-dealer has established would be coordinated by an attorney working with operations specialists from the various risk management departments in the firm. We further estimate that the project would be overseen by an associate general counsel. The SIA Management Report 2005 indicates the average hourly costs of these positions respectively are approximately \$431 for an associate general counsel, \$327 for an attorney and \$144 for an operations specialist. We estimate that the attorney would spend 40 hours compiling and documenting the procedures, the operations specialists collectively would spend 70 hours working with the attorney, and the associate general counsel would spend ten hours overseeing the project. Therefore, we estimate that the average one-time cost per firm to comply with these proposed

amendments would be \$27,470.¹⁸⁷ We estimated with respect to the PRA that these amendments would apply to approximately 517 broker-dealers. For these reasons, we estimate that the total one-time cost to the industry would be approximately \$14,201,990.¹⁸⁸

As noted above, we request comment on these proposed cost estimates. In particular, we request comment on additional costs to broker-dealers that would arise from these proposals, such as costs arising from making changes to systems and costs associated with maintaining these records. We also request comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

E. Amendments to the Net Capital Rule

1. Requirement to Add Back Certain Liabilities to Net Worth and Treat Certain Capital Contributions as Liabilities

These proposed amendments to Rule 15c3-1 would require a broker-dealer to add back to net worth, when calculating net capital, liabilities assumed by a third-party if the third-party did not have the financial wherewithal to pay the liabilities. The proposed amendments also would require a broker-dealer to treat as liabilities capital contributions where the investor has the option to withdraw the capital at any time.

i. Benefits

These proposed amendments to Rule 15c3-1 would assist investors and regulators by requiring broker-dealers to provide a more accurate picture of their financial condition. This would permit regulators to react more quickly if a firm experiences financial difficulty. This would benefit customers of a troubled broker-dealer as well as its counterparties and, accordingly, reduce systemic risk in the securities markets. We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

ii. Costs

These proposed amendments would apply to all broker-dealers. However,

¹⁸⁷ $[(40 \text{ hours}) \times \$327 \text{ per hour}] + [(70 \text{ hours}) \times \$144 \text{ per hour}] + [(10 \text{ hours}) \times \$431 \text{ per hour}] = \$27,470.$

¹⁸⁸ $517 \text{ broker-dealers} \times \$27,470 = \$14,201,990.$

the requirements only would impact a few broker-dealers, namely those that have sought to shift their liabilities to a third-party that lacks the resources— independent of the broker-dealer—to assume the liabilities or those that provide investors with options to withdraw capital. We believe the vast majority of broker-dealers either do not seek to transfer responsibility for their liabilities to a third-party or, if they do so, rely on a third-party that has the financial resources— independent of the assets and revenue of the broker-dealer—to pay the obligations as they become due. We also believe that most broker-dealers do not accept capital contributions under agreements permitting the investor to withdraw the capital at any time.

FOCUS Report filings indicate that approximately 702 broker-dealers report having no liabilities. For the purposes of this analysis, we conservatively estimate that the proposed amendment would impact all of these firms. Requiring these broker-dealers to book liabilities would decrease the amount of equity capital held by the firms and in some cases may require them to obtain additional capital. The majority of broker-dealers reporting no liabilities are introducing broker-dealers that have a \$5,000 minimum net capital requirement. The reported average for total aggregate liabilities of introducing broker-dealers is \$280,354 per firm. Therefore, conservatively estimating that the 702 broker-dealers would have to each raise \$280,354 in additional capital as result of the proposed requirement, the total aggregate amount of additional capital that would need to be raised would be \$196,808,508.¹⁸⁹ We further estimate that the cost of capital is approximately 5%.¹⁹⁰ Therefore, we estimate that the total annual cost to the industry would be approximately \$10 million.¹⁹¹

We estimate that amendments requiring broker-dealers to treat certain capital contributions as liabilities should not result in significant additional costs. Generally, broker-dealers do not enter into agreements permitting an owner to withdraw capital at any time. To the extent some firms may have engaged in this practice, they could have to pay more for capital. Conservatively, we estimate that no more than \$100 million in capital at broker-dealers is subject to such agreements. Assuming an incremental

¹⁸⁹ $702 \text{ broker-dealers} \times \$280,354 = \$196,808,508.$

¹⁹⁰ We estimate this generally would be the cost to a broker-dealer to obtain a subordinated loan that meets requirements of Rules 15c3-1 and 15c3-1d (17 CFR 240.15c3-1d).

¹⁹¹ $\$196,809,000 \times 5\% = \$9,840,300.$

cost of capital of 2.5%, we estimate that the proposed amendment would result in an annual cost of approximately \$2.5 million.¹⁹²

As noted above, we request comment on these proposed cost estimates. In particular, we request comment on additional costs to broker-dealers that would arise from these proposals. We also request comment on whether these proposals would impose costs on other market participants, including broker-dealer customers. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

2. Account for Excess Fidelity Bond Deductibles

This proposed amendment would require broker-dealers to deduct from net capital, with regard to fidelity bonding requirements prescribed by a broker-dealer's examining authority, the excess of any deductible amount over the maximum amount permitted by self-regulatory organization rules.

i. Benefits

Self-regulatory organization rules relating to fidelity bonding requirements provide safeguards with respect to the financial responsibility and related practices of broker-dealers. This proposed amendment would clarify that broker-dealers subject to capital charges under self-regulatory organization rules for excess fidelity bond deductibles also should include such deductions when determining net capital for purposes of Rule 15c3-1.¹⁹³ This would help in ensuring that broker-dealers do not exceed regulatory limitations for fidelity bond deductibles.

ii. Costs

This proposed amendment would codify in a Commission rule capital charges that broker-dealers are currently required to take pursuant to the rules of various self-regulatory organizations. The proposed amendment would not impose additional costs on broker-dealers with respect to the purchasing or carrying of fidelity bond coverage. Nor would the proposed amendment cause broker-dealers to incur additional costs in determining or reporting excess deductible amounts over the maximum amount permitted. Broker-dealers already make such determinations under self-regulatory organization rules, and the manner in which such excesses are typically reported (*i.e.*, through periodic FOCUS and other reports) would remain the same. For these

reasons, we believe any costs arising from this proposed amendment would be de minimis.

As noted above, we request comment on this cost estimate. In particular, we request comment on whether there would be any costs to broker-dealers as a consequence of this proposal. We also request comment on whether this proposal would impose costs on other market participants, including broker-dealer customers. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

3. Broker-Dealer Solvency Requirement

This proposed amendment to Rule 15c3-1 would require broker-dealers to cease doing a securities business if they become subject to certain insolvency events. The companion amendment to Rule 17a-11 would require such broker-dealers to provide notice of their insolvency to regulatory authorities.

i. Benefits

The proposed amendment to Rule 15c3-1 would benefit the securities markets by removing risks associated with having a financially unstable firm continue to operate. For example, the broker-dealer would not be able to take on new customers and place their assets at risk of being lost in its financial collapse or frozen in a liquidation proceeding. Furthermore, the broker-dealer would not be able to enter into proprietary transactions with other broker-dealers and place them or clearing agencies at risk of counterparty default. The broker-dealer's existing customers also would benefit in that ceasing a securities business would assist in preserving any remaining capital of the firm, which could be used to facilitate an orderly liquidation.

The proposed amendment to Rule 17a-11 also would benefit the securities markets in that it would provide regulators with the opportunity to take steps to protect customers and counterparties at the onset of the insolvency. These steps could include facilitating the transfer of customer accounts to a solvent broker-dealer and monitoring the liquidation of proprietary positions.

ii. Costs

For the most part, the proposed amendments would have no impact on existing broker-dealers. Should a broker-dealer become subject to an insolvency proceeding, it would incur the cost of sending notice of that fact to the Commission and its designated examining authority. We believe this would be a rare occurrence and,

accordingly, with respect to the PRA estimated it would happen approximately six times a year. For these reasons, we estimate that any costs arising from this proposed amendment would be de minimis.

As noted above, we request comment on this cost estimate. In particular, we request comment on whether there would be costs to broker-dealers as a consequence of this proposal. We also request comment on whether this proposal would impose costs on other market participants, including broker-dealer customers. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

4. Order Restricting Withdrawal of Capital From a Broker or Dealer Amendment

This proposed amendment to Rule 15c3-1(e) would eliminate the qualification on Commission orders restricting withdrawals, advances and unsecured loans made by broker-dealers that limits the order to instances when recent withdrawals, advances or loans, in the aggregate, exceed thirty percent of the broker-dealer's excess net capital.

i. Benefits

The proposed amendment to Rule 15c3-1 would benefit the securities markets by protecting customers and counterparties of a financially stressed broker-dealer. For example, the broker-dealer would not be able to make an unsecured loan to a stockholder or withdraw equity capital while the order was outstanding, thereby preserving the assets and liquidity of the broker-dealer and enabling the Commission and its staff to examine the broker-dealer's financial condition, net capital position and the risk exposure to the customers and creditors of the broker-dealer to ensure the financial integrity of the firm.

ii. Costs

The current rule permitting the Commission to restrict withdrawals of capital from a financially distressed broker-dealer was adopted in 1991.¹⁹⁴ Based on this experience with the rule, we estimate that the proposed amendment would result in no or de minimis costs to broker-dealers.

