

**Securities Industry Association**

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April 6, 1998

Mr. Michael Macchiaroli
Associate Director
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Re: Proposed Changes to Exchange Act Rules 17a-3 and 17a-4

Dear Mr. Macchiaroli:

Over the past several months representatives from the broker-dealer community, staff of the Securities and Exchange Commission (SEC) and officials from the North American Securities Administrators Association (NASAA) have held a number of meetings and discussions concerning possible revisions to the SEC's books and records proposals (Exchange Act Rules 17a-3 and 17a-4), which were originally proposed on October 25, 1996. As you know, our members vigorously opposed the October 1996 proposals. We continue to question the need for sweeping books and records reforms, particularly when the prospective investor protection benefits of extensive changes to the current regulatory regime are contrasted with the costs and administrative burdens associated with their implementation.

Nevertheless, the dialogue that has ensued since October 1996 among representatives of the industry, the SEC and NASAA appears to have produced a number of areas of apparent compromise, and potential agreement, on books and records reform. Members of the industry have worked in good faith to identify situations in which policy justifications exist for revising current books and records requirements, and to devise reasonable and practical means of implementing those changes. Through this process, general agreement seems to have been reached on a variety of important issues. Specific comments and language changes drafted by a group of industry firms and their trade association representatives to implement these areas of general agreement have previously been forwarded to you.¹ In spite of this progress, however, at least two significant issues remain outstanding: the current formulations of (1) the definition of "local office," and (2) requirements for broker-dealers to preserve and furnish audit and examination reports to regulators.

As you consider how to deal with these issues in the context of a revised books and records proposal, we thought it would be helpful to provide you with the following, additional perspective regarding the nature of our concerns. We also wanted to propose addressing these issues in the revised proposals in a manner which we believe is more consistent with federal precedent, including NSMIA (at least with respect to the definition of local office). We also believe that the revised proposals should address both the local office definition and the audit and examination report requirement in a manner which is reasonable and responsive to the SEC's and NASAA's basic investor protection concerns, without imposing unnecessary and unwarranted burdens on the industry.

These recommendations were developed by a core group of interested firms and are offered in an attempt to minimize the number of provisions at issue when the proposal is again released for public comment. Even if these recommendations are included in the reproposal, however, it will necessarily undergo a thorough review by all of the undersigned associations' individual members. Accordingly, on their behalf, we reserve the right to comment on these and other provisions. Given the complexity of the regulations, we would anticipate offering, at a minimum, additional technical comments. Individual firms also may submit comments on substantive portions of the proposal.

It should not go unnoticed that, even in its least intrusive iteration, the requirement to maintain books and records at local offices is a major change from current law. The same is true with respect to the requirement that we furnish certain examination and audit reports as these reports are generally of a confidential nature and have the ability to cause significant reputational damage if handled improperly. Accordingly, we respectfully request that you consider not republishing the standards set forth in the unpublished revised draft of October 8, 1997 and instead consider a standard, as discussed below, supported by a core group of the affected industries that has negotiated this issue in good faith and thought through the ramifications of any changes in this area as well as the public policy objectives of the proposal. To do otherwise is to place the burden of preserving the status quo on the industry when there hasn't been evidence of widespread abuse or similar justification for changing a system that works properly.

DEFINITION OF LOCAL OFFICE

The current draft would require broker-dealers to maintain and provide ready access to required books and records in each local office of the broker-dealer. "Local office" for this purpose would include any office of two or more associated persons. This proposal generally is unnecessarily burdensome in light of NASAA's rationale for seeking a change to the status quo to provide easier access to records than is currently provided. It is quite significant, we believe, that this request does not result from any systematic or pervasive environment of demonstrated fraud, abuse or delays in providing required records. Against this backdrop, the current proposal must be balanced against the imposition of significant additional recordkeeping obligations on broker-dealers and the elimination of the much-needed discretion of a broker dealer to bring to the public small, convenient, minimally-staffed offices in areas outside of major population centers without unnecessarily burdensome record retention and maintenance requirements, as is the case under current regulation.

Despite the industry's many offers to compromise, NASAA representatives have offered only

that states could individually waive this requirement and replace it with a different standard. This is unacceptable to the industry. It would lead to the possibility of 50 different sets of state requirements, and to different requirements for different firms or categories of firms. Putting aside the difficulties that this would cause firms, we believe this proposal represents a step backwards that is not even an option in light of NSMIA, which prohibits states from implementing individual, and possibly divergent, books and records regulations.

