[DRAFT – 3/20/07]

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IT HAS NOT BEEN APPROVED BY THE SEC OR ITS STAFF AND IS SUBJECT TO MODIFICATION.

[Securities Industry and Financial Markets Association]

[Date]

Michael A. Macchiaroli, Esq.
Associate Director
Division of Market Regulation
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Agency Lending Disclosure Initiative

Dear Mr. Macchiaroli:

As you know, the Securities Industry and Financial Markets Association[1] ("SIFMA") and its predecessors, the Securities Industry Association and The Bond Market Association, have been engaged in an active dialogue for several years with the staff of the Securities and Exchange Commission (the "Commission" or the "SEC") and other regulators and industry participants regarding the procedures that SEC-registered broker-dealers borrowing securities through intermediaries should follow in order to have adequate information regarding the principals on whose behalf the securities are being loaned. SIFMA is now writing to request the Commission staff's confirmation that it will not recommend enforcement action against SEC-registered broker-dealers that implement these procedures for purposes of complying with the Commission's books and records, net capital, and related requirements, as described below.

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[1] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

I. Background

Broker-dealers frequently borrow securities through an intermediary (the "Agent Lender") that acts as agent on behalf of one or more lenders (the "Principals"). Although broker-dealers may pre-approve the Principals on whose behalf the Agent Lender may lend securities to them, under long-standing securities industry practices for these transactions broker-dealers historically obtained little or no information from the Agent Lender regarding the specific Principal(s) involved in each transaction. Accordingly, broker-dealers would record such transactions on their books and records only on an aggregate basis (i.e., reflecting the Agent Lender as the counterparty), and were unable to determine their credit exposures to individual Principals.

The Commission staff expressed concerns regarding transparency and disclosure under these traditional agency lending arrangements. We understand the Commission staff has determined that for purposes of the Commission's financial responsibility rules, particularly the net capital rule (Rule 15c3-1) and related interpretations, SEC-registered broker-dealers engaged in agency securities lending transactions generally should (i) maintain books and records of their loan activity with each Principal, (ii) monitor credit exposure to each Principal, and (iii) calculate regulatory capital exposure as to each Principal.

In order to address the Commission's concerns, industry representatives began meeting in January 2003 with representatives of the Commission, the New York Stock Exchange, Inc. ("NYSE"), the National Association of Securities Dealers, Inc. ("NASD"), and the Federal Reserve Bank of New York. These discussions led to the formation, in January 2004, of an Agency Lending Disclosure Taskforce (the "Taskforce"), which consisted of representatives of SIFMA and its predecessors as well as the Risk Management Association's Committee on Securities Lending, The Depository Trust & Clearing Corporation ("DTCC"), and technology vendors that support securities lending.[2] The Taskforce worked to develop a consensus among regulatory and industry representatives regarding a uniform set of processes and procedures, and related infrastructure, that would permit disclosure by Agent Lenders of data regarding the Principals involved in each securities lending transaction.[3]

The work of the Taskforce and its consultations with regulators resulted in an agreed set of procedures and requirements (the "Procedures"), outlined in Part II below, that broker-dealers would follow for purposes of their agency securities lending transactions. As

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[2] The Taskforce established five working groups: Regulatory Capital, Credit, Infrastructure, Legal, and Testing. In addition, in May 2004 the Taskforce engaged Capco as a project manager to provide support for the agency lending disclosure initiative.

[3] See NYSE Information Memos 05-39 (June 6, 2005), 06-16 (March 2006) and 06-21 (April 2006); NASD Notice to Members 05-45 (June 2005, updated Dec. 2005); and "Question and Answer Regarding Broker-Dealer Customer Identification Rule (31 CFR 103.122) Responsibilities under the Agency Lending Disclosure Initiative" published by the staffs of the Department of the Treasury and the Commission (http://www.sec.gov/divisions/marketreg/qa-cip.htm).

noted above, the purpose of this letter is to confirm our understanding that compliance by SEC-registered broker-dealers with these Procedures will be deemed adequate for purposes of the Commission rules discussed in Part III below.