As noted above, we request comment on this cost estimate. In particular, we request comment on whether there would be costs to broker-dealers as a consequence of this proposal. We also request comment on whether this proposal would impose costs on other

¹⁹² \$100,000,000 × 2.5% = \$2,500,000.

¹⁹³ 17 CFR 240.15c3-1.

¹⁹⁴ See Exchange Act Release No. 28927 (February 28, 1991), 56 FR 9124 (March 5, 1991).

market participants. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

5. Adjusted Net Capital Requirements

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

i. Calculating Theoretical Pricing Charges

The proposed amendment to paragraph (b)(1)(vi) of Rule 15c3-1a would make permanent the reduced net capital requirements that apply to listed option positions in major market foreign currencies and high-capitalization and non-high-capitalization diversified indexes in non-clearing option specialist and market maker accounts. This would benefit the broker-dealers that have been calculating charges under the temporary relief granted by the Commission staff. Because broker-dealers are already operating under the temporary relief, we believe the amendment would not result in any costs.

We request comment on available metrics to quantify the benefits identified above and any other benefits the commenter may identify.

Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

In addition, we request comment on whether the proposal would result in costs. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

ii. Reduced Haircut on Money Market Funds

Reducing the money market funds haircut from 2% to 1% would benefit all broker-dealers in that it will make it less costly, in terms of capital allocation, to hold these investments. We do not believe the proposed amendment would result in any costs.

We request comment on available metrics to quantify the benefits identified above and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.

In addition, we request comment on whether the proposal would result in costs. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

F. Total Estimates Costs

Given the estimates set forth above, the total one-time estimated cost to the industry resulting from these rule proposals would be approximately \$32,814,454¹⁹⁵ and the total estimated annual cost to the industry resulting from these rule proposals would be approximately \$39,651,716.¹⁹⁶

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

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and must consider or determine if an action is necessary or appropriate in the public interest, to consider if the action will promote efficiency, competition, and capital formation.¹⁹⁷ In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact that any such rule would have on competition.¹⁹⁸ Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The proposed amendments are intended to promote efficiency, competition, and capital formation. They should not have any anti-competitive effects.

The Commission requests comment on whether the proposed amendments are likely to promote efficiency, competition, and capital formation.

A. Amendments to the Customer Protection Rule

The proposed amendments to the customer protection rule respecting PAB accounts,¹⁹⁹ cash deposits at special reserve bank accounts,²⁰⁰ allocation of short positions,²⁰¹ and the treatment of free credit balances²⁰² are designed to protect and preserve customer property held at broker-dealers. These

¹⁹⁵ \$8,773,410 + \$603,000 + \$28,930 + \$3,752,000 + \$2,680,000 + \$1,000,000 + \$1,149,720 + \$62,604 + \$562,800 + \$14,201,990 = \$32,814,454.

¹⁹⁶ \$2,599,300 + \$24,500,000 + \$52,416 + \$10,000,000 + \$2,500,000 = \$39,651,716.

¹⁹⁷ 15 U.S.C. 78c(f).

¹⁹⁸ 15 U.S.C. 78w(a)(2).

¹⁹⁹ See section II.A.1 of this release.

²⁰⁰ See section II.A.2 of this release.

²⁰¹ See section II.A.4 of this release.

²⁰² See section II.A.5.i of this release.

protections would reduce the risks to individual investors and, thereby, promote participation in the securities markets. Also, by strengthening requirements designed to protect customer property, they would mitigate potential exposure of the fund administered by the Securities Investor Protection Corporation ("SIPC") that is used to make advances to customers whose securities or cash are unable to be returned by a failed broker-dealer. The amendments reducing the debit reduction for alternative standard firms from 3% to 1% and clarifying that funds in certain commodities accounts need not be treated as "free credit balances" would free up capital and, in the latter case, clarify an ambiguity in Rule 15c3-3.²⁰³ These results would promote capital formation and increase efficiency. The amendment expanding the definition of qualified securities would reduce operational burdens associated with holding securities in the customer reserve account and, thereby, promote efficiency.²⁰⁴

B. Portfolio Margining Amendments

The proposed amendments to accommodate portfolio margining²⁰⁵ would promote greater efficiency, competition and capital formation. They are designed to provide portfolio margin customers with greater protection through the reserve requirements of Rule 15c3-3 and SIPA. This, in turn, would make portfolio margining more attractive to investors. Portfolio margining can significantly reduce customer margin requirements for offsetting positions involving securities and futures products, which in turn reduces the costs of trading such products. Moreover, portfolio margining promotes competition and better price discovery across securities and futures products by allowing customers to offset a position assumed in one market with a product traded on another market.

C. Securities Lending and Borrowing Amendments

The proposed amendment requiring broker-dealers to disclaim principal liability in securities lending transactions to avoid certain capital charges under Rule 15c3-1²⁰⁶ is consistent with the goal of promoting efficiency and competition in the marketplace. This proposed amendment would help eliminate the legal uncertainty among counterparties as to the role played by market participants

²⁰³ See sections II.A.6 and II.A.7 of this release.

²⁰⁴ See section II.A.3 of this release.

²⁰⁵ See section II.B of this release.

²⁰⁶ See section II.C of this release.

in such transactions and clarify the nature of the services that securities lending intermediaries provide their counterparties. The proposed amendment to Rule 17a-11²⁰⁷ to require a broker-dealer to provide notice if its securities lending or repo transactions reach a certain threshold, or alternatively provide its DEA with a monthly report, is designed to enhance the monitoring of these activities by securities regulators and, thereby, protect broker-dealer customers and counterparties from the impact of a financial collapse. This would strengthen the securities markets and make them more attractive to investors.

D. Documentation of Risk Management Procedures

The proposed amendments to Rules 17a-3 and 17a-4²⁰⁸ requiring firms to document their risk management controls and procedures are designed to reduce the risks inherent to the business of operating as a broker-dealer and, thereby, enhance a broker-dealer's financial soundness. This would strengthen the securities markets making them more attractive to investors.

E. Amendments to the Net Capital Rule

The proposed amendments to Rule 15c3-1 (1) requiring a broker-dealer to account for certain liabilities or treat certain capital contributions as liabilities,²⁰⁹ (2) requiring a broker-dealer to account for certain excess fidelity bond deductibles,²¹⁰ (3) requiring an insolvent broker-dealer to cease conducting a securities business and provide notice under the proposed amendment to Rule 17a-11,²¹¹ (4) eliminating the qualification on Commission orders restricting withdrawals, advances, and unsecured loans to instances where recent withdrawals, advances or loans, in the aggregate, exceed thirty percent of the broker-dealer's excess net capital,²¹² (5) making permanent the reduced net capital requirements under Appendix A for market makers,²¹³ and (6) lowering the haircut for money market funds,²¹⁴ are consistent with promoting efficiency and competition in the market place.

A broker-dealer that fails to account for liabilities that depend on the broker-dealer's assets and revenues and accepts temporary capital is obscuring its true

financial condition. This interferes with the process by which regulators monitor the financial condition of broker-dealers and, thereby, impedes their ability to take proactive steps to minimize the harm to customers, counterparties and clearing agencies resulting from a broker-dealer failure.

Requiring broker-dealers to take net capital charges for excess fidelity bond deductibles imposed under self-regulatory organization rules would promote efficiency by providing certainty as to the applicability of such rules for purposes of Rule 15c3-1. Because fidelity bond requirements provide a safeguard with regard to broker-dealer financial responsibility, the proposed amendment would enhance competition through the operation of more financially sound firms.

The continued operation of an insolvent broker-dealer or the withdrawal of capital from a broker-dealer that may jeopardize such broker-dealer's financial integrity poses financial risk to its customers, counterparties and the securities industry clearance organizations. These risks increase costs.

The elimination of the limitation on Commission orders restricting capital withdrawals from a financially troubled broker-dealer would provide greater protection to customers and counterparties of the firm and securities industry clearance organizations. While such orders would be infrequent, when issued they would lower costs to these entities associated with having an outstanding obligation from the troubled broker-dealer.

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

VII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"²¹⁵ we must advise the OMB as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in (1) an annual effect on the economy of \$100 million or more

(either in the form of an increase or a decrease), (2) a major increase in costs or prices for consumers or individual industries, or (3) significant adverse effect on competition, investment or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of each of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

VIII. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis (IRFA), in accordance with the provisions of the Regulatory Flexibility Act,²¹⁶ regarding the proposed amendments to Rules 15c3-1, 15c3-1a, 15c3-2, 15c3-3, 15c3-3a, 17a-3, 17a-4, and 17a-11 under the Exchange Act.

