Securities Industry Association

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January 13, 1997

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
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Dear Mr. Katz:

On behalf of the Federal Regulation and Self-Regulation and Supervisory Practices Committees and the Compliance and Legal Division of the Securities Industry Association ("SIA"),[1] we appreciate the opportunity to comment on the proposed amendments to the books and records requirements set out in Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934.[2] At the outset, we wish to underscore our general support for the existing federal rules governing the regulation of broker-dealer books and records that have served the industry well for over 50 years. The records kept pursuant to these requirements have, to date, provided federal regulators with sufficient information to conduct thorough examinations and investigations. Over the years, the Securities and Exchange Commission ("SEC" or "Commission") has conducted thousands of oversight and cause examinations. To our knowledge, the SEC has never stated publicly any concern about any material deficiency in the books and records requirements that those examinations are intended to enforce.

We are sympathetic to problems that may be encountered by some state regulators in getting prompt access to well-organized broker-dealer books and records. We have in the past worked with the North American Securities Administrators Association ("NASAA") to attempt to achieve a sensible solution to state regulators' access problems without creating massive new costs and inefficiencies in the securities industry. Nevertheless, we believe the comprehensive transformation of the federal books and records rules, as proposed, is prohibitively burdensome on the efficiency of the capital markets, the competitiveness of the U.S. securities industry and capital markets, and the process of capital formation.[3] As discussed below, these rule proposals could impose very substantial start-up and ongoing costs on securities broker-dealers and their customers. Such a drastic increase in regulatory burden is unwise, especially when it is proposed not to address any problem that the SEC has encountered, but for the convenience of other regulatory authorities who could more directly address any problems that they may encounter through enforcement of existing rules and regulations. We believe that a far more sensible approach would be for the Commission to consider amendments to its rules governing transactions in "penny stocks." As discussed below, our understanding is that sales practice abuses in the "penny stock" market, not the capital markets as a whole, are at the heart of the concerns expressed by state securities officials.

While we would support reasonable enhancements to Rules 17a-3 and 17a-4 that would clarify a broker-dealer's obligation to provide records to state regulators promptly, we believe that the Commission has grossly underestimated the burden and cost of collecting and retaining the additional records that would be required under the proposed amendments. As discussed below, we believe that the proposed rules are likely to create costs vastly higher than the costs estimated in the Commission's release. Moreover, the records would be required to be maintained in a manner that is duplicative and inconsistent with sound business practices. In many cases, the required records would have to be maintained outside of systems that represent state of the art technology. We also believe that the proposed amendments, although characterized as additional record-keeping requirements, actually impose new substantive obligations on firms in areas that are adequately regulated under existing self-regulatory organization ("SRO rules. We therefore respectfully request that the Commission consider withdrawing the proposed amendments.

I. Introduction

In general, many of the new records that would be required under the proposed amendments are standard at many firms. Nevertheless, the systems or format in which they are retained do not necessarily lend themselves to the easy retrieval contemplated by the proposed amendments. To comply with the proposed amendments, broker-dealers would have to make significant adjustments to their record-keeping and reporting practices.

The proposed amendments to Rule17a-3 would require broker-dealers:

- to generate local office blotters;
- to record supplemental information on brokerage order memoranda;
- to create new kinds of customer account forms; and
- to maintain additional records concerning associated persons, customer complaints, and exceptional numerical occurrences.

The proposed amendments to Rule 17a-4 would:

- require broker-dealers to preserve certain additional types of records, including advertising and marketing materials, registrations and licenses, audit and examination reports, records concerning recommended securities, and manuals relating to compliance, supervision, and procedures;
- modify the Commission's existing requirements concerning preservation of certain correspondence and contracts;
- supplement the existing standards concerning the organization of books and records;
- require broker-dealers to designate a principal to be responsible for books and records compliance; and
- require broker-dealers to make certain records available in each of their local offices.

