

## 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 15c3-3<sup>1</sup> under the Securities Exchange Act of 1934 (“Exchange Act”) and rule 30-3<sup>2</sup> 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.<sup>3</sup> The proposed amendments would allow the Commission to expand the categories of collateral broker-dealers may pledge when borrowing customer securities.<sup>4</sup> 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.<sup>5</sup> 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”<sup>6</sup> and “excess-margin”<sup>7</sup> securities carried for the accounts of customers<sup>8</sup> (“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.

<sup>5</sup> Exchange Act Release No. 9856 (Nov. 10, 1972).

<sup>6</sup> 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.

<sup>7</sup> 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.

<sup>8</sup> 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 their 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 1970<sup>9</sup> may not protect the lenders with respect to the securities loan transactions.<sup>10</sup> 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.<sup>11</sup> 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,<sup>12</sup> one from a bank

<sup>1</sup> 17 CFR 240.15c3-3.

<sup>2</sup> 17 CFR 200.30-3.

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

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

<sup>9</sup> 15 U.S.C. 78aaa *et seq.*

<sup>10</sup> Rule 15c3-3(b)(3).

<sup>11</sup> Rule 15c3-3(b)(3)(iii).

<sup>12</sup> Letter from Morgan Stanley & Co., dated August 7, 2002 (“Morgan Stanley letter”).

that lends its clients' securities to broker-dealers,<sup>13</sup> and a joint letter from two trade associations, which collectively represent broker-dealers, mutual fund companies and banks.<sup>14</sup> All three expressed support for the proposed amendment.<sup>15</sup>

In the proposing release, the Commission requested comment on whether authority to issue orders should be delegated to the Division. Two commenters provided comments on this proposal. Both expressed support for such a delegation of authority.<sup>16</sup>

The Commission identified in the proposing release categories of collateral being considered for an order should the amendment to rule 15c3-3 become effective.<sup>17</sup> It also set forth certain conditions for the use of these collateral types. The Commission sought comment on whether the collateral and conditions were appropriate. All commenters supported the issuance of such an order.<sup>18</sup> The Commission intends to issue an order exempting these collateral types after the amendment becomes effective.

The Commission also sought comment on whether institutional

lenders of securities should be allowed to negotiate collateral agreements other than those required by rule 15c3-3. Two of the commenters responded that the Commission should consider whether the minimum requirements are necessary for certain narrowly defined institutional customers. However, they also urged the Commission to act quickly on the amendment as proposed and not let such consideration delay its adoption.<sup>19</sup> They suggested that any changes to address institutional lenders be accomplished through separate orders or rulemakings. Due to the complexities of the issue and in order to act expeditiously on the proposed amendment, further consideration of any change to the collateral requirements for institutional lenders will be addressed by subsequent Commission action.

#### D. Final Rule

The Commission is adopting a final rule amendment substantially in the form proposed in the proposing release.<sup>20</sup> The amendment adds language to paragraph (b)(3) of rule 15c3-3 providing that broker-dealers may pledge "such other collateral as the Commission designates as permissible by order as necessary or appropriate in the public interest and consistent with the protection of investors after giving consideration to the collateral's liquidity, volatility, market depth and location, and the issuer's creditworthiness." This is in addition to the categories of collateral (cash, U.S. treasury bills and notes, and bank letters of credit) currently permitted.

## II. Paperwork Reduction Act

The Commission stated in the proposing release that the amendment will not require a new collection of information. The amendment does not alter the range of collateral that a broker-dealer can pledge when borrowing customer securities, but instead amends the rule to establish criteria that the Commission will consider when issuing an order allowing additional collateral. The comment letters did not disagree with this assessment. In connection with rule 15c3-3, the Commission previously submitted to the Office of Management and Budget, pursuant to the Paperwork Reduction Act, a request for approval and received an OMB control number for the rule, OMB control number 3235-0078.

<sup>19</sup> See State Street letter; Associations letter.

<sup>20</sup> After the rule becomes effective, the Commission will consider whether to issue an order similar to the draft order included in the proposing release. See footnote 18 and accompanying text.

