The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 21298

June 25, 2007

Institute Comment Letter on Amendments to SEC's Financial Responsibility Rules for Broker-Dealers

[21298]

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TO: INST. MONEY MARKET FUNDS ADVISORY COMMITTEE No. 16-07
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 16-07
SEC RULES MEMBERS No. 67-07 RE: INSTITUTE COMMENT LETTER ON AMENDMENTS TO SEC'S FINANCIAL RESPONSIBILITY RULES FOR BROKER-DEALERS

The Institute has filed a comment letter with the Securities and Exchange Commission on proposed amendments to its financial responsibility rules for broker-dealers under the Securities Exchange Act of 1934. [1] The most significant aspects of the comment letter are summarized below and a copy of the letter is attached.

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 solely invest in securities meeting the definition of "qualified securities" in Rule 15c3-3.

The letter strongly supports permitting the use of money market funds for this purpose. The letter 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. Expanding the definition of "qualified security" to include money market funds 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.

Proposal Should be Extended to Include Other Money Market Funds

The letter recommends expanding the proposal to include money market funds that invest exclusively in "first tier" securities as defined under Rule 2a-7. Such an expansion would afford investor protections that are even higher than the current strict standards of Rule 2a-7 and similar to the safety of U.S. Treasury-only money market funds. By expanding the proposal to include money market funds beyond those that only invest in U.S. Treasury securities, there also would be a significant increase in the availability of funds, and, in turn, an increase in liquidity for broker-dealers to satisfy their special reserve account requirements.

The letter recommends that if the Commission determines not to extend its proposal in the manner described above, at the very least, it clarify that shares of money market funds that invest in repurchase agreements collateralized fully by U.S. Treasury securities be considered "qualified securities" for purposes of the broker-dealer responsibility rules. The letter notes that broker-dealers currently utilize repurchase agreements that are collateralized by U.S. Treasury securities in special reserve accounts. Expanding the proposal in this manner would be consistent with the current treatment of repurchase agreements.

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 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 letter generally supports this condition, but it recommends that the Commission include exceptions for unscheduled closings of Federal Reserve Banks or registered securities exchanges.

The 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] For a summary of the proposed amendments, 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”).
