



July 25, 2002

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

RE: File No. S7-20-02, Customer Protection – Reserves and Custody of Securities (Rule 15c3-3)

The Bond Market Association (“TBMA”)¹ and the Securities Lending Division of the Securities Industry Association² (collectively with TBMA, “we” or the “Associations”) appreciate the opportunity to comment on the proposal by the Securities and Exchange Commission (the “Commission”) to amend Rule 15c3-3 of the Securities Exchange Act of 1934 (the “Exchange Act”).³ Our response is divided into two parts: Part I comments on the Commission’s proposed amendment to Rule 15c3-3; Part II responds to the Commission’s specific request for comment regarding the operation of Rule 15c3-3 in connection with borrowings from institutional counterparties.

¹ TBMA represents securities firms and banks that underwrite, distribute and trade fixed income securities, both domestically and internationally. TBMA’s member firms are actively involved in the funding markets for such securities, including the repurchase and securities lending markets. This letter was drafted based on the input of members of TBMA’s Funding Division Executive Committee and Funding Division Legal Advisory Committee. Further information regarding TBMA and its members and activities can be obtained from our web site (www.bondmarkets.com).

² The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The focus of the Securities Lending Division of the SIA is to increase operating efficiencies and to develop uniform practices consistent with the ongoing development of the global marketplace. Success in these endeavors is critical in order to continue the evolution of the Securities Lending marketplace from an activity which was designed principally to support various clearance and settlement conventions, to an integral component of the industry’s highly sophisticated trading and investment strategies

³ Exchange Act Release No. 46,019 (May 31, 2002), 67 Fed. Reg. 39,642 (June 10, 2002) (the “Proposing Release”).

Part I – Proposed Amendment and Order

The Associations fully support the Commission's proposed amendment, and urge the Commission to adopt such amendment and issue the order (the "Order") referred to in the Proposing Release as soon as possible.

A. Need to Expand the Scope of Permitted Collateral. The Associations agree with the Commission's assessment that expanding the types of collateral that broker-dealers may pledge when borrowing customer securities will enhance liquidity in the financial markets and lower securities transaction costs.

Dramatic changes have occurred in the securities lending and financing markets in the twenty years since the collateral requirements of Rule 15c3-3 were adopted. The collateral requirements were updated in 1989 when the Commission staff – at the request of TBMA – issued a no-action letter expanding the categories of permitted collateral for

Dramatic changes have occurred in the securities lending and financing markets in the twenty years since the collateral requirements of Rule 15c3-3 were adopted. The collateral requirements were updated in 1989 when the Commission staff – at the request of TBMA – issued a no-action letter expanding the categories of permitted collateral for borrowings of U.S. government securities, thereby significantly improving the liquidity of both the securities borrowed and the securities pledged as collateral.⁴ Since that time, however, significant developments in the securities lending markets have occurred. Among the most important of these developments is the increasing internationalization of the securities markets. As U.S. investors have sought access to foreign securities and markets, and foreign investors have sought access to U.S. securities and markets, U.S. broker-dealers have been required to borrow a much wider range and higher volume of U.S. and non-U.S. securities to accommodate their customers' trading activities.⁵ In addition, market participants are now engaged in an expanded array of transactions permitting or requiring the borrowing of securities.⁶

In light of these and other market developments, there is a significant need for greater flexibility in the types of collateral that may be provided by U.S. broker-dealers when borrowing U.S. and foreign securities.⁷ Such flexibility will enhance

⁴ See Letter to Frances R. Bermanzohn, Esq. (Mar. 2, 1989).

⁵ With respect to transactions involving European securities, for example, the introduction of the Euro has expanded the types of currencies and securities which market participants are willing to accept as collateral.

⁶ For example, the Board of Governors of the Federal Reserve System (the "Board") has amended its Regulation T to permit broker-dealers to borrow and lend any debt securities for purposes other than to cover a short sale or a fail.