## III. Costs and Benefits of the Rule Amendments

In the proposing release, the Commission requested comment on the costs and benefits of the amendment to rule 15c3-3. The Commission estimated that the primary benefits of the amendment would be lowered borrowing costs and increased liquidity in the securities lending markets. All three commenters concurred with this estimate.<sup>21</sup> Two commenters also pointed out that the amendment will increase their ability to compete in foreign securities markets.<sup>22</sup>

The Commission estimated that there would not be any direct costs associated with the amendment because of its deregulatory nature. The Commission did not receive any comments on this estimate.

### A. Benefits

The primary benefits of the amendment should be lowered borrowing costs and increased liquidity in the securities lending markets, and greater opportunity for U.S. firms to compete abroad. The current collateral requirements in rule 15c3-3 make it more economical for broker-dealers to borrow securities from other broker-dealers (which are not customers) since customers must be provided with a limited range of collateral. In such a case, the broker-dealer would be limited to borrowing the securities from broker-dealers agreeable to accepting another type of collateral. Expanding the categories of collateral will increase the supply of eligible lenders, which should decrease costs as a consequence of greater competition.

On the other side, customers will have the opportunity to enter into more lending transactions with broker-dealers. This will allow them to earn the fees associated with such transactions and thereby realize greater returns on their securities portfolios. The increased opportunities to borrow and lend securities should add liquidity to the securities lending markets.

<sup>21</sup> See Morgan Stanley letter ("[T]he ability to use these new types of collateral will provide substantially greater flexibility and reduced borrowing costs for U.S. broker-dealers, as well as increased liquidity in the securities markets."); State Street letter ("[T]he prompt issuance of the Final Rule and Collateral Orders will facilitate and promote efficient securities markets, decrease costs, increase competition and enhance the liquidity of securities markets."); Associations letter ("The Associations believe that these collateral types would materially increase liquidity and decrease borrowing costs \* \* \*").

<sup>22</sup> See Morgan Stanley letter; Associations letter.

<sup>13</sup> Letter from State Street Bank and Trust Company, dated July 31, 2002 ("State Street letter").

<sup>14</sup> Letter from The Bond Market Association, and Securities Industry Association, dated July 25, 2002 ("Associations letter").

<sup>15</sup> See Morgan Stanley letter ("We strongly support the proposed amendments to rule 15c3-3 and urge the Commission to adopt them without delay."); State Street letter ("State Street strongly supports and welcomes the Proposed Amendment."); Associations letter ("The Associations fully support the Commission's proposed amendment.").

<sup>16</sup> See Morgan Stanley letter ("[Delegation] will enable the Commission to be more responsive to short-term market conditions—including liquidity crises and settlement failures—as well as longer-term developments, such as evolving approaches to risk management and tightening settlement periods."); State Street letter ("State Street also supports and welcomes the delegation of the Commission's authority to the Division of Market Regulation.").

<sup>17</sup> The categories of collateral identified in the proposing release were: "Government securities" as defined in sections 3(a)(42)(A) and (B) of the Exchange Act; certain "government securities" meeting the definition in section 3(a)(42)(C) of the Exchange Act; securities issued or guaranteed by certain Multilateral Development banks; "mortgage related securities" as defined in section 3(a)(41) of the Exchange Act; certain negotiable certificates of deposit and bankers acceptances; foreign sovereign debt securities; foreign currency; and certain corporate debt securities.

<sup>18</sup> See Morgan Stanley letter ("Morgan Stanley also supports prompt issuance of the Commission's proposed order. Permitting the assets described in the order to be used as collateral for securities borrowing transactions would not, in our view, undermine in any way the Commission's customer protection objectives."). State Street letter; Associations letter ("[T]he conditions specified for each of the collateral types are appropriate to meet the goal of ensuring that borrowings of customer securities remain fully collateralized.").

### B. Costs

There should not be any direct costs associated with the amendment. It will have no impact on broker-dealers that do not borrow customer securities or customers that do not lend securities. For those who participate in such transactions, the amendment is not imposing any changes as to how they must be structured. As described above, it will provide greater opportunities; however, it also maintains the status quo, and therefore, broker-dealers and customers do not have to avail themselves of these new opportunities. Broker-dealers can continue to pledge the types of collateral currently allowed under the rule and, while new categories of collateral may have risk characteristics that differ from those applicable to currently permitted collateral, customers could choose not to accept new categories of collateral.

