

III. Proposing Release and Comments

Based upon our experience with the pilot program, we proposed to amend Rule 17a-5(c) to codify the relief we granted in the pilot program.¹⁵ At the same time, we extended the pilot program to June 30, 2003 to allow us time to receive and consider comments on the proposed amendments.

Specifically, the proposed amendments would have permitted a broker-dealer that elected to take advantage of the exemption to send only a "financial disclosure statement" to its customers when it otherwise would have had to send its customers its full balance sheet. This financial disclosure statement consisted of the amount of the broker-dealer's net capital as of the date of the balance sheet the broker-dealer would have sent absent the exemption, the amount of the broker-dealer's required net capital as of that date, and information on how to obtain the broker-dealer's full balance sheet, at no cost to customers, by accessing the broker-dealer's Internet Web site or by calling a toll-free telephone number to promptly obtain the customer's choice of either a paper copy or an electronic copy.

The proposed amendments would have required that the financial information be "given prominence in the materials delivered to customers" and also would have required that, when posting its balance sheet to its Web site, the broker-dealer place a prominent link directly to the balance sheet on any Web page that a customer would typically use to enter the Web site.¹⁶

The proposed amendments would not have allowed a broker-dealer to take advantage of the relief if, during the year prior to the date of the broker-dealer's balance sheet, the broker-dealer was required to provide notice to the Commission of the occurrence of any disqualifying event specified in the rule. Disqualifying events would have included net capital deficiencies, net capital early warning deficiencies, books and records failures, and internal control or financial disclosure inadequacies.

In the Proposing Release, we solicited comment on whether we should codify the no-action relief to allow a broker-dealer taking advantage of the exemption to send its financial disclosure statement with its next mailing of quarterly customer account statements after the expiration of the

time limits prescribed by Rule 17a-5(c) and whether a broker-dealer taking advantage of the exemption should be required to place its balance sheet on its Web site sooner than it is required to send the financial disclosure statement to customers.

We received six comments in response to the proposed rule amendments: four comments from individuals, a comment from an industry representative, and a comment from a broker-dealer that is taking advantage of the exemption.¹⁷ Three individuals were opposed to the proposed amendments. Two of them stated that investors need more information. The third stated that having the full balance sheet sent to each customer was a more "up-front trustworthy approach." One of them suggested that broker-dealers distribute their balance sheets to customers electronically in PDF format. The fourth individual supported the amendments but was concerned that some mutual fund companies might try to use the amendments to raise fund expenses.

The industry representative and broker-dealer taking advantage of the exemption strongly supported the proposed amendments. Both were in favor of codifying the no-action relief to allow a broker-dealer taking advantage of the exemption to send its financial disclosure statement with its next mailing of quarterly customer account statements after the expiration of the time limits under Rule 17a-5(c). The industry representative also proposed requiring a broker-dealer taking advantage of the exemption to place its full balance sheet on its Web site within 90 calendar days after the date of the balance sheet. Under this proposal, the broker-dealer with a fiscal year end of November 30 in the example above that takes advantage of the exemption would be required to place its audited balance sheet on its Web site by February 28.

Since the financial disclosure statement typically consists of less than a half-page of printed material, we also requested comment on whether the statement should be required to be on a separate page, to help make customers

aware that the financial information is included in the materials (which generally include the customer's quarterly account statement) sent to them by their broker-dealer. The only comments we received on that issue were from the industry representative and the broker-dealer taking advantage of the exemption, both of whom were opposed to requiring that broker-dealers taking advantage of the exemption send the financial disclosure statement on a separate page from other materials sent to customers. The industry representative stated that the requirement that the financial information be "given prominence in the materials delivered to customers" provides sufficient guidance for broker-dealers. The broker-dealer taking advantage of the exemption stated that requiring the financial information to be reported on a separate page would add to the expense and paperwork burden on firms taking advantage of the exemption.

IV. Final Rule Amendments

After considering the comment letters, we are adopting rule amendments substantially as proposed. Specifically, pursuant to amended Rule 17a-5(c), a broker-dealer that elects to take advantage of the exemption must send only a "financial disclosure statement" to its customers when it otherwise would have had to send its customers its full balance sheet. The financial disclosure statement consists of the amount of the broker-dealer's net capital as of the date of the balance sheet the broker-dealer would have sent absent the exemption, the amount of the broker-dealer's required net capital as of that date, and information on how to obtain the broker-dealer's full balance sheet, at no cost to customers, by accessing the broker-dealer's Internet Web site or by calling a toll-free telephone number to promptly obtain the customer's choice of either a paper copy or an electronic copy. We are adding a requirement that a broker-dealer taking advantage of the exemption place its full audited balance sheet on its Web site within 90 days after the date of the audited balance sheet and its full unaudited balance sheet on its Web site within 75 days after the date of the unaudited balance sheet.

We solicited comment on whether a broker-dealer taking advantage of the exemption should be required to post its balance sheet on its Web site sooner than it is required to send the financial disclosure statement to customers. In its comments, the industry representative proposed requiring a broker-dealer

¹⁵ Exchange Act Release No. 46920 (Nov. 26, 2002), 67 FR 71909 (Dec. 3, 2002).

¹⁶ Proposed paragraphs (c)(5)(ii) and (iii) of Rule 17a-5.

¹⁷ Division staff has prepared a summary of the comment letters received on the proposed rule amendments entitled "Comment Summary, Broker-Dealer Exemption From Sending Certain Financial Information to Customers" ("Comment Summary"). Copies of the comment letters and Comment Summary have been placed in Public Reference File No. S7-48-02 and are available for inspection in the Commission's Public Reference Room. The commenters are as follows: *Individuals* Carolyn Allen, James Marolda, Keith McCallion, Fred Winkler; *Broker-Dealer* Merrill Lynch, Pierce, Fenner & Smith; *Industry Representative* Securities Industry Association Capital Committee.