⁷ In recognition of this need for greater flexibility, the Board and its staff have gradually expanded the categories of collateral permitted to be provided by broker-dealers under Regulation T. For example, in

the ability of U.S. broker-dealers to compete more effectively with other financial services providers, particularly those located in foreign jurisdictions with less restrictive collateral requirements for borrowing securities. In addition, broadening the categories of permitted collateral will reduce a number of costs and operational burdens currently imposed on broker-dealers. For example, a broker-dealer holding in inventory highly-rated securities that are not currently permissible collateral under the Rule frequently must first borrow cash against those securities (through a repurchase (“repo”) transaction or bank loan) and then pledge the cash to a lender of securities – a two-step process that results in potential delays as well as higher financing and related transactional costs. Permitting such highly-rated securities to serve as collateral for securities borrowings will reduce such costs and market inefficiencies, thereby promoting greater liquidity and reducing settlement risks.⁸

B. Comments on the Commission’s Specific Proposals. The Associations support the Commission’s proposal to modernize the collateral requirements of Rule 15c3-3 by creating a process for issuing orders from time to time that update or modify the types of permitted collateral (rather than expressly adding new categories of collateral into the Rule). We also believe the factors that the Commission proposes to consider in determining whether a particular asset should be considered eligible collateral – such as its liquidity, volatility, market depth and location, and the issuer’s creditworthiness – are appropriate and consistent with the purposes of the Rule. Taken together, the Commission’s proposals will provide the necessary flexibility to modify the Rule’s collateral requirements in a timely and efficient manner as markets develop and change over time; we therefore urge the Commission to adopt the proposed amendments as soon as possible.⁹

1988 the Board staff indicated that certain highly-rated foreign sovereign bonds were acceptable collateral if they were in the same currency as the borrowed securities. See Staff opinion formerly at Fed. Res. Reg. Serv. ¶ 5-615.15 (Sept. 23, 1988). In 1990, the Board staff permitted certain irrevocable letters of credit issued by U.S. branches or agencies of foreign banks to be used as collateral for borrowings of securities from any counterparty. See Staff opinion formerly at Fed. Res. Reg. Serv. ¶ 5-615.17 (Mar. 27, 1990). Also in 1990, the Board staff clarified that broker-dealers could use foreign currency as collateral if the securities borrowed were denominated in the same currency. See Staff opinion formerly at Fed. Res. Reg. Serv. ¶ 5-615.18 (Oct. 22, 1990). In 1996, the Board expanded the types of permissible collateral for securities lending transactions to include all collateral acceptable under Rule 15c3-3. See 61 Fed. Reg. 20,386, at 20,388 (May 6, 1996). In 1998, the Board completely eliminated the Regulation T collateral requirements for securities borrowing transactions. See 63 Fed. Reg. 2,806, at 2,810 (Jan. 16, 1998).

⁸ See Joint Task Force of the Committee on Payment and Settlement Systems and the IOSCO Technical Committee, Recommendations for Securities Settlement Systems (Jan. 2001) (emphasizing that securities lending markets play an integral role in settling securities transactions and that jurisdictions should encourage securities lending, repos, and economically equivalent transactions as means of expediting settlement and reducing failures).

⁹ In order to further enhance the ability of the Commission to respond to changes in the securities lending markets, the Associations also support the Commission’s proposal to delegate its authority to issue orders under amended Rule 15c3-3(b)(3) to the Division of Market Regulation.

We also support the specific types of collateral identified in the proposed Order, and therefore urge prompt issuance of the Order. The Associations believe that these collateral types would materially increase liquidity and decrease borrowing costs in a manner consistent with the customer protection objectives of Rule 15c3-3. For example, allowing broker-dealers to pledge a broader range of collateral will improve liquidity in times of market stress when there is a strong demand for U.S. government securities for purposes other than collateralizing borrows of securities. Even absent market stress, the ability to utilize a broad range of securities as collateral for borrows will further facilitate broker-dealers' ability to cover fails or other delivery obligations in a cost-effective manner.

In addition, the Associations believe that the conditions specified for each of the proposed collateral types are appropriate to meet the goal of ensuring that borrowings of customer securities remain fully collateralized (including, for example, the overcollateralization requirements to address cross-currency transactions).