In the Release, the Commission states that it is proposing the amendments in response to concerns raised by members of NASAA. A NASAA Committee that had drafted a model state regulation to supplement the books and records requirements set forth in Rules 17a-3 and 17a-4 advised the Commission that state examinations of broker-dealers are frequently hindered by the absence of relevant records in local offices, by long delays in producing required records from a central location, and by poorly organized records. In addition, the NASAA Committee reported that certain provisions of the Commission's current books and records rules have been interpreted differently by broker-dealers, regulators, hearing officers, and courts, and that clarification of the requirements of such provisions would assist regulatory enforcement initiatives. Finally, the NASAA Committee indicated that requiring broker-dealers to maintain certain additional types of books and records would facilitate state regulators' efforts to monitor d control the broker-dealer industry and would increase levels of customer protection.[4]

We fully support uniformity in the books and records requirements among the various regulators. This policy objective is embodied in new subsection 15(h) of the Securities Exchange Act, which was added as part of the National Securities Markets Improvement Act of 1996. However, it is perplexing that the Commission should consider rewriting one of its basic regulatory functions to suit a misguided state books and records proposal. The Commission's action is especially distressing coming only months after Congress, responding to hearing testimony by SIA about the very same NASAA proposal, effectively discredited that proposal as a possible goal of national securities regulatory policy by preempting state law to preclude states from imposing such burdensome regulations directly. The Commission has in place extensive record keeping rules that require broker-dealers to maintain complete and accurate records. These records are subject to inspection at any time by the Commission and other regulatory authoritiesuch as the SROs. In circumstances where a broker-dealer is dually registered, the required records may be reviewed by other organizations (e.g., the Commodity Futures Trading Commission, the commodities exchanges and federal banking regulators) as well. All of these entities routinely conduct examinations and inspections and none has expressed similar concerns.

We believe the proposed amendments should not be adopted for the reasons stated below. Our comments do not address each provision of the proposed amendments, although we have highlighted certain specific provisions to demonstrate areas of the proposed amendments that are particularly problematic. We do not believe, however, that other, less objectionable provisions in the proposed rules should be adopted. Rather, we believe the entire proposal reflects a misguided effort to reinvent rules that work well, and therefore we urge that the proposed amendments be withdrawn. The Commission might then consider more measured changes to its books and records rules, if necessary to address problems that the Commission might identify with its own regulatory oversight, or to fill regulatory gaps, if any, between the Commission's oversight of broker-dealers and the oversight of state examination authorities.

II. The Proposed Amendments are Unnecessary

Broker-dealers in the United States are subject to a very complex overlapping regulatory scheme. In addition to the Commission, which generally has plenary authority over registered broker-dealers, the activities of most broker-dealers are also subject to regulations and examination by the National Association of Securities Dealers ("NASD"), the New York Stock Exchange and other self-regulatory organizations ("SROs"). Local oversight by state authorities provides yet another level of regulatory oversight. Within this matrix of regulatory oversight, we believe that existing Rules 17a-3 and 17a-4 have served their purpose well.

The additional records that would be required under the proposed amendments would involve significant changes to firms' systems for generating and storing records and will result in costs that will ultimately be passed along to the investing public and which far outweigh any possible increase in investor protection. The primary reason for the proposed rules is to make a variety of information or records more accessible to state regulators who have encountered problems in connection with examinations and investigations of firms that do not maintain information or records or do not produce them in a timely fashion. We believe the focus should be on facilitating the production of documents sought by state regulators during examinations and investigations rather than on revolutionizing the federal books and records rules.

The Commission has not demonstrated how the proposed amendments would resolve these problems any more effectively than would enforcement of existing state rules and regulations. If the problem that state regulators face is that broker-dealers are slow or lax in complying with requests for records, state regulators should seek penalties for non-compliance with such requests.[5] Moreover, we believe that the specific time frames for production of documents set forth in the proposed amendments may present a problem and rather, the requirement should be production within a reasonable time. It would then be left to the discretion of the state regulator to set a reasonable time, and to enforce penalties for non-compliance.