II. Procedures

Under the Procedures, a broker-dealer may continue to negotiate and agree to securities loans with Agent Lenders without identifying at the time of the transaction the specific Principals involved. In addition, a broker-dealer may continue to book such transactions without reference to the underlying Principals (i.e., a broker-dealer may book a single contract for a borrowing of securities from the relevant Agent Lender, without identifying or separately booking transactions with each relevant Principal from whom securities are being borrowed). The broker-dealer also may continue to follow existing mark-to-market practices in the securities lending industry pursuant to which certain events – such as certain corporate actions or operational circumstances – may result in a temporary delay in marking securities loans to market.[4]

A broker-dealer relying on the relief requested under this letter, however, would comply with the following requirements:[5]

A. Pre-Approval of Principals. The broker-dealer will obtain from each Agent Lender a written agreement not to lend securities to such broker-dealer on behalf of any Principal unless the broker-dealer has notified the Agent Lender that it has approved such Principal (and has not notified the Agent Lender that it has withdrawn such approval). The broker-dealer shall establish and implement appropriate policies and procedures for performing a credit risk review with respect to the prospective Principal prior to providing any such approval.

In connection with any approval of a prospective Principal, the broker-dealer shall have received from the Agent Lender a data file containing information sufficient for the broker-dealer to identify the prospective Principal for purposes of undertaking the necessary credit risk review.[6] These data files (as well as the Daily Files described below) will be communicated

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[4] These current mark-to-market practices could result in the temporary over- or under-collateralization of loans. Any over-collateralization in excess of applicable thresholds would require net capital charges under Rule 15c3-1. The risk of under-collateralization is reduced by the cushion of excess collateral (102% or 105%) typically provided by the broker-dealer.

[5] Based on discussions between the Taskforce and staff of the SEC, the NYSE and the NASD, broker-dealers generally began following these Procedures on October 2, 2006.

[6] The Taskforce has developed standardized data files that Agent Lenders would use to convey information regarding prospective Principals. Although these files may evolve over time, they currently specify the Principal's name and U.S. tax identification number (or another unique identifier – DTCC has assigned "pseudo" identification numbers to certain parties that do not have a U.S. tax identification number or for whom a tax identification number is not sufficient to uniquely identify the party) and a number of optional fields for additional information that could further assist the broker-dealer in identifying the Principal and performing its credit risk review.

through the facilities of DTCC, through a vendor used by both the Agent Lender and the broker-dealer, or through vendors that have established interoperability with DTCC.

B. Daily Specification of Principal(s) for Each Securities Loan. The broker-dealer will obtain from each Agent Lender a written agreement to provide the broker-dealer a data file (a "Daily File")[7] no later than the close of business on the next business day after the date loaned securities are transferred to the broker-dealer.[8] With respect to each outstanding loan to the broker-dealer, the Daily File shall provide the following information:[9]

(i) Booked Contract Information:

- the identity of the securities loaned by the Agent Lender (e.g., CUSIP, SEDOL, ISIN, etc.);
- the quantity of securities loaned;
- the type of collateral (cash or non-cash) provided to the Agent Lender; and
- if cash collateral is provided, the amount of cash (i.e., the contract value).

(ii) Principal Allocation Information:

- the Principals involved in the transaction;
- the quantity of securities loaned by each Principal;
- the amount of any cash collateral allocated to each Principal;
- the type of non-cash collateral allocated to each Principal; and
  - for securities collateral, the identity and quantity of the securities
  - for a letter of credit, the amount of the letter of credit, and
  - for tri-party non-cash collateral,[10] the value of the collateral, or the percentage of collateral, in the tri-party account allocated to the Principal.

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7 A Daily File may consist of a "Daily Loan Data File" and a "Daily Non-Cash Collateral File" which, collectively, include the information described below.

8 It is currently expected that such data will be transmitted by 3:00 a.m. on such next business day or as soon thereafter as possible. To the extent data is not received prior to any cut-offs or deadlines for reconciling such data on such next business day established under the broker-dealer's systems, policies and procedures, the broker-dealer will perform the required reconciliations with respect to the next Daily File that is received prior to the relevant cut-offs or deadlines for that Daily File. If a broker-dealer does not receive a Daily File from an Agent Lender for five consecutive business days, the broker-dealer will promptly notify its designated examining authority.

