



Securities Industry Association



December 10, 2002

Jonathan Katz, Secretary
Securities and Exchange Commission
450 Fifth St, N.W.
Washington, D.C. 20549

Re: Release No. 34-46492; File No. S7-34-02 [Reserve Requirements for Margin Related to Security Futures Products, 67 *Fed.Reg.* 59748 (September 23, 2002)]

Dear Sir:

The Steering Committee on Securities Futures of the Futures Industry Association¹ and Securities Industry Association² is pleased to submit its comments on the amendments to Rule 15c3-3a (the "Customer Reserve Formula") proposed in the Release referenced above. The amendments relate to the conditions under which margin related to securities futures products written, purchased or sold in customer securities accounts may be treated as debits in the Customer Reserve Formula when deposited with a clearing organization registered with the Commission or a derivatives clearing organization ("DCO") registered with the Commodity Futures Trading Commission.

We appreciate the Commission's clarifying, in new Item 14 of the Customer Reserve Formula, that margin for securities futures products on deposit in a clearing organization or DCO will be treated in a manner equivalent to customer margin deposited with the

¹ The Futures Industry Association ("FIA") is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 50 of the largest futures commission merchants ("FCMs") in the United States, the majority of which are also registered broker-dealers. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international.

² The Securities Industry Association's ("SIA's") members include more than 740 securities firms (including investment banks, broker-dealers and mutual fund companies) that are active in all US and foreign markets and in all phases of corporate and public finance. The US securities industry manages the accounts of more than 80 million investors directly and indirectly through corporate, thrift and pension plans.

Options Clearing Corporation (“OCC”) for options contracts written or purchased in customer accounts. (Item 13 in the Formula).

We note that, with respect to options, Item 13 refers specifically to OCC as the only depository for margin that is entitled to be treated as a debit in the Customer Reserve Formula. New Item 14 and Note G thereto do not identify any clearing organization or DCO by name. Note G, instead, creates a criteria-based test consisting of 3 elements. First, the clearing house must maintain the highest investment grade rating or meet a financial test. Second, margin must be deposited in a bank. Third, the clearing organization or DCO must establish, document and maintain safeguards for handling margin, provide a fidelity bond for employees and be periodically examined by independent public accountants. In addition, the clearinghouse must agree to be inspected by the Commission.

The Committee does not believe that it is appropriate to place on the broker-dealer the burden of making either the factual or the subjective judgments necessary to determine whether or not the clearing organization or DCO meets the conditions set forth in paragraph 3 of Note G. In addition, the Committee is concerned that a downgrade or failure by the organization or DCO to meet the financial criteria set forth in paragraph one of Note G (or, for that matter, any of the other criteria of Note G) immediately disqualifies the organization or DCO under Item 14. This could result in a financially material “lock up” requirement (potentially measured in hundreds of millions of dollars) if customer funds and securities at the clearing organization suddenly change from debits to credits. The resulting funding requirement is a liquidity risk that has the perverse result of creating systemic risk through a rule designed to protect customer funds.

We do not express a view as to whether the criteria as such are appropriate, although we do agree with comment of the Futures Industry Association that the practical impact of the criteria is to substantially limit potentially safe and sound DCOs as qualifying under Item 14. Our primary objection is to the precedent set by the Commission in establishing criteria that require a subjective judgment on the part of the depositing firm, without clear guidance about what assurance of compliance is sufficient to determine that the criteria are met. How does a depositing firm satisfy itself that the clearing organization establishes, documents and maintains “[s]afeguards in the handling, transfer and delivery of cash and securities”? Is a representation from the DCO or clearing organization enough? Must the depositing firm investigate independently? No answer is a good answer, because the penalty for being wrong can be enormously disruptive.

Securities futures products have begun trading, and at the moment only the OCC clears transactions carried by broker-dealers in securities accounts. The Committee believes that broker-dealers depositing customer margin with the OCC are assuming that OCC qualifies under Item 14, and are treating such margin deposited as a debit in the formula. We urge the Commission to confirm that assumption, and to remove any possibility that OCC may suddenly cease to meet any of the tests in Note G, by specifically referencing OCC in Item 14.

We also urge the Commission to delegate authority to the Division of Market Regulation to amend Item 14 to specify by name the clearing organizations or DCOs that qualify under that Item. Alternatively, the Committee urges the Commission to amend Note G to remove the criteria of paragraph 3 entirely (other than the requirement in sub clause (iv) thereof relating to examination by the Commission), and to allow firms to rely on representations that the organization or DCO is in compliance with paragraphs 1 and 2. We also request that Note G specifies that a firm has a 60-day grace period during which it can continue to treat margin deposited in a clearing organization that fails to meet the criteria as a debit in the Formula.

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We would be please to respond to any questions the Commission or staff may have about this letter. The Committee asks that any such inquiries be directed to Anthony Leitner, Co-chair of the Committee's Legal/Regulatory Subcommittee, at 212-902-5730, or to Edward Rosen, counsel to the Committee, at 212-225-2820.

Very truly yours,

Jonathan Barton, Chairman
FIA/SIA Steering Committee on Security Futures

Cc: Annette Nazareth
Catherine McGuire
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