We also note that NASAA representatives have stated that the genesis for the rules that the SEC now proposes lies in problems that state regulators have encountered with one limited portion of the securities industry: firms that deal in "penny stocks."[6] The SEC in 1992 adopted the 15g series of rules[7] to address abuses associated with many "penny stock" firms. We believe that the concerns of state regulators would be much more appropriately addressed by considering amendments to those rules to provide greater regulatory oversight and investor protection in that area, rather than by targeting the entire securities industry for regulatory requirements that are irrational and extremely burdensome outside the very distinct "penny stock" segment of the market.

III. The Costs of the Proposed Amendments Would be Significant.

Many of the proposed provisions would impose significant new burdens and costs on broker-dealers. We believe these costs are unjustified given the detailed records currently required under existing Rules 17a-3 and 17a-4. The requirement for a mandatory account form, requiring written annual updating that includes customer information such as investment objectives and the approximate percentage of invested capital that the customer wants allocated to speculative investments would create significant new costs, and is completely unworkable in practice.

The Release accompanying the proposed amendments contains estimates of the total annual reporting time and cost burdens of the proposed amendments. The Commission suggests that the "only" significant new cost would be an estimated 383,333 hours required by the account form updating requirements. The Commission's release dismisses as insubstantial the start-up costs involved in developing the new records required under the proposed amendments. We believe that the Commission's cost estimates are vastly understated.[8]

The continuing costs of monitoring such a system could be many times greater than the

Commission's estimate. Although the Release states that this provision is not intended to create a monitoring obligation, it goes on to say that the designated percentage will be useful in assessing the suitability of recommendations made by broker-dealers. The litigation risk that this poses is unacceptable and, therefore, the provision is likely to create a de facto monitoring obligation for many or all customer accounts, not 10 per cent of customer accounts as the Commission assumes.**9** The Commission's estimate of five minutes per account to comply with the updating requirement is also much too low. Because updating would usually involve communication between the registered representative and client, as well as back-office personnel, it is more likely that each update would take at least 30 minutes and perhaps several hours for many clients. This means that the burden of annual monitoring for the securities industry is likely to be far higher than the 383,333 hours estimated by the Commission. In addition, the costs of labor and production involved in a mailing to all customer accounts could be very substantial. **10** The Commission's estimate also does not take into account the time spent on supervisory review or the administrative support that would be required for each update. Since many registered representatives have hundreds or even thousands of accounts, this process could take months to complete. While the overall cost of reviewing and updating tens of millions of accounts is very difficult to estimate with any precision, the discussion of costs in the proposing release does not adequately analyze the real cost impact of the proposal and thus does not reflect the significance of the regulatory burden that the proposals would place upon the securities industry.

Moreover, other provisions would require costly enhancements or modifications to firms' record retention systems. For example, among other provisions, proposed Rule 17a-3(a)(1) would require trade blotters with respect to the activities of each local office to be maintained in each local office. Many firms have expended large sums in recent years to automate and centralize their records. Great strides in automation have produced improvements in firms' ability to oversee their employees. Some large broker-dealers use computer systems to generate as many as two dozen or more daily exception reports, as well as weekly and monthly exception reports. Some of these reports are produced physically and some are produced electronically. However, the underlying data from which the report can readily be reconstructed is retained. This provision imposes burdens that are counter-productive to the development and use of such systems, notwithstanding that many large retail firms have found them to be the most effecte form of review. The requirement that purchase and sale blotters be maintained at local offices is both out of date as to the type of record referenced and runs counter to the trend toward maintaining records on a centralized basis. Those firms that are less automated would incur the additional cost of duplicating records to be maintained at local offices, and on-site storage of those records for significantly longer periods of time.