We encourage comments with respect to any aspect of this IRFA, including comments with respect to the number of small entities that may be affected by the proposed amendments. Comments should specify the costs of compliance with the proposed amendments, and suggest alternatives that would accomplish the goals of the amendments. Comments will be considered in determining whether a Final Regulatory Flexibility Analysis is required, and will be placed in the same public file as comments on the proposed amendments. Comments should be submitted to the Commission at the addresses previously indicated.

A. Amendments to the Customer Protection Rule

1. Reasons

The proposed amendment that would require broker-dealers to perform a reserve computation for domestic and foreign broker-dealer accounts is responding to a disparity between Rule 15c3-3 and the SIPA. The proposed amendment that would require broker-dealers to limit the amount of cash deposited in a reserve account at any individual bank and exclude cash deposited with a parent or subsidiary bank is responding to the fact that some firms are concentrating such deposits or placing them at risk of group-wide financial collapses. The proposed amendment that would expand the definition of qualified securities is intended to provide broker-dealers with

²⁰⁷ *Id.*

²⁰⁸ See section II.D of this release.

²⁰⁹ See section II.E.1 of this release.

²¹⁰ See section II.E.2 of this release.

²¹¹ See section II.E.3 of this release.

²¹² See section II.E.4 of this release.

²¹³ See section II.E.5.i of this release.

²¹⁴ See section II.E.5.ii of this release.

²¹⁵ Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

²¹⁶ 5 U.S.C. 603.

another option with respect to assets that can be deposited into the customer reserve account. The proposed amendment that would require broker-dealers to obtain possession and control of customers' fully paid and excess margin securities allocated to a short position is responding to the fact that some firms are permitting these positions to accumulate, which puts customers at risk. The proposed amendment that would require broker-dealers to provide certain notices and disclosures before changing the terms and conditions under which the broker-dealer treats customer free credit balances is intended to help assure that the use of customer free credit balances accords with customer preferences. The proposed amendment lowering the aggregate debit item reduction from 3% to 1% is responding to the dramatic increase in debit items accumulating at broker-dealers. The proposed amendment clarifying that funds in certain commodities accounts are not to be treated as "free credit balances" is intended to remove uncertainty with respect to their treatment.

2. Objectives

Most of the proposed amendments to Rule 15c3-3 are intended to strengthen the protections afforded to customer assets held at a broker-dealer. The intended result of the proposed amendments is to minimize the risk that customer assets will be lost, tied-up in a liquidation proceeding, or held in a manner that is inconsistent with a customer's expectations. The proposed amendment expanding the definition of qualified security is intended to lower operational burdens of broker-dealers. The proposed amendment eliminating the 3% reduction is intended to better align the requirement to reduce debits with the credit risk being addressed by the requirement. The proposed amendment clarifying the treatment of funds in certain commodities accounts is intended to remove an ambiguity in the rule.

3. Legal Basis

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

4. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0-10²¹⁷ states that the term "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial

statements were prepared pursuant to Rule 17a-5(d);²¹⁸ and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

The Commission estimates there are approximately eight broker-dealers that performed a customer reserve computation pursuant to Rule 15c3-3 and were "small" for the purposes of Rule 0-10.²¹⁹

5. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments would (1) require broker-dealers to perform a reserve computation for domestic and foreign broker-dealer accounts, (2) limit the amount that a broker-dealer may deposit in a reserve account at any individual bank in the form of cash, (3) require broker-dealers to obtain possession and control of customers' fully paid and excess margin securities allocated to a short position by borrowing equivalent securities within a specified period of time, (4) require broker-dealers to obtain an affirmative consent from a customer before changing the terms and conditions under which the broker-dealer holds credit balances related to the customer, and (5) lower the aggregate debit reduction.

6. Duplicative, Overlapping or Conflicting Federal Rules

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

7. Significant Alternatives

Pursuant to section 3(a) of the RFA,²²⁰ the Commission must consider certain types of alternatives, including (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities, (3) the use of performance rather than design standards, and (4) an exemption from coverage of the rule, or any part thereof, for small entities.

Given the negligible impact these amendments would have on small entities, we do not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and

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

8. Request for Comments

We encourage the submission of comments to any aspect of this portion of the IRFA. Comments should specify costs of compliance with the proposed amendment and suggest alternatives that would accomplish the objective of the proposed amendments.

B. Portfolio Margining Amendments

1. Reasons

The CBOE and the NYSE rules permit broker-dealers to determine customer margin requirements using a portfolio margin methodology and permit cross-margining; namely, the inclusion in the portfolio margin account of futures and futures options on broad-based securities indices. These proposed amendments are designed to provide portfolio margin customers with protection for futures positions carried in their securities accounts.

2. Objectives

These proposed amendments are designed to provide customers with futures and futures options in a portfolio margin account with SIPA protections.

3. Legal Basis

Pursuant to the Exchange Act and, particularly, section 15.²²¹

4. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0-10²²² states that the term "small business" or "small organization," when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d);²²³ and is not affiliated with any person (other than a natural

²¹⁸ 17 CFR 240.17a-5(d).

²¹⁹ This estimate is based on FOCUS Report filings.

²²⁰ 5 U.S.C. 603(c).

²²¹ 15 U.S.C. 78o.

²²² 17 CFR 240.0-10(c)(1).

²²³ 17 CFR 240.17a-5(d).

²¹⁷ 17 CFR 240.0-10(c)(1).

person) that is not a small business or small organization.

The Commission estimates there are approximately eight broker-dealers that performed a customer reserve computation pursuant to Rule 15c3-3 and were “small” for the purposes of Rule 0-10.²²⁴

5. Reporting, Recordkeeping, and Other Compliance Requirements

These proposed amendments would (1) revise the definition of “free credit balances” in Rule 15c3-3 to include funds in a portfolio margin account relating to certain futures and futures options positions and the market value of futures options as of the filing date in a SIPA proceeding, and (2) add a debit line item to the customer reserve formula in Rule 15c3-3a consisting of margin posted by a broker-dealer to a futures clearing agency.

6. Duplicative, Overlapping or Conflicting Federal Rules

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

7. Significant Alternatives

Pursuant to Section 3(a) of the RFA,²²⁵ the Commission must consider certain types of alternatives, including (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities, (3) the use of performance rather than design standards, and (4) an exemption from coverage of the rule, or any part thereof, for small entities.

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

The Commission also does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed amendments as the amendments already propose performance standards and do not dictate for entities of any size any

particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed amendments.

8. Request for Comments

We encourage the submission of comments to any aspect of this portion of the IRFA. Comments should specify costs of compliance with the proposed amendment and suggest alternatives that would accomplish the objective of the proposed amendments.

C. Securities Lending, Borrowing, and Repurchase/Reverse Repurchase Amendments

1. Reasons

In 2001, MJK Clearing, a broker-dealer with a substantial number of customer accounts, failed when it could not meet its securities lending obligations. This failure has highlighted the risks associated with securities lending and the economically similar repurchase and reverse repurchase agreements and the need to manage those risks.

2. Objectives

These proposed amendments are intended to strengthen the documentation controls broker-dealers employ to manage their securities lending and borrowing and securities repurchase and reverse repurchase activities and to enhance regulatory monitoring. The intended result of the amendments is to minimize the risk that a firm would fail as a result of inadequate controls over its securities lending and borrowing securities repurchase and reverse repurchase activities.

3. Legal Basis

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

4. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0-10²²⁶ states that the term “small business” or “small organization,” when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d);²²⁷ and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

The Commission estimates that none of the broker-dealers that engage in securities lending and borrowing or

securities repurchase and reverse repurchase activity are “small” for the purposes Rule 0-10.²²⁸ Therefore, the proposed amendments should not impact on “small” broker-dealers.

5. Reporting, Recordkeeping, and Other Compliance Requirements

These proposed amendments would require broker-dealers to (1) disclose the principals and obtain certain agreements from the principals in a transaction where they provide settlement services in order to be considered an agent (as opposed to a principal) for the purposes of the net capital rule, and (2) provide notice to the Commission and other regulatory authorities if the broker-dealer's securities lending or repo activity reaches a certain threshold or, alternatively, provide regulatory authorities with a monthly report of the broker-dealer's securities lending and repo activity.

6. Duplicative, Overlapping or Conflicting Federal Rules

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

7. Significant Alternatives

Pursuant to Section 3(a) of the RFA,²²⁹ the Commission must consider certain types of alternatives, including (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities, (3) the use of performance rather than design standards, and (4) an exemption from coverage of the rule, or any part thereof, for small entities.

As noted above, we estimate that this proposed amendment would have no impact on small entities. Thus, we do not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities; use performance rather than design standards, or any part thereof.

The Commission also does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed amendments as the amendments already

²²⁴ This estimate is based on FOCUS Report filings.

²²⁵ 5 U.S.C. 603(c).

²²⁶ 17 CFR 240.0-10(c)(1).

²²⁷ 17 CFR 240.17a-5(d).

