

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200 and 240

[Release No. 34-47480; File No. S7-20-02]

RIN 3235-A151

Customer Protection—Reserves and Custody of Securities; Delegation of Authority to the Director of the Division of Market Regulation

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting an amendment to its broker-dealer customer protection rule. Currently, broker-dealers are required to provide cash, U.S. Treasury bills or notes, or irrevocable bank letters of credit as collateral when borrowing securities from customers. The amendment allows the Securities and Exchange Commission to expand the categories of permissible collateral by order. In addition, the Securities and Exchange Commission is adopting a rule amendment delegating authority to the Director of the Division of Market Regulation to issue such orders.

EFFECTIVE DATE: April 16, 2003.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is adopting amendments to rule 15c3-3¹ under the Securities Exchange Act of 1934 ("Exchange Act") and rule 30-3² of its Rules of Organization and Program Management.

I. Discussion

A. Introduction

On June 10, 2002, the Securities and Exchange Commission ("Commission") proposed amending its broker-dealer customer protection rule, rule 15c3-3, and one of its authority delegation rules, rule 30-3.³ The proposed amendments would allow the Commission to expand the categories of collateral broker-dealers may pledge when borrowing customer securities.⁴ Today, the

Commission is adopting the amendments.

The amendment to rule 15c3-3 provides that broker-dealers may pledge such collateral as the Commission designates by order after giving consideration to the collateral's liquidity, volatility, market depth, and location, and the issuer's creditworthiness. This will give the Commission greater flexibility to impose conditions on the pledging of certain collateral to account for differences among collateral types. This flexibility will permit the establishment of safeguards designed to ensure that the rule's objective—the receipt of full collateral by customers—is not compromised. The amendment also will allow for a wider range of broker-dealer assets to be deemed permissible collateral, thereby adding liquidity to the securities lending markets and lowering borrowing costs for broker-dealers. The amendment to rule 30-3 will allow the Commission to react sooner to changes in the securities lending markets.

B. Background

The Commission adopted rule 15c3-3 in 1972 in response to a congressional directive to create rules regarding, among other things, the acceptance, custody, and use of customer securities.⁵ The rule requires broker-dealers to take steps to protect the securities that customers leave in their custody. These steps include the requirement that broker-dealers promptly obtain and thereafter maintain possession or control of all "fully paid"⁶ and "excess-margin"⁷ securities carried for the accounts of customers⁸ ("customer securities"). The possession or control requirement is designed to ensure that broker-dealers do not put customers at risk by borrowing their

1989. See Exchange Act Release No. 26608 (March 8, 1989), 54 FR 10680 (March 15, 1989). The Commission did not adopt the proposed amendments.

⁵ Exchange Act Release No. 9856 (Nov. 10, 1972).

⁶ Subparagraph (a)(3) of rule 15c3-3 defines "fully paid securities" as securities carried in any type of account for which the customer has made a full payment.

⁷ Subparagraph (a)(5) of rule 15c3-3 defines "excess margin securities" as securities having a market value in excess of 140% of the amount the customer owes the broker-dealer and which the broker-dealer has designated as not constituting margin securities.

⁸ Subparagraph (a)(1) of rule 15c3-3 defines the term "customer." Generally, a customer is any person from whom or on whose behalf the broker-dealer has received or acquired securities for such person's securities account. The definition does not include general partners, directors, or principals of the broker-dealer, or other broker-dealers to the extent of they have proprietary accounts at the broker-dealer.

securities to expand or otherwise further the broker-dealer's proprietary activities.

Paragraph (b)(3) of rule 15c3-3 sets forth conditions under which broker-dealers may borrow fully paid or excess margin securities from customers for their own use without violating the rule's possession or control requirement. These conditions include the requirement that broker-dealers and their lending customers enter into written agreements that (1) set forth the basis of compensation for the loans as well as the rights and liabilities of the parties in the borrowed securities, (2) require the broker-dealers to provide the lenders with schedules of the securities actually borrowed, (3) require the broker-dealers to provide the lenders with, at least, 100% collateral consisting exclusively of cash, United States Treasury bills and notes, or an irrevocable letter of credit issued by a bank, and (4) contain a prominent notice that the provisions of the Securities Investor Protection Act of 1970⁹ may not protect the lenders with respect to the securities loan transactions.¹⁰ Moreover, the loaned securities and pledged collateral must be marked to market daily, and additional collateral posted if necessary to maintain the 100% collateralization requirement.¹¹ These requirements are designed so that borrowings of customer securities remain fully collateralized for the term of the loan.

C. Proposing Release and Comments

In addition to the collateral types currently permitted, the amendment to rule 15c3-3 would allow broker-dealers to pledge such other collateral as the Commission designates by order after giving consideration to the collateral's liquidity, volatility, market depth and location, and the issuer's creditworthiness. The relative weight given these factors will vary on a case-by-case basis. The Commission's orders may impose limitations and conditions on the use of a particular type of collateral depending on its characteristics. This will further the rule's goal of providing customers with full collateral while their loans remain outstanding.

The Commission received three comment letters in response to the proposing release—one from a broker-dealer that engages in borrowings of customer securities,¹² one from a bank

¹ 17 CFR 240.15c3-3.

² 17 CFR 200.30-3.

³ See Exchange Act Release No. 34-46019 (June 3, 2002), 67 FR 39642 (June 10, 2002).

⁴ The Commission proposed amendments to rule 15c3-3 to add certain categories of collateral in

⁹ 15 U.S.C. 78aaa *et seq.*

¹⁰ Rule 15c3-3(b)(3).

¹¹ Rule 15c3-3(b)(3)(iii).

¹² Letter from Morgan Stanley & Co., dated August 7, 2002 ("Morgan Stanley letter").