The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 21148

May 11, 2007

Draft Comment Letter on SEC Proposal to Amend its Financial Responsibility Rules for Broker-Dealers

[21148]

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TO: INST. MONEY MARKET FUNDS ADVISORY COMMITTEE No. 11-07
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 9-07
SEC RULES COMMITTEE No. 45-07 RE: DRAFT COMMENT LETTER ON SEC PROPOSAL TO AMEND ITS FINANCIAL RESPONSIBILITY RULES FOR BROKER-DEALERS

As we previously informed you, the Securities and Exchange Commission has proposed amendments to its financial responsibility rules for broker-dealers under the Securities Exchange Act of 1934. [1] The Institute has prepared a draft comment letter that supports the Commission's proposal to expand the use of money market funds under these rules. The most significant aspects of the draft letter, which is attached, are summarized below.

Comments on the proposal must be filed with the SEC not later than May 18, 2007. If you have any comments on the draft letter, please contact the undersigned at 202-371-5410 or jheinrichs@ici.org.

Expansion of Definition of "Qualified Security" under Exchange Act Rule 15c3-3

Under Rule 15c3-3 of the Exchange Act, a broker-dealer is limited to depositing cash or "qualified securities" [2] into a bank account it maintains to meet its customer reserve deposit requirements ("special reserve account"). To address issues associated with holding and managing a portfolio of U.S. Treasury securities, the proposal would expand the definition of "qualified securities" to include money market funds that only invest in cash or

"qualified securities."

The draft letter strongly supports this aspect of the proposal and notes that permitting the use of money market funds for this purpose is particularly appropriate. Expanding the definition of "qualified security" in this manner would promote numerous cash management efficiencies for broker-dealers without compromising the safety of customer assets or the other customer protections that the financial responsibility rules were designed to effect. The letter also states that money market funds are subject to the strict regulatory requirements of Rule 2a-7 under the Investment Company Act of 1940, which are designed to limit exposure to interest rate, liquidity and credit risk.

Proposal Should be Extended to Include Other Money Market Funds

The draft letter recommends that the proposal be expanded to include money market funds beyond those that invest in U.S. Treasury securities, specifically those money market funds that have received the highest rating from a nationally recognized statistical rating organization ("NRSRO") and those that invest in repurchase agreements that themselves are "collateralized fully" as that term is defined in the Investment Company Act. Permitting these types of money market funds to be used for purposes of Rule 15c3-3 would further address operational difficulties faced by broker-dealers, such as avoiding the need to actively manage a portfolio of U.S. Treasury securities.

The letter states that expanding the proposal to include money market funds that are rated in the highest rating category by an NRSRO would afford investor protections that are even higher than the current standards of Rule 2a-7. Expanding the definition of qualified securities to include money market funds that invest in repurchase agreements that themselves are "collateralized fully" as that term is defined in Rules 2a-7 and 5b-3 under the Investment Company Act also would further the goals of the proposal. The letter states that repurchase agreements are generally recognized by the SEC as having substantially the same safety and investment quality characteristics as the underlying securities to which they relate.

Conditions to Be Considered a "Qualified Security"

Under the proposal, a money market fund eligible for deposit into a broker-dealer's special reserve account must meet several conditions: (i) the money market fund may not be affiliated with the broker-dealer; (ii) the money market fund must agree to redeem fund shares in cash on the next business day; and (iii) the money market fund must have an amount of net assets at least ten times the value of the fund's shares held by the broker-dealer in its special reserve account.

The draft letter recommends that the Commission eliminate the proposed affiliation condition. The letter explains that the Investment Company Act imposes structural

safeguards that limit the extent to which financial problems at the investment adviser or affiliates can impact the fund.

With respect to the proposed redemption period, the draft letter generally supports this condition, but recommends that the Commission include exceptions for situations when there are unscheduled closings of Federal Reserve Banks or registered securities exchanges.

The draft letter states that the proposed concentration requirement is too restrictive in light of the extremely high liquidity of money market funds and the extensive requirements of Rule 2a-7. Instead, the letter recommends the Commission adopt a higher threshold limitation for purposes of Rule 15c3-3 (e.g., 25 percent).

“Haircut” Reduction for Money Market Funds under Exchange Act Rule 15c3-1

The proposal would reduce the “haircut” under Rule 15c3-1 under the Exchange Act that broker-dealers are required to apply to proprietary positions in money market funds from two percent to one percent. Given the safety, stability, and liquidity of money market funds and the strict requirements of Rule 2a-7, however, the letter states that the Commission should lower the haircut for money market funds to zero percent. Alternatively, the letter recommends that a bifurcated haircut scheme be implemented. Bifurcation could, for example, recognize the distinction between Rule 2a-7 money market funds generally, (which would be subject to a haircut greater than zero percent) and money market funds that qualify for deposit in a broker-dealer’s special reserve account under Rule 15c3-3 (which would be subject to a zero percent haircut).

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Attachment

endnotes

[1] See Memorandum to Inst. Money Market Funds Advisory Committee No. 6-07, Money Market Funds Advisory Committee No. 5-07, and SEC Rules Members No. 36-07 [20962], dated March 16, 2007.

[2] Currently, the rule defines “qualified securities” to include investments in securities issued or guaranteed as to principal or interest by the United States (“U.S. Treasury securities”).

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