9 Currently, the Taskforce's standard files for transmitting this information also specify a number of optional fields for additional information regarding the securities borrowed and the collateral provided by the broker-dealer.

10 "Tri-party" collateral refers to collateral pledged by the broker-dealer to secure securities loans and held in an account of the Agent Lender at a custodian pursuant to a tri-party agreement among the broker-dealer, the Agent Lender and the custodian.

The data from the Daily Files will be maintained and preserved by the broker-dealer as part of its books and records for a period of not less than six years, the first two years in an easily accessible place.[11]

C. Policies and Procedures for Reconciliations. The broker-dealer will review and reconcile data provided by the Agent Lender in the Daily File, as follows:

- Reconciliation of Booked Contract Information: The broker-dealer generally will continue its existing practices and procedures with respect to identifying and resolving discrepancies between the Agent Lender's and the broker-dealer's Booked Contract Information.

- Reconciliation of Principal Allocation Information: The broker-dealer will develop and implement policies and procedures for (i) reviewing daily each Daily File to identify any discrepancies between the Booked Contract Information for a loan and the related Principal Allocation Information provided by the Agent Lender (i.e., whether the sum of the loaned securities and cash collateral in the Principal Allocation Information equals the quantity of loaned securities and cash collateral in the Booked Contract Information), (ii) identifying any material discrepancies and actions to be taken with respect to any such material discrepancies, (iii) identifying recurring patterns of material discrepancies and actions to be taken with respect to such recurring patterns, and (iv) creating a record of any such material discrepancies or recurring patterns and how they were addressed.[12] For purposes of clauses (ii) and (iii) above, the thresholds for determining what is a material discrepancy or recurring pattern, and the actions to be taken, may vary based on the type of discrepancy or pattern.

III. Relief Requested

On behalf of all SEC-registered broker-dealers, we respectfully request the following no-action relief with respect to borrowings of securities through Agent Lenders:

A. Recordkeeping Rules. The Commission staff will not recommend enforcement action under Rule 17a-3(a)(1), (a)(2), (a)(3), (a)(4)(iii), (a)(4)(vi), (a)(5), (a)(6), (a)(7), (a)(8), or (a)(11) against an SEC-registered broker-dealer that borrows securities through

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[11] This may include maintenance and preservation by an outside service bureau, depository, bank, or other recordkeeping service in accordance with Rule 17a-4(i).

[12] We understand that due to systems limitations with respect to the preparation of the Daily Files by Agent Lenders, it is not practicable for Agent Lenders to update a Daily File after it has been delivered to the broker-dealer. Accordingly, discrepancies in a Daily File identified by the broker-dealer to the Agent Lender will not result in any amendments or modifications being made to that Daily File, and would only be reflected (to the extent relevant) in a subsequent Daily File.

an Agent Lender in accordance with the Procedures and records the transaction (and related information) as occurring with the Agent Lender, without identifying or recording separate transactions (and related information) with each Principal; provided that the broker-dealer maintains the data from the Daily Files received from the Agent Lender for a period of not less than six years, the first two years in an easily accessible place. Similarly, the Commission staff will not recommend enforcement action under Rule 17a-13 against an SEC-registered broker-dealer that borrows securities through an Agent Lender in accordance with the Procedures and conducts its quarterly examination, count, verification and comparison pursuant to Rule 17a-13 based on the securities borrowed from, and the collateral provided to, the Agent Lender (rather than based on Principal-level information).[13]

B. Net Capital Rule. The Commission staff will not recommend enforcement action under Rule 15c3-1(c)(1), (c)(2)(iv)(B) (including the "Securities Borrowed Deficits" interpretation at NYSE Interpretation Handbook Rule 15c3-1(c)(2)(iv)(B)/09), (c)(2)(iv)(C), or (c)(2)(iv)(G), or Rule 15c3-1g (Appendix G), against an SEC-registered broker-dealer that borrows securities through an Agent Lender in accordance with the Procedures, if the broker-dealer (and with respect to Rule 15c3-1g, its ultimate holding company) relies on information in the latest Daily File provided by the Agent Lender,[14] in the form provided by the Agent Lender, to determine the amount of securities borrowed from each Principal and the amount and type of collateral provided to such Principal, notwithstanding (i) that the information contained in the Daily Files is based on the Agent Lender's records as of a prior date, or (ii) any inaccuracies in such Daily Files that the broker-dealer may have identified when reconciling the information contained therein.[15]