Part II – Securities Borrowings from Institutional Counterparties

In response to the Commission's request for comment on whether the collateral requirements of Rule 15c3-3 should apply to borrowings of securities from institutional counterparties, the Associations believe that Rule 15c3-3 should be revised to provide broker-dealers and their institutional lenders with the flexibility to determine the types of collateral that will be delivered. We strongly urge the Commission, however, not to permit consideration of this issue to delay in any way the prompt adoption of its proposed amendments to Rule 15c3-3 and the issuance of the proposed Order. Any additional changes to the collateral requirements of Rule 15c3-3 to address borrowings from institutional lenders should be addressed in subsequent orders or rulemakings. In this regard, the Associations would welcome the opportunity to work with the Commission in further defining the appropriate treatment of institutional lenders under Rule 15c3-3.

As the Commission is aware, numerous existing regulations recognize reduced regulatory requirements for broker-dealers and other financial institutions in their dealings with institutional investors that meet some minimum standards.¹⁰ As in

¹⁰ See, e.g., (i) the definition of "accredited investor" in Section 2(a)(15) of the Securities Act of 1933 (the "Securities Act") and Rule 501 of Regulation D thereunder; (ii) the definition of "qualified institutional buyer" in Securities Act Rule 144A; (iii) the definitions of "major U.S. institutional investor" and "U.S. institutional investor" in Rule 15a-6 under the Exchange Act; (iv) the definition of "designated account" in NYSE Rule 431(a)(3) and the definition of that term for purposes of NYSE Rule 431(e)(2)(F); (v) the definition of "institutional account" in NASD Rule 3110(c)(4); (vi) the definition of "qualified eligible participant" and "qualified eligible client" in CFTC Rule 4.7 (providing relief from disclosure and other requirements with respect to certain commodity pools and commodity trading advisors' accounts); (vii) the definition of "eligible contract participant" under Section 1a(12) of the Commodity Exchange Act (the "CEA") (for purposes of determining eligibility for certain exemptions from the CEA); and (viii) the

these cases, the Associations believe that the Commission's regulatory objectives with respect to Rule 15c3-3 could be achieved by permitting certain institutional counterparties that lend securities to broker-dealers to make their own determinations regarding the risks of agreeing to accept any particular type of asset as collateral. Moreover, such institutions may well benefit from the ability to take collateral that is of a type, form and amount that is consistent with their overall risk management and investment objectives. For example, certain institutional lenders may prefer to accept collateral of a type not currently permitted by Rule 15c3-3 because such collateral will more effectively hedge their specific risk exposures. For the same reasons, the Associations believe that the minimum collateralization requirement should be subject to negotiation between a broker-dealer and a qualified institutional counterparty.

In the Associations' view, the Commission could consider several approaches to identifying those institutional lenders from whom broker-dealers may borrow securities without restriction under Rule 15c3-3. For example, we believe that any institutional lenders satisfying minimum financial or other thresholds should be presumed to be capable of determining which types of collateral they should accept from a broker-dealer.¹¹ In defining these thresholds, the Commission could look to a number of currently-recognized categories of sophisticated institutional investors, such as "qualified investors" under the Exchange Act,¹² "qualified purchasers" under the Investment Company Act of 1940¹³ and "exempt accounts" under the proposed amendments to New York Stock Exchange Rule 431.¹⁴ In the Associations' view, institutional lenders satisfying any of these standards are sufficiently sophisticated to understand the consequences of the collateral arrangements they negotiate with a broker-dealer in a securities lending transaction. In this regard, we note that the ability of all persons (without

definition of "financial institution" in Regulation EE of the Board (for purposes of the netting provisions set forth in Sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of 1991); see also notes 12-14 and accompanying text.

¹¹ The definition of a qualified institutional lender should also include any financial institution, such as a custodial bank, that lends securities in an agency capacity, without regard to the status of its principals. Such lending agents – which generally are responsible for negotiating all the terms of the securities lending transaction, including the collateral – typically employ securities lending, risk management and credit professionals who are among the most sophisticated participants in the securities lending markets and are therefore capable of evaluating the risks and benefits of any particular collateral arrangement.

¹² The term "qualified investor" includes certain persons that own and invest on a discretionary basis, not less than \$25,000,000 in investments. Exchange Act Section 3(a)(54).

¹³ The term "qualified purchaser" includes certain persons, acting for their own account or the accounts of other qualified purchasers, who in the aggregate own and invest on a discretionary basis, not less than \$25,000,000 in investments. Investment Company Act of 1940 Section 2(a)(51).