Additionally, proposed Rule 17a-3(a)(20) would require additional records on associated persons and proposed Rule 17a-4(1) would require these additional records to be maintained in each local office. Moreover, proposed changes to Rule 17a-4(a) would modify the requirement that documents be kept in an "easily accessible place" during the first two years of the retention period. The rules would require all records to be maintained in such a place for the entire retention period. This will require significant additional expenses that have not been factored in to the Commission's analysis. Many of these records are simply not maintained in an automated format and therefore would need to be duplicated and sent to the local office. Many of these records are sensitive, confidential personnel files which for valid reasons should be maintained in a central location.

The proposed amendments, in addition, assume widespread use of electronic systems where documents can be displayed and produced at each branch office. In fact, while some firms are developing this technology, it is currently not commonplace. Indeed, there are many firms that are consistently profitable and able to meet their regulatory responsibilities without sophisticated automated systems. In order to comply with the proposed amendments, such firms would be required to make significant modifications to their record storage systems. Moreover, as noted above, many of the required records are not maintained in an automated format. In many cases the required records would have to be duplicated and held in more than one and, in some cases, in fifty locations. In a society and industry that is moving toward a paper-less environment, such decentralization would be a huge step backwards.

Proposed Rule 17a-3(a)(19) would require the creation of activity reports of unusual numerical occurrences such as frequent trading in customer accounts, unusually high commissions, or unusually high numbers of trade corrections or canceled trades that would be particularly costly or impossible to implement. Many retail-oriented firms employ such exception reports and many such firms have highly automated, sophisticated systems that generate the reports in order to comply with their supervisory obligations under self-regulatory organization rules. Other firms, however, are able to demonstrate consistently that they meet their supervisory obligations without such reports. The provision is anti-competitive in that it would have a disproportionate impact on small firms. In addition, in the cases of institutional, discount, clearing and other specialized firms, such reports not only would entail great expense, but would serve little or no justifiable function or need from either a business or regulatory persctive.

Section 23(a) of the Exchange Act requires the Commission, in adopting rules under the Act, to consider the anti-competitive effect of such rules if any, and to balance any impact against regulatory benefits gained in terms of furthering the purposes of the Act. **11** The Release states that the Commission has considered the proposed amendments in light of these standards and believes that, if adopted, they would not likely impose any significant burden on competition not necessary or appropriate in furtherance of the Exchange Act, in that any burden imposed would be less than that imposed by individual, and possibly divergent, state regulations.

To the contrary, as discussed above, we believe that the proposed amendments will impose a significant burden on broker-dealers, particularly small broker-dealers with limited staff, resources, and access to automated systems. We note that the National Securities Markets Improvement Act of 1996 ("NSMIA"), signed by the President on October 11, 1996, contains a provision that prohibits states from adopting supplemental books and records requirements and, therefore, the costs of the proposed amendments cannot be assessed in relation to the cost involved in possible divergent state regulations because this is a circumstance that has been foreclosed by the new legislation.

Indeed, NSMIA amends the Securities Exchange Act to provide that "whenever pursuant to this Title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."**12** As noted above, we believe the proposed amendments are unnecessary, anti-competitive, and will require a tremendous amount of money and resources to adapt existing systems or to create new systems. For some firms, particularly smaller firms, the amendments will be prohibitively expensive to implement.

IV. Proposed Amendments Cover Areas Adequately Regulated by SRO Rules.

Many provisions of the proposed amendments impose new substantive obligations on firms in areas that are adequately regulated under SRO rules. For example, broker-dealers that deal with particular classes of clients must now make reasonable efforts to determine a customer's financial status and needs, and to make suitable recommendations in light of those needs.[13] The additional information required by the customer account form in proposed Rule 17a-3(a)(16) provides no additional protection for investors and, as a practical matter, is not how business is done in many cases. For example, to require broker-dealers who do not offer investment advice (so-called "discount brokers") to collect and update customer information to assist state regulatory authorities in making suitability determinations is a waste of time and resources. Additionally, the NASD's recently-promulgated institutional suitability rule recognizes that in the institutional context, there are circumstances under which these obligations don't apply. Mandatory collection and receipt of this information would create new obligations or supporting recordkeeping requirements in areas where the SEC or SROs have determined there should be no substantive obligations.