The following clarifications and interpretations apply for purposes of the foregoing relief:

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[13] For the sake of clarity, since the broker-dealer's stock record and other records referred to above will reflect transactions on an Agent Lender basis only (rather than on a Principal-level basis), we understand that any records, calculations or other determinations that a broker-dealer makes based on the records listed above (other than the net capital calculations described in Part III.B of this letter) will not be expected to include or be based on information regarding each loan on a Principal-by-Principal basis. For example, since the broker-dealer's stock record will not include Principal-level information, Reserve Formula calculations under Rule 15c3-3 derived from the stock record will not include or be based on Principal-level information. As discussed in Part III.B below, however, calculations made pursuant to Rule 15c3-1 (including Appendix G, if applicable) will be based on the Principal-level information in the Daily File.

[14] If a Daily File is not received prior to any cut-offs or deadlines established under the firm's systems, policies and procedures for incorporating such Daily File in the firm's net capital calculations, such calculations will be based on the last Daily File received prior to the relevant cut-offs or deadlines (subject to the alternative procedures described in Part III.B.3 below in the case of month-end capital computations). See also note 8 above.

[15] The broker-dealer's written policies and procedures may include procedures for taking into account certain obvious material errors in the Daily File when determining its net capital charges.

(1) Excess Collateral Charges. When determining whether any capital charges must be taken under NYSE Interpretation Handbook Rule 15c3-1(c)(2)(iv)(B)/09 ("Interpretation (c)(2)(iv)(B)/09"), a broker-dealer would aggregate all excess collateral provided to the same Principal through different Agent Lenders, without reducing any such excess arising with respect to one Agent Lender by a deficit arising with respect to another Agent Lender unless there is a legal right of offset. For example, for purposes of paragraph (a) of Interpretation (c)(2)(iv)(B)/09,[16] a broker-dealer may not reduce the amount of excess collateral provided to a Principal through one Agent Lender by a deficit in the amount of collateral provided to that Principal through another Agent Lender, unless there is a legal right of offset. Similarly, when determining excess collateral for purposes of paragraphs (b) and (c) of Interpretation (c)(2)(iv)(B)/09, a broker-dealer must aggregate all excess collateral provided to a Principal through each Agent Lender, without any reduction for deficits in the amount provided to that Principal through another Agent Lender unless there is a legal right of offset.

(2) Rebates or Interest. The interpretation at NYSE Interpretation Handbook Rule 15c3-1(c)(2)(iv)(C)/081 ("Interpretation (c)(2)(iv)(C)/081") requires that rebates or interest receivable from non-broker-dealers in connection with securities borrowing transactions be deducted in computing net capital unless certain requirements are met. One such requirement is that the rebates or interest receivable are billed "promptly" and not aged more than 30 days from the date they arise. Under current industry practice, rebates or interest related to transactions involving equity securities or corporate bonds are generally billed on a monthly basis, and rebates or interest with respect to transactions involving U.S. Government or agency bonds are generally not billed until after the transaction is closed out. For purposes of Interpretation (c)(2)(iv)(C)/081, (i) rebates or interest will be deemed to have been billed "promptly" if they are billed in accordance with these industry practices (meaning in the case of U.S. Government or agency bonds that they are billed promptly after the close out of the borrow transaction, even if such transaction remains open for several months), and (ii) for purposes of determining whether they have aged more than 30 days, receivables are deemed to arise when they are billed.

(3) Procedures for Month-End Processing. The following procedures may be followed by a broker-dealer for purposes of performing its month-end capital computations if the broker-dealer does not receive a Daily File from an Agent Lender for

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[16] Paragraph (a) generally requires a broker-dealer to determine the amount by which collateral held by any one lender exceeds 105% of the current market value of the securities borrowed from that lender. Paragraph (b) requires a broker-dealer to determine the amount by which excess collateral held by any one lender is greater than 20% of the broker-dealer's excess net capital. Under Interpretation (c)(2)(iv)(B)/09, the broker-dealer must deduct the greater of the amounts determined under paragraphs (a) and (b). Paragraph (c) requires a broker-dealer to take an additional capital charge for the amount by which excess collateral held by all lenders in aggregate exceeds 300% of the broker-dealer's excess net capital (reduced by the charge incurred under paragraph (a) or (b)).

the last business day of the month (or for such other day as of which the broker-dealer closes it's books for the relevant month) (either such day, the "Month-End Date").