We proposed to NASAA representatives that "local office" instead be defined as being, within the discretion of the broker-dealer, either one office per state or any office of five or more registered persons. In other words, for offices of four or fewer registered persons or in situations in which records for an office of five or more registered persons were not maintained at that office, such records would be required to be retained at a designated facility within the same state, thereby facilitating reasonable access by regulatory officials within that jurisdiction. Upon reflection, however, we believe that even this standard could prove unworkable and that the most sensible approach would be to require books and records in those offices where supervision using those records occurs.

Presently, NASD rules require certain records to be kept at offices of supervisory jurisdiction ("OSJs"). The federal securities laws do not dictate a specified location for maintaining required books and records. Many firms consolidate their records at one or more central locations while other firms house them at OSJs. Among other reasons, consolidation and centralization of records is desirable to conserve space, efficiently allocate staff resources, and facilitate internal control. Although examiners are, of course, authorized to visit local offices, document production requests have traditionally been handled centrally at the consolidated locations where the documents are maintained, and where staff are located who have the time, training and responsibility for managing this process efficiently. To force a new burdensome model on the entire industry because some state examiners may have experienced delays or added travel to access records at these locations would be uneconomical. We do not believe that any problems that may exist in this area are of a magnitude that would justify such a drastic change in broker-dealers' current business practices. Any individual offenses should be targeted for appropriate sanction, leaving the segment of the industry that has not contributed to the alleged problems free to conduct business in a manner already proven workable.

A basic problem with the current formulation of this provision is that it would measure the size and significance of a local office solely by the number of associated persons residing in that office. However, for purposes of the current draft, the term "associated person" is defined much more broadly than the current definition of this term elsewhere in the federal securities laws, which does not include persons performing purely administrative or ministerial functions. Under the current draft, however, a branch office consisting of two employees, one of whom is an administrator, would nevertheless qualify as a local office, thus triggering the full complement of record maintenance and retention requirements.

Defining local office in the manner proposed would impose a number of incremental costs and burdens on broker-dealers. These include the following, among others:

- Duplication of all local office records, which would also be maintained at the central record retention location;
- The need to significantly expand and implement independent staff training and

compliance programs at each local office, including procedures to detect and prevent violations of recordkeeping requirements;

- Costs related to obtaining the additional personnel and other resources that would be needed for each local office to establish and maintain a separate records retention and maintenance capability;
- Systems-related costs necessary to provide for electronic storage and retrieval of information in the field; and
- Acquiring additional storage capacity/facilities, since previous space planning decisions would not have taken this need into account.

It appears that the current draft presupposes that all recordkeeping will be decentralized, rather than duplicated, but this ignores important variations in business and practical reality. We recognize that the proposal would add a provision in Section 17a-4(1)(2) that the capability to make documents stored in a form other than hard copy available at a local office within a specified period of time will satisfy the local office record maintenance requirements. However, not all broker-dealers may be able to rely on this provision. The threat of mishandling of originals in local offices, and lack of centralized controls, would dissuade many firms from implementing a policy in which the retention of original versions of documents would be decentralized. Accordingly, if the current draft is adopted, we believe that many firms would retain required records in original form at a central recordkeeping or supervisory facility, and in duplicate at each local office.

We believe these costs and burdens are entirely unnecessary and unwarranted in light of the absence of a compelling justification for modifying the status quo. The alternative that we have proposed clearly provides state regulators with reasonable, reliable and complete access to all required books and records for any office operating within their jurisdiction.

Since the time that we proposed (and NASAA declined to consider) the above recommendations, we have taken the opportunity to further consider the ramifications of this alternative and to explore other options. At this time, we believe that it will not only be costly and disruptive to accommodate NASAA by retaining the required records as originals in many locations within a state, but that it is potentially harmful to separate the supervisory responsibilities from the requirement that certain records be maintained by a broker-dealer. Clearly, it is essential that these records be located at the OSJ, because that is where supervision has to be performed using those records. Because some OSJs do not have five or more registered representatives, even this proposal would not work in all cases. Indeed, we have come to believe that the whole concept of multiple locations separate from the supervisory function creates the potential for more harm than good.

Accordingly, we would respectfully suggest that you consider, in light of NSMIA's mandate of uniformity among the states, defining "local office," at the discretion of the broker-dealer, to be either one office in a state designated by the broker-dealer, or the office with the responsibility for supervising the activities of the persons associated with the member to which the records relate, so long as there is one such office in each state.