### IV. Effects on Competition, Efficiency, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, when engaged in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act requires the Commission to consider the impact on competition of any rule proposed under that Act. In addition, the law requires that the Commission not adopt any rule that would impose a burden on competition not necessary or appropriate in the furtherance of the purposes of the Exchange Act.

The Commission stated in the proposing release, and continues to believe, that the proposed amendment should improve efficiency, competition, and capital formation by adding liquidity to the securities lending markets, lowering the costs of borrowing securities, and providing investors with the opportunity to realize greater returns on their securities portfolios. All commenters agreed that the amendment would increase liquidity and lower borrowing costs.<sup>23</sup> In addition, the Commission stated that the amendment should have no anticompetitive effects not necessary or appropriate in furtherance of the purposes of the Act because it will apply equally to all broker-dealers. The Commission did not receive any comments on this assessment of the possibility of anticompetitive effects. Therefore, the Commission believes that the

amendment should have no anticompetitive effects not necessary or appropriate in furtherance of the purposes of the Act.

### V. Regulatory Flexibility Act Certification

Section 3(a) of the Regulatory Flexibility Act<sup>24</sup> requires an agency to undertake an initial regulatory flexibility analysis of the effects of proposed rules and rule amendments on small entities, unless the agency certifies that the rules and rule amendments, if adopted, would not have a significant economic impact on a substantial number of small entities.<sup>25</sup> The Chairman of the Commission has certified that the amendment to rule 15c3-3 would not have a significant economic impact on a substantial number of small entities.<sup>26</sup> The final amendment is identical to the proposed amendment. Accordingly, there have been no changes to the proposal that would alter the basis upon which the certification was made.

### VI. Amendment to Rule 30-3

The Commission has adopted an amendment to rule 30-3 of its rules of Organization and Program Management governing delegations of authority to the Director of the Division of Market Regulation ("Director").<sup>27</sup> The amendment divides paragraph (a)(10) of rule 30-3 into two paragraphs, (a)(10)(i) and (ii). Paragraph (a)(10)(i) now contains the previously existing delegation of authority in paragraph (a)(10), which authorizes the Director to find and designate certain broker-dealer accounts as control locations for the purposes of paragraph (c)(7) of rule 15c3-3.<sup>28</sup> Paragraph (a)(10)(ii) contains a new delegation authorizing the Director, under section 36(a) of the Exchange Act, to exempt types of collateral from certain requirements in paragraph (b)(3) of rule 15c3-3, provided the collateral exempted by the Division has similar characteristics to collateral previously exempted by the Commission.

Section 36(a) provides, in pertinent part, that the Commission may by rule, regulation or order exempt any classes of persons, securities or transactions from any rule or regulation under the Exchange Act, provided the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. The Commission

is delegating to the Director its exemptive authority pursuant to section 36(a) for the limited purpose of exempting collateral types from certain requirements set forth in paragraph (b)(3) of rule 15c3-3.

The delegation of authority to the Director is intended to conserve Commission resources by permitting the staff to review and act on exemptive applications under section 36(a) when appropriate. Nevertheless, the staff may submit matters to the Commission for consideration as it deems appropriate. In addition, under section 4A(b) of the Exchange Act, the Commission retains discretionary authority to review, upon its own initiative or upon application by a party adversely affected, any exemption granted or denied by the Division pursuant to delegated authority. Information concerning the filing of exemptive relief applications can be found in Release No. 34-39624; rule 240.0-12, 17 CFR 240.0-12.

The Commission finds, in accordance with the Administrative Procedure Act, 5 U.S.C. 553(b)(3)(A), that this amendment to rule 30-3 relates solely to agency organization, procedure, or practice. Accordingly, notice and opportunity for public comment, as well as publication 30 days before its effective date are unnecessary. Because notice and comment are not required for this final rule, a regulatory flexibility analysis is not required under the Regulatory Flexibility Act.

The amendment to rule 30-3 does not contain any collection of information requirements as defined by the Paperwork Reduction Act of 1995 as amended. In addition, it will not impose any costs on the public.