²²⁸ This estimate is based on FOCUS Report filings.

²²⁹ 5 U.S.C. 603(c).

propose performance standards and do not dictate for entities of any size any particular design standards (*e.g.*, technology) that must be employed to achieve the objectives of the proposed amendments.

8. Request for Comments

We encourage the submission of comments to any aspect of this portion of the IRFA. Comments should specify costs of compliance with the proposed amendment and suggest alternatives that would accomplish the objective of the proposed amendments.

D. Documentation of Risk Management Procedures

1. Reasons

Requiring certain large broker-dealers to document their risk management procedures would assist firms in ensuring adherence to their established risk controls and regulators in reviewing the controls.

2. Objectives

These proposed amendments are intended to strengthen the controls certain large broker-dealers employ to manage risk. The intended result of these proposed amendments is to lower systemic risk in the securities industry by enhancing risk management.

3. Legal Basis

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

4. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0–10²³⁰ states that the term “small business” or “small organization,” when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d);²³¹ and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

The Commission estimates that none of the broker-dealers that would be subject to this proposed amendment would be “small” for the purposes Rule 0–10.²³² Therefore, these amendments should not have any impact on “small” broker-dealers.

5. Reporting, Recordkeeping, and Other Compliance Requirements

These proposed amendments would require broker-dealers to document any controls, procedures and guidelines they use for managing risk. The proposed amendments do not require broker-dealers to implement procedures. Rather, they require the documentation of any procedures that are being used.

6. Duplicative, Overlapping or Conflicting Federal Rules

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

7. Significant Alternatives

Pursuant to section 3(a) of the RFA,²³³ the Commission must consider certain types of alternatives, including (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities, (3) the use of performance rather than design standards, and (4) an exemption from coverage of the rule, or any part thereof, for small entities.

As noted above, these proposed amendments would have no impact on “small” broker-dealers. Thus, we do not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities; or exempt small entities from coverage of the rule, or any part thereof.

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

8. Request for Comments

We encourage the submission of comments to any aspect of this portion of the IRFA. Comments should specify costs of compliance with the proposed amendment and suggest alternatives that would accomplish the objective of the proposed amendments.

E. Amendments to the Net Capital Rule

1. Limitations on Withdrawal of Capital, Solvency, Expense Sharing, Temporary Capital and Fidelity Bond Deductions

i. Reasons

Some broker-dealers have excluded from their regulatory financial reports certain liabilities that have been shifted to third-parties that lack the resources— independent of the assets and revenue of the broker-dealer—to pay the liabilities or have utilized infusions of temporary capital. These practices obscure the true financial condition of the broker-dealer and, thereby, impede the ability of regulators to take proactive steps to reduce the harm to customers, counterparties and clearing agencies that may result from the broker-dealer’s failure.

Currently, broker-dealers are required to take net capital charges pursuant to self-regulatory organization rules relating to fidelity bond deductions, but Rule 15c3–1 does not explicitly incorporate such charges for purposes of computing net capital.

In the past several years, a number of broker-dealers have sought to obtain protection under the bankruptcy laws while still engaging in a securities business. Permitting an insolvent broker-dealer to continue to transact a securities business endangers its customers and counterparties and places clearance organizations at risk.

An important goal of the Commission is to protect the financial integrity of the broker-dealer so that if the firm must liquidate it may do so in an orderly fashion. Allowing a withdrawal of capital that may jeopardize the financial integrity of a broker-dealer exposes customers and creditors of the broker-dealer to unnecessary risk.

ii. Objectives

The objective of these proposed amendments is to reduce systemic risk to the securities industry associated with the failure of the broker-dealer.

iii. Legal Basis

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

iv. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0–10²³⁴ states that the term “small business” or “small organization,” when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial

²³⁰ 17 CFR 240.0–10(c)(1).

²³¹ 17 CFR 240.17a–5(d).

²³² This estimate is based on FOCUS Report filings.

²³³ 5 U.S.C. 603(c).

²³⁴ 17 CFR 240.0–10(c)(1).

statements were prepared pursuant to Rule 17a-5(d);²³⁵ and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

The Commission estimates that there are approximately 915 broker-dealers that are “small” for the purposes Rule 0-10.²³⁶ These proposed amendments would apply to all “small” broker-dealers in that they would be subject to the requirements in the proposed amendments.

v. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments would require an insolvent broker-dealer to cease conducting a securities business and provide the securities regulators with notice of its insolvency. They also would require broker-dealers to add back certain liabilities and treat certain capital as a liability, as well as require broker-dealers to deduct from net capital, with regard to fidelity bonding requirements, the excess of any deductible amount over the maximum amount permitted by self-regulatory organization rules. Finally, under the proposed amendment to the rule on Commission orders restricting withdrawals of capital, a broker-dealer subject to an order would not be permitted to withdraw any capital.

vi. Duplicative, Overlapping or Conflicting Federal Rules

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

vii. Significant Alternatives

Pursuant to section 3(a) of the RFA,²³⁷ the Commission must consider certain types of alternatives, including (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities, (3) the use of performance rather than design standards, and (4) an exemption from coverage of the rule, or any part thereof, for small entities.

Given the minimal impact these amendments will have on small entities, we do not believe it is necessary or appropriate to establish different compliance or reporting requirements or timetables; clarify, consolidate, or

simplify compliance and reporting requirements under the rule for small entities; or exempt small entities from coverage of the rule, or any part thereof.

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

viii. Request for Comments

We encourage the submission of comments to any aspect of this portion of the IRFA. Comments should specify costs of compliance with the proposed amendment and suggest alternatives that would accomplish the objective of the proposed amendments.

2. Adjusted Net Capital Requirements

i. Reasons

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

ii. Objective

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

iii. Legal Basis

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

iv. Small Entities Subject to the Rule

Paragraph (c)(1) of Rule 0-10²³⁸ states that the term “small business” or “small organization,” when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d);²³⁹ and is not affiliated with any person (other than a natural person) that is not a small business or small organization.

The Commission estimates that there are approximately 915 broker-dealers that were “small” for the purposes Rule

0-10.²⁴⁰ The amendment to Appendix A of Rule 15c3-1 likely should have no, or little, impact on “small” broker-dealers, since most, if not all, of these firms do not carry non-clearing option specialist or market maker accounts. The reduction of the haircut for money market funds from 2% to 1% could impact all “small” firms, since they may hold these securities as part of their net capital.

v. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments would (1) make permanent a temporary rule that reduced the haircut for non-clearing options specialist and market maker accounts under Appendix A, and (2) lower the haircut for money market funds from 2% to 1%. As noted, we estimate that generally only the second proposed amendment would affect “small” broker-dealers.

vi. Duplicative, Overlapping or Conflicting Federal Rules

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

vii. Significant Alternatives

Pursuant to section 3(a) of the RFA,²⁴¹ the Commission must consider certain types of alternatives, including (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities, (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities, (3) the use of performance rather than design standards, and (4) an exemption from coverage of the rule, or any part thereof, for small entities.

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

The Commission also does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed amendments as the amendments already propose performance standards and do not dictate for entities of any size any

²³⁵ 17 CFR 240.17a-5(d).

²³⁶ This estimate is based on FOCUS Report filings.

²³⁷ 5 U.S.C. 603(c).

²³⁸ 17 CFR 240.0-10(c)(1).

²³⁹ 17 CFR 240.17a-5(d).

²⁴⁰ This estimate is based on FOCUS Report filings.

²⁴¹ 5 U.S.C. 603(c).

particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed amendments.

viii. Request for Comments

We encourage the submission of comments to any aspect of this portion of the IRFA. Comments should specify costs of compliance with the proposed amendment and suggest alternatives that would accomplish the objective of the proposed amendments.

IX. Statutory Authority

The Commission is proposing amendments to Rules 15c3-1, 15c3-3, 17a-3, 17a-4 and 17a-11 under the Exchange Act pursuant to the authority conferred by the Exchange Act, including Sections 15, 17, 23(a) and 36.²⁴²

Text of Proposed Rule

List of Subjects in 17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, the Commission hereby proposes that Title 17, Chapter II of the Code of Federal Regulation be amended as follows.

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

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

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

* * * * *

2. Section 240.15c3-1 is amended by:

- Revising the first sentence of the introductory text of paragraph (a);

- Revising paragraph (a)(1)(ii)(A);

- Removing from paragraph (a)(6)(iii)(A) the text “paragraph (c)(2)(x)(A)(1) through (9) of this section” and in its place adding the text “Appendix A (§ 240.15c3-1a)”;

- Revising the introductory text of paragraph (c)(2)(i);

- Adding paragraphs (c)(2)(i)(F) and (G);

- Revising paragraphs (c)(2)(iv)(B), (c)(2)(iv)(E), and (c)(2)(vi)(D)(1);

- Adding paragraph (c)(2)(xiv) before the undesignated heading;

- Adding paragraph (c)(16) and an undesignated heading;

- Revising paragraph (e)(3)(i); and

- Removing from the second sentence in paragraph (e)(3)(ii) the text “The hearing” and in its place adding the text “A hearing on an order temporarily prohibiting the withdrawal of capital”.