First, the broker-dealer may perform its month-end capital computations based on the most recent Daily File received from the Agent Lender for a day that is not more than three business days before the Month-End Date. Alternatively, in order to take into consideration activities that reduce capital charges (e.g., returns and marks-to-market), the broker-dealer (i) must have Daily Files from the Agent Lender for two consecutive business days, the first of which may not be for a day more than three business days prior to the Month-End Date, and (ii) may then base month-end capital computations on the second most recent Daily File received from the Agent Lender (and use the most recent Daily File received to identify activities that may reduce capital charges).

Second, if no Daily File has been received from the Agent Lender for a day not more than three business days before the Month-End Date, the broker-dealer may elect to perform month-end capital computations using the first Daily File it receives for a day not more than three business days after the Month-End Date. In order to take into consideration activities that reduce capital charges (e.g., returns and marks-to-market), the broker-dealer would need to have Daily Files from the Agent Lender for two consecutive business days, and the first such Daily File, which is used for month-end computations, may not be for a day more than three business days after the Month-End Date.

Third, if no Daily Files satisfy the procedures outlined in the previous two paragraphs, the broker-dealer may take one of the following approaches to determine the Daily File it will use for month-end capital computations:[17]

> **Alternative 1:** The broker-dealer may perform capital computations using the Daily File for the day during the relevant month when it had the largest total balance borrowed through the relevant Agent Lender.
>
> **Alternative 2:** The broker-dealer may use the Daily File for the day during the relevant month for which it had the largest initial capital charges at a Principal level from that Agent Lender (i.e., aggregating all capital charges for excess collateral provided to individual Principals lending through that Agent Lender, before applying cures and without reference to loans by such Principals through other Agent Lenders).

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[17] If the broker-dealer has failed to receive a Daily File for the Month-End Date from more than one Agent Lender, the broker-dealer must consistently follow either Alternative 1 or Alternative 2 for any Agent Lender for which the broker-dealer is not using a Daily File based on the procedures outlined in the previous two paragraphs.

After identifying the appropriate Daily File to use for month-end capital computations under Alternative 1 or 2 above, the broker-dealer would then perform such computations in the ordinary course (e.g., applying permissible offsets and using the next business day's Daily File, if available, to take into account cures (e.g., returns and marks-to-market)).

C. Customer Protection Rule. The Commission staff will not recommend enforcement action under Rule 15c3-3(b)(3) or Rule 15c3-3(e) against an SEC-registered broker-dealer that borrows securities through an Agent Lender in accordance with the Procedures and, for purposes of these requirements, treats the Agent Lender as the lender and determines collateralization levels for such securities borrowings by reference to the overall types and amounts of collateral provided to the Agent Lender (rather than the collateral allocated by the Agent Lender to each Principal); provided, that for purposes of any Reserve Formula calculation the broker-dealer applies a credit equal to any excess in the aggregate value of securities borrowed through the Agent Lender over the aggregate value of the collateral provided to the Agent Lender, to the extent that such excess has not been eliminated by the close of business on the business day after the date as of which the Reserve Formula calculation is being made.

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We appreciate your assistance in this matter. If you have any questions, please do not hesitate to contact the undersigned or Robert W. Cook of Cleary Gottlieb Steen & Hamilton LLP, special counsel to SIFMA in this matter, at 202-974-1538.

Sincerely,

Leslie Nelson Managing Director, Goldman, Sachs & Co 212-902-2121	Robert B. Toomey Vice President and Assistant General Counsel, SIFMA 646-637-9224	Marshall Levinson Senior Managing Director, Bear, Stearns & Co. Inc. Chair, SIFMA Capital Committee 212-272-0531

cc: [to be determined]