### VII. Statutory Authority

The amendments are made pursuant to authority conferred on the Commission by the Exchange Act, including sections 15(c)(3), 23(a) and 36.

### List of Subjects

#### 17 CFR Part 200

Administrative practice and procedure, Authority delegations (government agencies), Organization and functions (government agencies).

#### 17 CFR Part 240

Broker-dealers, Reporting and recordkeeping requirements, Securities.

### Text of Rule Amendments

In accordance with the foregoing, the Commission amends title 17, chapter II of the *Code of Federal Regulations* as follows:

<sup>24</sup> 5 U.S.C. 603(a).

<sup>25</sup> 5 U.S.C. 605(b).

<sup>26</sup> See Proposing Release, 67 FR 39643, Appendix A.

<sup>27</sup> 17 CFR 200.30-3.

<sup>28</sup> 17 CFR 240.15c3-3.

<sup>23</sup> *Id.*

**PART 200—ORGANIZATION;  
CONDUCT AND ETHICS; AND  
INFORMATION AND REQUESTS**

**Subpart A—Organization and Program  
Management**

1. The authority section for Part 200, subpart A, continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77s, 78d-1, 78d-2, 78w, 78ll(d), 78mm, 79t, 77sss, 80a-37, 80b-11, unless otherwise noted.

2. Section 200.30-3 is amended by revising paragraph (a)(10) to read as follows:

**§ 200.30-3 Delegation of authority to  
Director of Division of Market Regulation.**

\* \* \* \* \*

(a) \* \* \*

(10) (i) Pursuant to Rule 15c3-3 (§ 240.15c3-3 of this chapter) to find and designate as control locations for purposes of Rule 15c3-3(c)(7) (§ 240.15c3-3(c)(7) of this chapter) certain broker-dealer accounts which are adequate for the protection of customer securities.

(ii) Pursuant to section 36(a) of the Act (15 U.S.C. 78mm(a)) to review and, either unconditionally or on specified terms and conditions, grant or deny exemptions from the collateral requirements of paragraph (b)(3) of Rule 15c3-3 of the Act (§ 240.15c3-3 of this chapter) for a type of collateral after concluding that the characteristics of such collateral are substantially

comparable to the characteristics of a type of collateral previously exempted by the Commission.

\* \* \* \* \*

**PART 240—GENERAL RULES AND  
REGULATIONS, SECURITIES  
EXCHANGE ACT OF 1934**

3. The authority citation for Part 240 continues to read as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, and 80b-11, unless otherwise noted.

\* \* \* \* \*

4. Section 240.15c3-3 is amended by removing the authority citation following § 240.15c3-3 and revising paragraph (b)(3)(iii) to read as follows:

**§ 240.15c3-3 Customer protection—  
reserves and custody of securities.**

\* \* \* \* \*

(b) *Physical possession or control of securities.* \* \* \*

(3) \* \* \*

(iii) Specifies that the broker or dealer:

(A) Must provide to the lender, upon the execution of the agreement or by the close of the business day of the loan if the loan occurs subsequent to the execution of the agreement, collateral, which fully secures the loan of securities, consisting exclusively of cash

or United States Treasury bills and Treasury notes or an irrevocable letter of credit issued by a bank as defined in section 3(a)(6)(A)-(C) of the Act (15 U.S.C. 78c(a)(6)(A)-(C)) or such other collateral as the Commission designates as permissible by order as necessary or appropriate in the public interest and consistent with the protection of investors after giving consideration to the collateral's liquidity, volatility, market depth and location, and the issuer's creditworthiness; and

(B) Must mark the loan to the market not less than daily and, in the event that the market value of all the outstanding securities loaned at the close of trading at the end of the business day exceeds 100 percent of the collateral then held by the lender, the borrowing broker or dealer must provide additional collateral of the type described in paragraph (b)(3)(iii)(A) of this section to the lender by the close of the next business day as necessary to equal, together with the collateral then held by the lender, not less than 100 percent of the market value of the securities loaned; and

\* \* \* \* \*

By the Commission.

Dated: March 11, 2003.

**Margaret H. McFarland,**

*Deputy Secretary.*

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