The revisions and additions read as follows:

§ 240.15c3-1 Net capital requirements for brokers or dealers.

(a) Every broker or dealer shall at all times have and maintain net capital no less than the greater of the highest minimum requirement applicable to its ratio requirement under paragraph (a)(1) of this section, or to any of its activities under paragraph (a)(2) of this section, and shall otherwise not be “insolvent” as that term is defined in paragraph (c)(16) of this section. * * *

* * * * *

(1)(i) * * *

(ii) * * *

(A) Make the computation required by § 240.15c3-3(e) and set forth in Exhibit A, § 240.15c3-3a, on a weekly basis;

* * * * *

(c) * * *

(2) * * *

(i) *Adjustments to net worth related to unrealized profit or loss, deferred tax provisions, and certain liabilities.* * * *

* * * * *

(F) Adding to net worth any liability or expense relating to the business of the broker-dealer for which a third party has assumed the responsibility, unless the broker or dealer can demonstrate that the third-party has adequate resources independent of the broker-dealer to pay the liability or expense.

(G) Subtracting from net worth any contribution of capital to the broker or dealer:

(1) Under an agreement that provides the investor with the option to withdraw the capital; or

(2) That is intended to be withdrawn within a period of one year unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer. Any withdrawal of capital made within one year of its contribution to the broker or dealer is presumed to be subject to this deduction.

* * * * *

(iv) * * *

(B) All unsecured advances and loans; deficits in customers' and non-customers' unsecured and partly secured notes; deficits in omnibus credit accounts maintained in compliance with the requirements of 12 CFR 220.7(f) of Regulation T under the Act, or similar accounts carried on behalf of another broker or dealer, after application of calls for margin, marks to

the market or other required deposits that are outstanding 5 business days or less; deficits in customers' and non-customers' unsecured and partly secured accounts after application of calls for margin, marks to market or other required deposits that are outstanding 5 business days or less, except deficits in cash accounts as defined in 12 CFR 220.8 of Regulation T under the Act for which not more than one extension respecting a specified securities transaction has been requested and granted, and deducting for securities carried in any of such accounts the percentages specified in paragraph (c)(2)(vi) of this section or Appendix A, § 240.15c3-1a; the market value of stock loaned in excess of the value of any collateral received therefore; receivables arising out of free shipments of securities (other than mutual fund redemptions) in excess of \$5,000 per shipment and all free shipments (other than mutual fund redemptions) outstanding more than 7 business days, and mutual fund redemptions outstanding more than 16 business days; and any collateral deficiencies in secured demand notes as defined in Appendix D, § 240.15c3-1d; a broker or dealer that participates in a loan of securities by one party to another party shall be deemed a principal for the purpose of the deductions required under this section, unless the broker or dealer has fully disclosed the identity of each party to the other and each party has expressly agreed in writing that the obligations of the broker or dealer shall not include a guarantee of performance by the other party and that such party's remedies in the event of a default by the other party shall not include a right of setoff against obligations, if any, of the broker or dealer.

* * * * *

(E) *Other deductions.* All other unsecured receivables; all assets doubtful of collection less any reserves established therefore; the amount by which the market value of securities failed to receive outstanding longer than thirty (30) calendar days exceeds the contract value of such fails to receive; the funds on deposit in a “segregated trust account” in accordance with 17 CFR 270.27d-1 under the Investment Company Act of 1940, but only to the extent that the amount on deposit in such segregated trust account exceeds the amount of liability reserves established and maintained for refunds of charges required by sections 27(d) and 27(f) of the Investment Company Act of 1940; and cash and securities held in a securities account at another

²⁴² 15 U.S.C. 78o, 78q, 78w and 78mm.

broker-dealer if the other broker-dealer does not treat the account, and the assets therein, in compliance with paragraphs (b)(5) and (e) of § 240.15c3-3; Provided, That any amounts deposited in special reserve bank accounts established for the exclusive benefit of customers or PAB accounts pursuant to § 240.15c3-3(e) and clearing deposits shall not be deducted.

* * * * *

(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.

* * * * *

(xiv) *Deduction from net worth for excess deductible amounts related to fidelity bond coverage.* Deducting, with respect to fidelity bond coverage, the excess of any deductible amount over the maximum deductible amount permitted by the Examining Authority for the broker or dealer.

* * * * *

Insolvent

(16) A broker or dealer is insolvent for the purposes of this section if the broker-dealer:

(i) Is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate such broker or dealer or its property whether commenced voluntarily or involuntarily or is applying for the appointment or election of a receiver, trustee, or liquidator or similar official for such broker or dealer or its property;

(ii) Has made a general assignment for the benefit of creditors;

(iii) Is insolvent within the meaning of section 101 of title 11 of the United States Code, or is unable to meet its obligations as they mature, and has made an admission to such effect in writing or in any court or before any agency of the United States or any State; or

(iv) Is unable to make such computations as may be necessary to establish compliance with this section.

* * * * *

(e) * * *

(3)(i) *Temporary restrictions on withdrawal of net capital.* The Commission may by order restrict, for a period of up to twenty business days, any withdrawal by the broker-dealer of equity capital or unsecured loan or

advance to a stockholder, partner, sole proprietor, member, employee or affiliate if the Commission, based on the information available, concludes that such withdrawal, advance or loan may be detrimental to the financial integrity of the broker or dealer, or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities which may cause a significant impact on the markets or expose the customers or creditors of the broker or dealer to loss without taking into account the application of the Securities Investor Protection Act of 1970.

* * * * *

3. Section 240.15c3-1a is amended by:

a. Removing paragraph (b)(1)(iv)(B); and

b. Redesignating paragraphs (b)(1)(iv)(A), (b)(1)(iv)(A)(1), (b)(1)(iv)(A)(2), and (b)(1)(iv)(A)(3) as paragraphs (b)(1)(iv), (b)(1)(iv)(A), (b)(1)(iv)(B), and (b)(1)(iv)(C) respectively.

4. Section 240.15c3-2 is removed and reserved.

5. Section 240.15c3-3 is amended by:

a. Removing from paragraph (a)(1), third sentence, the citation "220.19" and in its place adding the citation "220.12";

b. In paragraph (a)(1)(iii), revising the phrase "(15 U.S.C. 78aaa *et seq.*)" to read "(15 U.S.C. 78aaa *et seq.*) (SIPA)";

c. Revising paragraphs (a)(3), (a)(4), (a)(6), (a)(7) and (a)(8);

d. Adding paragraph (a)(16);

e. Removing from paragraph (b)(3)(iv) the text "the Securities Investor Protection Act of 1970" and in its place adding the text "SIPA";

f. Removing from paragraph (b)(4)(i)(C) the text "the Securities Investor Protection Act of 1970" and in its place adding the text "SIPA";

g. Adding paragraph (b)(5);

h. Removing from paragraph (c)(2) the text "special omnibus" and in its place adding the text "omnibus credit" and removing the text "section 4(b) of Regulation T under the Act (12 CFR 220.4(b))" and in its place adding the text "section 7(f) of Regulation T (12 CFR 220.7(f))";

i. Removing the period at the end of paragraph (d)(3) and in its place adding "; or";

j. Redesignating paragraph (d)(4) as paragraph (d)(5);

k. Adding a new paragraph (d)(4);

l. Revising paragraphs (e) and (f);

m. Revising the first sentence in paragraph (g);

n. Removing from the first sentence of paragraph (i) the text "reserve bank account" and in its place adding the text "Reserve Bank Accounts";

o. Adding paragraph (j);

p. Revising paragraph (l)(2);

q. Removing from the last sentence in paragraph (m) the text "special omnibus" and in its place adding the text "omnibus credit" and removing the text "section 4(b) of Regulation T [12 CFR 220.4(b)]" and in its place adding "section 7(f) of Regulation T (12 CFR 220.7(f))"; and

r. Removing from the first sentence in paragraph (n) the cite "paragraphs (d)(2) and (3)" and in its place adding the cite "paragraphs (d)(2), (3) and (4)".

The revisions and additions read as follows:

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

(a) * * *

(3) 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.

(4) The term *margin securities* shall mean those securities carried for the account of a customer in a margin account as defined in section 4 of Regulation T (12 CFR 220.4), as well as securities carried in any other account (such accounts hereinafter referred to as "margin accounts") other than the securities referred to in paragraph (a)(3) of this section.

* * * * *

(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 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;

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

(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.

(7) The term *bank* shall mean a bank as defined in section 3(a)(6) of the Act and shall also mean any building and loan, savings and loan or similar banking institution subject to supervision by a Federal banking

authority. With respect to a broker or dealer who maintains his principal place of business in Canada, the term *bank* shall also mean a Canadian bank subject to supervision by a Canadian authority.