Likewise, requiring investors who choose multiple investment objectives to dedicate certain percentages to each objective serves no investor protection goal and is totally unworkable. An account's composition changes constantly. Allegations of unsuitable recommendations might be premised on the contents of a document containing investment objectives that have been superseded by ongoing communications between a registered representative and his client. Requiring an investor to repeatedly rededicate specific amounts of money for each objective in reaction to every event that may change a portfolio's composition, including market price movements, is an inconvenience for both investors and the broker-dealer.

Self-regulatory organizations also have in place detailed and thorough record keeping and reporting requirements with regard to customer complaints.[14] None of these requirements relate to oral complaints by customers which would be required to be memorialized under proposed Rule 17a-3(a)(17). We believe that broker-dealers should not be required to make records concerning oral communications that are not reduced to writing. There is too much uncertainty as to when an oral communication becomes so critical of a dealer's practices that it rises to the level at which the required records would need to be created and maintained. Further, the proposed rule makes no distinction based on who receives the "complaint." A person to whom an oral complaint is directed may not be positioned to determine whether the complaint alleges facts that would constitute fraud or theft, or whether it is really a complaint about the broker at all. Moreover, a customer who is making an oral inquiry may not intend it to be characterized as a complaint. Requiring that a record be maintained may inadvertently raise these inquiries to a status they do not deserve and could have chilling effect on the broker-dealer/client relationship.

Proposed Rule 17a-3(a)(18) would require a transaction by transaction commission schedule for each associated person. Ascertaining this information and maintaining it in the client trading record would create an extraordinary administrative burden without serving any useful function. Differing compensation structures would make it difficult to readily determine the remuneration per trade. For example, institutional salespersons are generally salaried employees. The NASD prohibition against charging any unreasonable fee or commission provides adequate protection for investors without imposing an undue burden on securities firms. Requiring firms to produce and maintain a record of remuneration per trade is unnecessary and unjustified.

Finally, SRO rules impose on broker-dealers a duty to supervise their employees.**15** The activity reports that would be required under proposed Rule 17a-3(a)(19) would dictate very specific procedures for reasonable supervision. This is inconsistent with the historical approach to regulation of the securities industry. This provision marks the first time that any regulator has mandated specific types of surveillance reports. Typically, the Commission and the SROs have set out general standards for compliance and have allowed broker-dealers to develop specific procedures to achieve compliance. For example, Section 15(f) of the Exchange Act requires that broker-dealers adopt procedures reasonably designed to prevent the misuse of material, non-public information, but does not specify the particular procedures that a broker-dealer must adopt to meet that requirement. **16** In addition, the NASD's recently-promulgated institutional suitability rule provides that the manner in which a member fulfills its suitability obligation will vary depending on the nature of the customer and the specific transaction. More recently, the New York Stock Exchange ("NYSE") took a similar approach in proposing a rule change to the Commission that would enable member firms to develop reasonable procedures for supervising communications with the public instead of requiring prior approval of all customer communication and the NASD has proposed a similar approach to supervisory approval. **17**

We acknowledge that the proposed provisions reflect a number of business practices that firms have determined are sound and, indeed, many firms have incorporated such practices into their supervisory procedures. Nevertheless, the determination with respect to specific supervisory practices and procedures should be left to each broker-dealer and is not an appropriate subject for a books and records rule.

As we have noted above, the proposed amendments would impose significant undue costs and burdens on the industry. Moreover, the proposed amendments are inconsistent with the trend in the industry toward automated, centralized record keeping and allowing firms to adopt reasonable supervisory procedures without dictating what those procedures should be.

We believe that the existing federal books and records rules combined with SRO oversight as described above provide significant safeguards for investors. Massive changes to those rules are unwarranted to address state regulators' concerns. We therefore respectfully request that the Commission withdraw the proposed amendments.