PRESERVING AND FURNISHING AUDIT AND EXAMINATION REPORTS TO STATE REGULATORS

Neither the current books and records rules nor the federal securities laws more generally explicitly provide regulatory or self-regulatory agencies with blanket authority to obtain audit and examination reports from broker-dealers. Nevertheless, upon formal request or in connection with a "for cause" examination, an ongoing investigation, or an enforcement proceeding, whether and how such documents are provided (if indeed they have been created) is often the subject of negotiation between the firm and the regulator. Under federal law, the SEC is authorized to protect the confidentiality of such documents so that an official inquiry would not result in the more general release of firms' records to the public. If states could provide similar protection, the provision would be much less problematic. As we understand it, though, Sunshine Laws in many states would preclude this.

As most recently drafted, the proposals would require a broker-dealer to preserve in an easily accessible place all audit or examination reports required by law or that are completed by a party other than the broker-dealer for three years after the date of each such audit or examination report. As such, these reports would be readily available, on demand, to a state regulator. We regard such a provision as extremely problematic, and strongly urge that it be eliminated from the proposals.

As noted in prior comment letters, such a requirement would create counter-productive disincentives for a broker-dealer to continue to conduct the type of honest, self-critical evaluation of its business that the Commission, consistent with the notion of self-regulation, should be encouraging. To discourage such self-critical analysis would be detrimental to public investors as well. A broker-dealer who would otherwise be prepared to bring in an outside auditor for an independent evaluation of its business will hesitate when it realizes that it will be required, when asked, to share the examination report with the SEC and/or any other regulatory authority, particularly one which has not agreed to take any steps to tailor its request to the situation or protect confidentiality. The potential damage to a broker-dealer's reputation and competitive position, should audit or examination reports containing proprietary and other sensitive information be inappropriately released or used, would likely outweigh the benefit to the firm of conducting such audits or examinations in the first place.

Further, as written, the current draft would include reports by other state regulators, self-regulatory organizations (NASD, NYSE, etc.) and banking regulators, including the Federal Reserve Board, Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, and state banking examiners with jurisdiction over bank- and insurance-affiliated broker-dealers. These reports are not written with public dissemination in mind.

We believe that NASAA understands, at least in concept, that this is overreaching and inappropriate. In conversations, NASAA tentatively agreed that only those examinations prepared as a result of an administrative or court order would be required to be provided to state examiners. NASAA declined to be committed to this specific requirement, however, in light of the group's inability to form a consensus on the books and records rule as a whole.

CONCLUSION

Representatives of the industry have agreed to many prospective changes in the books and records rules to respond to and accommodate NASAA's concerns. We continue to believe that

NASAA's proposal concerning the definition of "local office" is unreasonable, impractical and needlessly expensive. It is our understanding that only four states have themselves implemented the two-person standard in the past, leaving 46 states with less restrictive standards. Moreover, none of these states, as suggested above, has demonstrated any systematic breaches of responsibility by firms in producing appropriate documentation that would justify such a far reaching change from the current federal requirements. We suggest that the proponents of this major shift in policy and practice bear the burden of proving the need for such a change. This could readily be accomplished by the SEC proposing the standard that the industry supports, as outlined above, in its forthcoming books and records rulemaking release. At a minimum, the SEC should indicate in the release that it recognizes that there may be alternatives that are less burdensome than what NASAA has suggested, that may still achieve the desired public purpose. In any event, most of the proposed changes, even those that the core group of interested industry firms has agreed to, would require significant amounts of time, effort and expense to implement. Therefore, the industry must be given substantial time to comply with all of the changes that may be adopted.

With regard to preserving and furnishing audit and examination reports to securities regulatory and self-regulatory bodies, we continue to believe it essential to preserve adequate incentives for effective self-regulation, and to afford the industry reasonable protections against the risk that confidential information will be inappropriately released to the public. Moreover, there are significantly less burdensome alternatives than the current proposal that would achieve the desired public purpose. We appreciate the opportunity to share these further views with you, and look forward to continuing to work toward a revised books and records proposal that responds to legitimate regulatory and investor protection goals, while preserving the efficiency of current business practices within the industry, and consistency and uniformity between and among our regulators.

Sincerely,

George P. Miller
The Bond Market Association

Judith Poppalardo
Securities Industry Association

Sarah A. Miller
American Bankers Association and ABA Securities Association

cc: Richard R. Lindsey, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Peter R. Geraghty, Assistant Director, Division of Market Regulation

Footnote:

¹ Letter dated December 1, 1997 from Judith Poppalardo, Vice President and Associate General Counsel of the Securities Industry Association, to Michael Macchiaroli, Associate Director, SEC Division of Market Regulation.