(8) The term *free credit balances* shall mean liabilities of a broker or dealer to customers which are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits or otherwise, excluding, however, funds in commodity accounts which are segregated in accordance with the Commodity Exchange Act or in a similar manner, or which are funds carried in a *proprietary account* as that term is defined in regulations under the Commodity Exchange Act. The term *free credit balances* also shall include such liabilities carried in a securities account pursuant to a self-regulatory organization portfolio margining rule approved by the Commission under section 19(b) of the Act ("SRO portfolio margining rule"), including daily marks to market, and proceeds resulting from closing out futures contracts and options thereon, and, in the event the broker-dealer is the subject of a proceeding under SIPA, the market value as of the "filing date" as that term is defined in SIPA (15 U.S.C. 78lll(7)) of any long options on futures contracts.

* * * * *

(16) The term *PAB account* means a proprietary securities account of a broker or dealer (which includes a foreign broker or dealer, or a foreign bank acting as a broker or dealer), but shall not include an account where the account owner is a guaranteed subsidiary of the carrying broker or dealer, the account owner guarantees all liabilities and obligations of the carrying broker or dealer, or the account is a delivery-versus-payment account or a receipt-versus-payment account.

(b) * * *

(5) A broker or dealer shall not be required to obtain and thereafter to maintain the physical possession or control of securities carried for a PAB account, provided that the broker or dealer has obtained the written permission of the account owner to use the securities in the ordinary course of its securities business.

* * * * *

(d) * * *

(4) Securities included on his books or records as a proprietary short position or as a short position for another person, excluding positions covered by paragraph (m) of this section, for more than 10 business days (or more than 30 calendar days if the

broker or dealer is a market maker in the securities), then the broker or dealer shall, not later than the business day following the day on which the determination is made, take prompt steps to obtain physical possession or control of such securities.

* * * * *

(e) *Special reserve bank accounts for the exclusive benefit of customers and PAB accounts.*

(1) Every broker or dealer shall maintain with a bank or banks at all times when deposits are required or hereinafter specified "Special Reserve Bank Account for the Exclusive Benefit of Customers" (hereinafter referred to as the *Reserve Bank Account*) and a "Special Reserve Bank Account for Brokers and Dealers (hereinafter referred to as the *PAB Reserve Bank Account*, and together with the *Reserve Bank Account*, the *Reserve Bank Accounts*), each of which shall be separate from the other and from any other bank account of the broker or dealer. Such broker or dealer shall at all times maintain in the Reserve Bank Accounts, through deposits made therein, cash and/or qualified securities in amounts computed in accordance with the formula attached as Exhibit A, as applied to customer and PAB accounts respectively.

(2) With respect to each computation required pursuant to paragraph (e)(1) of this section, it shall be unlawful for any broker or dealer to accept or use any of the amounts under items comprising Total Credits under the formula referred to in paragraph (e)(1) of this section except for the specified purposes indicated under items comprising Total Debits under the formula, and, to the extent Total Credits exceed Total Debits, at least the net amount thereof shall be maintained in the Reserve Bank Accounts pursuant to paragraph (e)(1) of this section.

(3)(i) Computations necessary to determine the amount required to be deposited in Reserve Bank Accounts as specified in paragraph (e)(1) of this section shall be made weekly, as of the close of the last business day of the week, and the deposit so computed shall be made no later than one hour after the opening of banking business on the second following business day; provided, however, a broker or dealer which has aggregate indebtedness not exceeding 800 per centum of net capital (as defined in § 240.15c3-1 or in the capital rules of a national securities exchange of which it is a member and exempt from § 240.15c3-1 by paragraph (b)(2) of that section) and which carries aggregate customer funds (as defined in

paragraph (a)(10) of this section), as computed at the last required computation pursuant to this section, not exceeding \$1,000,000, may in the alternative make the computation monthly, as of the close of the last business day of the month, and, in such event, shall deposit not less than 105 per centum of the amount so computed no later than one hour after the opening of banking business on the second following business day.

(ii) If a broker or dealer, computing on a monthly basis, has, at the time of any required computation, aggregate indebtedness in excess of 800 per centum of net capital, such broker or dealer shall thereafter compute weekly as aforesaid until four successive weekly computations are made, none of which were made at a time when his aggregate indebtedness exceeded 800 per centum of his net capital.

(iii) Any broker or dealer that does not carry the accounts of a "customer" as defined by this section or conduct a proprietary trading business may make the computation to be performed with respect to PAB accounts under paragraph (e)(1) of this section monthly rather than weekly. If a broker or dealer performing the computation with respect to PAB accounts under paragraph (e)(1) of this section on a monthly basis is, at the time of any required computation, required to deposit additional cash or qualified securities in the PAB Special Reserve Account, the broker or dealer shall thereafter perform the computation required with respect to PAB accounts under paragraph (e)(1) of this section weekly until four successive weekly computations are made, none of which is made at a time when the broker or dealer was required to deposit additional cash or qualified securities in the PAB Special Reserve Account.

(iv) Computations in addition to the computations required in this section, may be made as of the close of any business day, and the deposits so computed shall be made no later than one hour after the opening of banking business on the second following business day.

(v) The broker or dealer shall make and maintain a record of each such computation made pursuant to this section or otherwise and preserve each such record in accordance with § 240.17a-4.

(4) If the computation performed under paragraph (e)(3) of this section with respect to PAB accounts results in a deposit requirement, the requirement may be satisfied to the extent of any excess debit in the computation performed under paragraph (e)(3) of this

section with respect to customer accounts of the same date. However, a deposit requirement resulting from the computation performed under paragraph (e)(3) of this section with respect to customer accounts cannot be satisfied with excess debits from the computation performed under paragraph (e)(3) of this section with respect to PAB accounts.

(5) In determining whether a broker or dealer maintains the minimum deposits required under this section, the broker or dealer shall exclude the total amount of any cash deposited with a parent or affiliate bank. The broker or dealer also shall exclude cash deposited with a non-parent and non-affiliated bank to the extent that:

(i) The amount of the deposit exceeds 50% of the broker-dealer's excess net capital, based on the broker-dealer's most recently filed FOCUS report; or

(ii) The amount of the deposit exceeds 10% of the bank's equity capital as reported by the bank in its most recent Call Report or Thrift Financial Report.

(f) *Notification of banks.* A broker or dealer required to maintain the Reserve Bank Accounts prescribed by this section or who maintains a Special Account referred to in paragraph (k) of this section shall obtain and preserve in accordance with § 240.17a-4 a written notification from each bank in which he has his Reserve Bank Accounts or Special Account that the bank was informed that all cash and/or qualified securities deposited therein are being held by the bank for the exclusive benefit of customers of the broker or dealer (or, in the case of the PAB Special Reserve Account, for the benefit of brokers or dealers) in accordance with the regulations of the Commission, and are being kept separate from any other accounts maintained by the broker or dealer with the bank, and the broker or dealer shall have a written contract with the bank which provides that the cash and/or qualified securities shall at no time be used directly or indirectly as security for a loan to the broker or dealer by the bank and, shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank.

(g) *Withdrawals from the reserve bank accounts.* A broker or dealer may make withdrawals from his Reserve Bank Accounts if and to the extent that at the time of the withdrawal the amount remaining in each Reserve Bank Account is not less than the amount then required by paragraph (e) of this section. * * *

* * * * *

(j) *Treatment of free credit balances.*

(1) It shall be unlawful for a broker or dealer to accept or use any free credit balance carried for the account of any customer of the broker or dealer unless such broker or dealer has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent, together with or as part of the customer's statement of account, whenever sent but not less frequently than once every three months, a written statement informing the customer of the amount due to the customer by the broker or dealer on the date of the statement, and that the funds are payable on demand of the customer.

(2) It shall be unlawful for a broker or dealer to convert, invest, or otherwise transfer to another account or institution, free credit balances held in a customer's account except as provided in paragraphs (j)(2)(i), (ii) and (iii).

(i) A broker or dealer is permitted to convert, invest, or otherwise transfer to another account or institution, free credit balances in a customer's account only upon a specific order, authorization, or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization, or draft.

(ii) A broker or dealer is permitted to transfer free credit balances held in the account of a customer opened on or after the effective date of this paragraph to either a money market mutual fund product as described in § 270.2a-7 of this chapter or an interest bearing account at a bank without a specific order, authorization or draft for each such transfer, provided:

(A) The customer has previously affirmatively consented to such treatment of the free credit balances after being notified of the different general types of money market mutual fund and bank account products in which the broker or dealer may transfer the free credit balances and the applicable terms and conditions that will apply if the broker or dealer changes the product or type of product in which free credit balances are transferred;

(B) The broker or dealer provides the customer on an ongoing basis with all disclosures and notices regarding the investment and deposit of free credit balances as required by the self-regulatory organizations for which the broker or dealer is a member;

(C) The broker or dealer provides notice to the customer as part of the customer's quarterly statement of account that the money market mutual funds or bank deposits to which the free

credit balances have been transferred can be liquidated on the customer's demand and held as free credit balances; and

(D) The broker or dealer provides the customer with at least 30 calendar days notice before the free credit balances will begin being transferred to a different product, different product type, or into the same product but under materially different terms and conditions. The notice must describe the new money market fund, bank deposit type, or terms and conditions, and how the customer can notify the broker or dealer if the customer chooses not to have the free credit balances transferred to the new product or product type, or under the new terms and conditions.