¹⁴ The proposed "exempt account" definition includes persons with a net worth of at least \$40 million.

regard to financial assets or other criteria) to understand the consequences of not being accorded the status of “customers” under Rule 15c3-3 (and of not having protections under the Securities Investor Protection Act of 1970 (“SIPA”)) has already been recognized in the context of certain transactions between such persons and OTC derivatives dealers.¹⁵

In addition, the Associations believe that there are compelling arguments for an exemption from the collateral requirements of Rule 15c3-3 for broker-dealers borrowing securities from institutional lenders that are not held in an account at the broker-dealer. For example, when a broker-dealer borrows securities from a custodial bank, the bank should have no expectation that the securities loaned – which are not otherwise held in custody by the broker-dealer – will be treated in the same manner as securities held in accounts at the broker-dealer for its customers. Indeed, such loans are generally made on the condition that the broker-dealer actually deliver the securities to a third party (to cover a short sale or a fail) rather than hold them for the account of the lender.¹⁶ Currently, however, the Rule creates the anomalous result that securities that are not held by the broker-dealer before, during or after the loan are treated, during the term of the loan, as securities “carried for the account of a customer” and are deemed subject to the “possession and control” requirements of the Rule.¹⁷ While the Associations recognize the Commission’s desire to address the status of lenders not eligible for SIPA and Rule 15c3-3 protections, this concern can be adequately addressed through appropriate disclosures to qualified institutional lenders.

In response to the Commission’s request for comment as to the types of disclosures that would be necessary if securities lending collateral were allowed to be the subject of negotiation between the borrower and lender, as noted above the Associations believe that some limited disclosures regarding the status of the

¹⁵ See Rule 15c3-3(a) (excluding from the definition of “customer” a counterparty to certain transactions with an OTC derivatives dealer, provided that the counterparty has received certain notices).

¹⁶ The Proposing Release notes that Rule 15c3-3 “requires broker-dealers to take steps to protect the securities *that customers leave in their custody*.” Proposing Release at 39,642 (emphasis added). In the case of securities borrowed from a bank that has established a custodial relationship with the customer, it would seem illogical to view the broker-dealer (which as noted above will generally use the securities to fulfill a delivery obligation) as the customer’s custodian. Moreover, Rule 15c3-3(a)(2) defines “securities carried for the account of a customer” or “customer securities” that are entitled to the protections of Rule 15c3-3(b) (including the provisions regarding required collateral for securities borrowing transactions) as (i) securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the account of any customer and (ii) securities sold to, or bought for, a customer by a broker or dealer. Securities borrowed by a broker-dealer from a third-party custodian, such as an agent bank, do not appear to fit clearly within either part of this definition.

¹⁷ See, e.g., Exchange Act Release No. 18420 (Jan. 13, 1982), 47 Fed. Reg. 3531, 3532 (Jan. 25, 1982) (“The term “customer,” as defined in Rule 15c3-3, includes any person, other than a broker, dealer or municipal securities dealer, that lends securities to a broker or dealer, whether or not the lender maintains an account with that broker or dealer. Thus, Rule 15c3-3(b) could be read to require brokers and dealers to maintain physical possession or control of securities borrowed from such persons.” (footnote omitted)).

lender under SIPA and Rule 15c3-3 (where applicable), and regarding the nature of the collateral, would be appropriate. For example, broker-dealers today frequently notify the lender that some of the securities being provided as collateral may not be guaranteed by the United States. Such disclosure affords the lender an opportunity to determine, to the extent it deems necessary, whether the particular collateral being delivered is acceptable to it. In the Associations' view, however, any requirement that the broker-dealer provide detailed disclosure regarding specific types of collateral actually delivered would result in substantially increased operational burdens and costs for the broker-dealer, without providing the lender with any information that is not otherwise readily available to it.¹⁸

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The Associations appreciate the opportunity to comment on the proposed amendment and Order. Please feel free to contact either Omer Oztan at 212.440.9474 or ooztan@bondmarkets.com, or Leslie S. Nelson at 212.902.2121 or leslie.nelson@gs.com with any questions.

Sincerely,

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¹⁸ For example, if an institutional lender desires more information regarding any particular assets to be pledged as collateral, it could require the broker-dealer to provide such information as a condition to the acceptance of such collateral.