The Federal Regulation and Self-Regulation and Supervisory Practices Committees and the Compliance and Legal Division thank you for the opportunity to provide comments on this significant proposal. If SIA or the Committees can provide any further information, please contact the undersigned, Judith C. Poppalardo, SIA Assistant General Counsel, or George R. Kramer, SIA Associate General Counsel, at 202-296-9410.

Sincerely,

C. Evan Stewart
Chair
Federal Regulation Committee

Richard O. Scribner
Chair
Self-Regulation and Supervisory Practices Committee

Allen B. Holeman
President
Compliance and Legal Division

cc: Chairman Arthur Levitt
Commissioner Steven M.H. Wallman
Commissioner Isaac Hunt
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Dr. Richard R. Lindsey, Director, Division of Market Regulation
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Footnotes

1 The Securities Industry Association ("SIA") is the trade association representing the business interests of about 750 securities firms in North America. Its members include securities organizations of virtually all types - investment banks, brokers, dealers, and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for 90% of securities firm revenue in the United States.

2 17 CFR 240.17a-3 and 240.17a-4.

3 As recently amended, Section 3 of the Securities Exchange Act requires the Commission, whenever it is required to consider the public interest in its rulemakings, to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." The Commission appears to have given insufficient consideration to those issues in its proposing release.

4 We note that the industry has repeatedly objected to similar proposals each time they were proposed by NASAA as a model books and records rule for the states. **See**, **e.g.**, Letter from Daniel J. Barry, Attorney, SIA, to The Honorable Richard W. Hubbard, Chairman, NASAA Broker-Dealer Operations Committee, dated August 23, 1995.

5 Under the Uniform Securities Act, state regulators can suspend or revoke the registration of a broker-dealer that willfully fails to comply with a request for records, or can seek criminal sanctions. **See** Uniform Securities Act Subsection 204(a)(B)(1956) and Subsection 409 (1956).

6 NASAA officials have stated to both SEC staff and SIA representatives that the NASAA books and records proposal on which the present proposed SEC rules are based were spawned largely by difficulties encountered in state examinations of "penny stock" firms, not by widespread difficulties in examining broker-dealers generally.

7 17 C.F.R, 240.15g **et seq.**

8 One firm estimates it has spent over $250,000 over the last seven years to develop and refine a basic system to record and monitor a customer account's primary investment objective. It estimates it would cost easily that much again (a) to develop, reprogram, and test that system for such substantive rule changes, and (b) to devote appropriate personnel to respond to the information generated by such a system. It is conceivable to extrapolate from this that costs could be many millions of dollars.

9 In its cost analysis, the Commission assumes that the annual updating requirement would only apply to 10 per cent of customer accounts. However, the proposed rule on its face could be read to require annual updating of all customer accounts. In fact, other language in the release suggests that the Commission may read the annual updating requirement as applying "with respect to the investment objective designated on **each** customer's account form." FR at 55595. The ambiguity of the updating requirement as a "factor" in fulfilling suitability obligations may also compel broker-dealers to perform annual updating for most or all customer accounts.

10 The postage and printing costs for a mailing to clients generally run in the range of $0.75 to $5 per account, depending on the size and business type of the firm.

11 15 U.S.C. 78w(a)(2).

12 Section 106, Public Law 104-290.

13 **See** New York Stock Exchange, Inc. ("NYSE") Rule 405 and National Association of Securities Dealers, Inc. ("NASD") Rule 2310.

14 **See** NYSE Rule 351 and NASD Rule 3070.

15 **See** NASD Rule 3010 and NYSE Rule 342 and NASD Rule 3010.

16 Similarly, Exchange Act Rule 15(b)(4)(E), 17 CFR 240.15(b)(4)(E), authorizes the Commission to impose sanctions for "failure reasonably to supervise," but excludes a broker-dealer or its associated persons from the coverage of this sanction if it has "established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect[a regulatory violation], insofar as practicable. . . ."

17 **See** Securities Exchange Act Release No. 34-37941 (November 13, 1996), 61 FR 58919 (November 19, 1996) and NASD Notice To Members 96-82 (December 1996).