(iii) A broker or dealer is permitted to transfer free credit balances that are held or will accumulate in the account of a customer opened before the effective date of this paragraph to either a money market mutual fund product as described in § 270.2a-7 of this chapter or an interest bearing account product at a bank without a specific order, authorization or draft for each such transfer, provided:

(A) The broker or dealer provides the customer on an ongoing basis with all disclosures and notices regarding the investment and deposit of free credit balances as required by the self-regulatory organizations for which the broker or dealer is a member;

(B) The broker or dealer provides notice to the customer as part of the customer's quarterly statement of account that the money market mutual funds or bank deposits to which the free credit balances have been transferred can be liquidated on the customer's demand and held as free credit balances; and

(C) The broker or dealer provides the customer with at least 30 calendar days notice before the free credit balances will begin being transferred to a different product, different product type, or into the same product but under materially different terms and conditions. The notice must describe the new money market fund, bank deposit type, or terms and conditions, and how the customer can notify the broker or dealer if the customer chooses not to have the free credit balances transferred to the new product or product type, or under the new terms and conditions.

* * * * *

(1) * * *

(2) Margin securities upon full payment by such customer to the broker or dealer of his indebtedness to the

broker or dealer; and, subject to the right of the broker or dealer under Regulation T (12 CFR part 220) to retain collateral for his own protection beyond the requirements of Regulation T, excess margin securities not reasonably

required to collateralize such customer's indebtedness to the broker or dealer.

* * * * *

6. Section 240.15c3-3a is revised to read as follows:

§ 240.15c3-3a Exhibit A—Formula for determination of customer and PAB account reserve requirements of brokers and dealers under § 240.15c3-3.

	Credits	Debits
1. Free credit balances and other credit balances in customers' security accounts. (See Note A)	\$XXX	.....
2. Monies borrowed collateralized by securities carried for the account of customers (See Note B)	XXX	.....
3. Monies payable against customers' securities loaned (See Note C)	XXX	.....
4. Customers' securities failed to receive (See Note D)	XXX	.....
5. Credit balances in firm accounts which are attributable to principal sales to customers	XXX	.....
6. Market value of stock dividends, stock splits and similar distributions receivable outstanding over 30 calendar days	XXX	.....
7. Market value of short security count difference over 30 calendar days old	XXX	.....
8. Market value of short securities and credits (not to be offset by longs or by debits) in all suspense accounts over 30 calendar days.	XXX	.....
9. Market value of securities which are in transfer in excess of 40 calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer during the 40 days	XXX	.....
10. Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection. (See Note E) .....	.....	\$XXX
11. Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver .....	.....	XXX
12. Failed to deliver of customers' securities not older than 30 calendar days .....	.....	XXX
13. Margin required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in customer and PAB accounts. (See Note F) .....	.....	XXX
14. Margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q-1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1) related to the following types of positions written, purchased or sold in customer accounts: (1) Security futures products and (2) futures contracts (and options thereon) carried in a securities account pursuant to an SRO portfolio margining rule (See Note G) ...	.....	XXX
Total credits .....	.....	.....
Total debits .....	.....	.....
15. Excess of total credits (sum of items 1-9) over total debits (sum of items 10-14) required to be on deposit in the "Reserve Bank Account" (§ 240.15c3-3(c)). If the computation is made monthly as permitted by this section, the deposit shall be not less than 105% of the excess of total credits over total debits .....	.....	XXX

Notes Regarding the Customer Reserve Computation

Note A. Item 1 shall include all outstanding drafts payable to customers which have been applied against free credit balances or other credit balances and shall also include checks drawn in excess of bank balances per the records of the broker or dealer.

Note B. Item 2 shall include the amount of options-related or security futures product-related Letters of Credit obtained by a member of a registered clearing agency or a derivatives clearing organization which are collateralized by customers' securities, to the extent of the member's margin requirement at the registered clearing agency or derivatives clearing organization. Item 2 shall also include the amount of such Letters of Credit related to other futures contracts (and options thereon) carried in a securities account pursuant to an SRO portfolio margining rule.

Note C. Item 3 shall include in addition to monies payable against customers' securities loaned the amount by which the market value of securities loaned exceeds the collateral value received from the lending of such securities.

Note D. Item 4 shall include in addition to customers' securities failed to receive the

amount by which the market value of securities failed to receive and outstanding more than thirty (30) calendar days exceeds their contract value.

Note E. (1) Debit balances in margin accounts shall be reduced by the amount by which a specific security (other than an exempted security) which is collateral for margin accounts exceeds in aggregate value 15 percent of all securities which collateralize all margin accounts receivable; provided, however, the required reduction shall not be in excess of the amounts of the debit balance required to be excluded because of this concentration rule. A specified security is deemed to be collateral for a margin account only to the extent it represents in value not more than 140 percent of the customer debit balance in a margin account.

(2) Debit balances in special omnibus accounts, maintained in compliance with the requirements of Section 7(f) of Regulation T (12 CFR 220.7(f)) or similar accounts carried on behalf of another broker or dealer, shall be reduced by any deficits in such accounts (or if a credit, such credit shall be increased) less any calls for margin, mark to the market, or other required deposits which are outstanding 5 business days or less.

(3) Debit balances in customers' cash and margin accounts included in the formula

under Item 10 shall be reduced by an amount equal to 1 percent of their aggregate value.

(4) Debit balances in cash and margin accounts of household members and other persons related to principals of a broker or dealer and debit balances in cash and margin accounts of affiliated persons of a broker or dealer shall be excluded from the Reserve Formula, unless the broker or dealer can demonstrate that such debit balances are directly related to credit items in the formula.

(5) Debit balances in margin accounts (other than omnibus accounts) shall be reduced by the amount by which any single customer's debit balance exceeds 25% (to the extent such amount is greater than \$50,000) of the broker-dealer's tentative net capital (*i.e.*, net capital prior to securities haircuts) unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the Reserve Formula. Related accounts (*e.g.*, the separate accounts of an individual, accounts under common control or subject to cross guarantees) shall be deemed to be a single customer's accounts for purposes of this provision.

If the registered national securities exchange or the registered national securities association having responsibility for examining the broker or dealer ("designated examining authority") is satisfied, after

taking into account the circumstances of the concentrated account including the quality, diversity, and marketability of the collateral securing the debit balances of margin accounts subject to this provision, that the concentration of debit balances is appropriate, then such designated examining authority may grant a partial or plenary exception from this provision. The debit balance may be included in the reserve formula computation for five business days from the day the request is made.

(6) Debit balances of joint accounts, custodian accounts, participation in hedge funds or limited partnerships or similar type accounts or arrangements of a person who would be excluded from the definition of customer ("noncustomer") with persons included in the definition of customer shall be included in the Reserve Formula in the following manner: if the percentage ownership of the non-customer is less than 5 percent then the entire debit balance shall be included in the formula; if such percentage ownership is between 5 percent and 50 percent then the portion of the debit balance attributable to the non-customer shall be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula; or if such percentage ownership is greater than 50 percent, then the entire debit balance shall be excluded from the formula unless the broker or dealer can demonstrate that the debit balance is directly related to credit items in the formula.

Note F. Item 13 shall include the amount of margin deposited with the Options Clearing Corporation to the extent such margin is represented by cash, proprietary qualified securities and letters of credit collateralized by customers' securities.

Note G. (a) Item 14 shall include the amount of margin required and on deposit with a clearing agency registered with the Commission under section 17A of the Act (15 U.S.C. 78q-1) or a derivatives clearing organization registered with the Commodity Futures Trading Commission under section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1) for customer accounts to the extent that the margin is represented by cash, proprietary qualified securities, and letters of credit collateralized by customers' securities.

(b) Item 14 shall apply only if the broker or dealer has the margin related to security futures products or futures (and options thereon) carried in a securities account pursuant to an approved SRO portfolio margining program on deposit with:

(1) A registered clearing agency or derivatives clearing organization that:

- (i) Maintains the highest investment-grade rating from a nationally recognized statistical rating organization; or

- (ii) Maintains security deposits from clearing members in connection with regulated options or futures transactions and assessment power over member firms that equal a combined total of at

least \$2 billion, at least \$500 million of which must be in the form of security deposits. For the purposes of this Note G, the term "security deposits" refers to a general fund, other than margin deposits or their equivalent, that consists of cash or securities held by a registered clearing agency or derivative clearing organization; or

- (iii) Maintains at least \$3 billion in margin deposits; or

- (iv) Does not meet the requirements of paragraphs (b)(1)(i) through (b)(1)(iii) of this Note G, if the Commission has determined, upon a written request for exemption by or for the benefit of the broker or dealer, that the broker or dealer may utilize such a registered clearing agency or derivatives clearing organization. The Commission may, in its sole discretion, grant such an exemption subject to such conditions as are appropriate under the circumstances, if the Commission determines that such conditional or unconditional exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors; and

(2) A registered clearing agency or derivatives clearing organization that, if it holds funds or securities deposited as margin for security futures products or portfolio margin account futures in a bank, as defined in section 3(a)(6) of the Act (15 U.S.C. 78c(a)(6)), obtains and preserves written notification from the bank at which it holds such funds and securities or at which such funds and securities are held on its behalf. The written notification shall state that all funds and/or securities deposited with the bank as margin (including customer security futures products and portfolio margin account futures margin), or held by the bank and pledged to such registered clearing agency or derivatives clearing agency as margin, are being held by the bank for the exclusive benefit of clearing members of the registered clearing agency or derivatives clearing organization (subject to the interest of such registered clearing agency or derivatives clearing organization therein), and are being kept separate from any other accounts maintained by the registered clearing agency or derivatives clearing organization with the bank. The written notification also shall provide that such funds and/or securities shall at no time be used directly or indirectly as security for a loan to the registered clearing agency or derivatives clearing organization by the bank, and shall be subject to no right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank. This provision,

however, shall not prohibit a registered clearing agency or derivatives clearing organization from pledging customer funds or securities as collateral to a bank for any purpose that the rules of the Commission or the registered clearing agency or derivatives clearing organization otherwise permit; and

(3) A registered clearing agency or derivatives clearing organization establishes, documents, and maintains:

- (i) Safeguards in the handling, transfer, and delivery of cash and securities;

- (ii) Fidelity bond coverage for its employees and agents who handle customer funds or securities. In the case of agents of a registered clearing agency or derivatives clearing organization, the agent may provide the fidelity bond coverage; and

- (iii) Provisions for periodic examination by independent public accountants; and

- (iv) A derivatives clearing organization that, if it is not otherwise registered with the Commission, has provided the Commission with a written undertaking, in a form acceptable to the Commission, executed by a duly authorized person at the derivatives clearing organization, to the effect that, with respect to the clearance and settlement of the customer securities futures products and portfolio margin account futures of the broker or dealer, the derivatives clearing organization will permit the Commission to examine the books and records of the derivatives clearing organization for compliance with the requirements set forth in § 240.15c3-3a, Note G (b)(1) through (3).

(c) Item 14 shall apply only if a broker or dealer determines, at least annually, that the registered clearing agency or derivatives clearing organization with which the broker or dealer has on deposit margin related to securities future products or portfolio margin account futures meets the conditions of this Note G.

Notes Regarding the PAB Reserve Computation

Note 1. Broker-dealers should use the formula in Exhibit A for the purposes of computing the PAB reserve requirement substituting the term "brokers or dealers" for the term "customers."

Note 2. Any credit (including a credit applied to reduce a debit) that is included in the computation required by § 240.15c3-3 with respect to customer accounts (the "customer reserve computation") may not be included as a credit in the computation required by § 240.15c3-3 with respect to PAB accounts (the "PAB reserve computation").

Note 3. Note E(1) to § 240.15c3–3a shall not apply to the PAB reserve computation.

Note 4. Note E(3) to § 240.15c3–3a which reduces debit balances by 1% shall not apply to the PAB reserve computation.

Note 5. Commissions receivable and other receivables of another broker or dealer from the broker or dealer (excluding clearing deposits) that are otherwise allowable assets under § 240.15c3–1 shall not be included in the PAB reserve computation, provided the amounts have been clearly identified as receivables on the books and records of the other broker or dealer and as payables on the books of the broker or dealer. Commissions receivable and other receivables of another broker or dealer from the broker or dealer that are otherwise non-allowable assets under § 240.15c3–1 and clearing deposits of another broker or dealer may be included as “credit balances” for purposes of the PAB reserve computation, provided the commissions receivable and other receivables are subject to immediate cash payment to the other broker or dealer and the clearing deposit is subject to payment within 30 days.

Note 6. Credits included in the PAB reserve computation that result from the use of securities held for a PAB account (“PAB securities”) that are pledged to meet intraday margin calls in a cross-margin account established between The Options Clearing Corporation and any regulated commodity exchange may be reduced to the extent that the excess margin held by the other clearing corporation in the cross-margin relationship is used the following business day to replace the PAB securities that were previously pledged. In addition, balances resulting from a portfolio margin account that are segregated pursuant to Commodity Futures Trading Commission regulations need not be included in the PAB reserve computation.

Note 7. Deposits received prior to a transaction pending settlement which are \$5 million or greater for any single transaction or \$10 million in aggregate may be excluded as credits from the PAB reserve computation if such balances are placed and maintained in a separate PAB Reserve Account by 12 noon Eastern Time on the following business day. Thereafter, the money representing any such deposits may be withdrawn to complete the related transactions without performing a new PAB reserve computation.

Note 8. A credit balance resulting from a PAB reserve computation may be reduced by the amount that items representing such credits are swept into money market funds or mutual funds of an investment company registered under the Investment Company Act of 1940 on or prior to 10 a.m. Eastern Time on the deposit date provided that the credits swept into any such fund are not subject to any right, charge, security interest, lien, or claim of any kind in favor of the

investment company or the broker or dealer. Any credits that have been swept into money market funds or mutual funds must be maintained in the name of a particular broker or for the benefit of another broker.

Note 9. Clearing deposits required to be maintained at registered clearing agencies may be included as debits in the PAB reserve computation to the extent the percentage of the deposit, which is based upon the clearing agency’s aggregate deposit requirements (e.g., dollar trading volume), that relates to the proprietary business of other brokers and dealers can be identified.

Note 10. A broker or dealer that clears PAB accounts through an affiliate or third party clearing broker must include these PAB account balances and the omnibus PAB account balance in its PAB reserve computation.

7. Section 240.17a–3 is amended by adding paragraph (a)(23) and to read as follows:

§ 240.17a–3 Records to be made by certain exchange members, brokers and dealers.

(a) * * *

(23) A record documenting the internal risk management controls established and maintained by the member, broker or dealer to assist it in analyzing and managing the risks associated with its business activities. Provided, That the records required by this paragraph (a)(23) need only be made if the member, broker or dealer has more than:

(i) \$1,000,000 in aggregate credit items as computed under § 240.15c3–3a; or

(ii) \$20,000,000 in capital, which includes debt subordinated in accordance with § 240.15c3–1d.

* * * * *

8. Section 240.17a–4 is amended by:

a. Removing from paragraph (b)(1) the citation “§ 240.17a–3(f)” and its place adding the citation “§ 240.17a–3(g)”;

b. Removing from paragraph (b)(9) the citation “§ 240.15c3–3(d)(4)” and in its place adding the citation “§ 240.15c3–3(d)(5)”;

c. Adding paragraph (e)(9).

The addition reads as follows:

§ 240.17a–4 Records to be preserved by certain exchange members, brokers and dealers.

* * * * *

(e) * * *

(9) All records required pursuant to paragraph (a)(23) of § 240.17a–3 until three years after the termination of the

use of the system of controls or procedures documented therein.

* * * * *

9. Section 240.17a–11 is amended by:

a. Revising the first sentence of paragraph (b)(1);

b. Removing from the introductory text of paragraph (c) the text “or (c)(4)” and in its place adding the text “(c)(4) or (c)(5)”;

c. Adding paragraph (c)(5).

The revision and addition read as follows:

§ 240.17a–11 Notification provisions for brokers and dealers.

* * * * *

(b)(1) Every broker or dealer whose net capital declines below the minimum amount required pursuant to § 240.15c3–1, or is insolvent as that term is defined in paragraph (c)(16) of § 240.15c3–1, shall give notice of such deficiency that same day in accordance with paragraph (g) of this section. * * *

* * * * *

(c) * * *

(5) If a computation made by a broker or dealer pursuant to § 240.15c3–1 shows that the total amount of money payable against all securities loaned or subject to a repurchase agreement or the total contract value of all securities borrowed or subject to a reverse repurchase agreement is in excess of 2500 percent of its tentative net capital; provided, however, that for purposes of this leverage test transactions involving government securities, as defined in section 3(a)(42) of the Act (15 U.S.C. 78c(a)(42)), shall be excluded from the calculation; provided further, however, that a broker or dealer shall not be required to send the notice required by this paragraph if it submits a monthly report of its securities lending and borrowing and repurchase and reverse repurchase activity (including the total amount of money payable against securities loaned or subject to a repurchase agreement and the total contract value of securities borrowed or subject to a reverse repurchase agreement) to its designated examining authority.

* * * * *

By the Commission.

Dated: March 9, 2007.

Nancy M. Morris,
Secretary.

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