



September 11, 2023

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Daily Computation of Customer and Broker-Dealer Reserve Requirements under the Broker-Dealer Customer Protection Rule (File Number S7-11-23); 88 Fed. Reg. 45836 (July 18, 2023)

Dear Ms. Countryman:

Better Markets¹ appreciates the opportunity to comment on the above-captioned Proposed Rule (“Proposal” or “Release”)² to strengthen the protections of Exchange Act Rule 15c3-3, the broker-dealer customer protection rule (“Customer Protection Rule”). The Proposal is a necessary measure to protect customer funds in the event that a broker-dealer fails financially. The Proposal would better ensure that broker-dealers maintain a reserve of funds or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers by requiring that broker-dealers calculate the net cash owed to customers daily rather than weekly.

The purpose of the Customer Protection Rule is to ensure that the customer property in a failed broker-dealer is adequate to satisfy the claims of its customers.³ The rule attempts to achieve this goal by requiring that broker-dealers that maintain custody of customer securities and cash have a special reserve account at a bank that must hold cash or qualified securities in an amount determined by a computation of the net cash owed to the broker-dealer’s customers.⁴ In this way, the rule safeguards the funds broker-dealers owe their customers.

Currently, the Customer Protection Rule requires that broker-dealers calculate the amount of funds they need to deposit into the special reserve account weekly. The problem with this approach is that broker-dealers may receive large cash inflows prior to the next required computation of the amount they need to keep on deposit in their special reserve account. In this situation, the value of the cash or qualified securities in the special reserve account may fall well

¹ Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

² 88 Fed. Reg. 45,836 (July 18, 2023).

³ Michael P. Jamroz, *The Customer Protection Rule*, 57 BUS. LAW. 1069, 1072 (2002).

⁴ The Proposal refers to broker-dealers that maintain custody of customer securities and cash as “carrying broker-dealers,” and the references in this letter to broker-dealers are to these types of broker-dealers.

short of the net cash owed to customers for a period of time. This mismatch poses a risk that the broker-dealer could fail financially and be unable to return all the cash owed to customers. The Proposal reduces the risk of a mismatch between funds owed to customers and funds on deposit in the special reserve account by increasing the frequency with which broker-dealers must calculate and deposit the amount owed to customers, thereby reducing the potential for a prolonged mismatch.

The reduced potential for a mismatch between the funds owed to customers and the funds on deposit in the special reserve account not only reduces the risk that a failing broker-dealer would be unable to return all the cash owed to customers but also reduces the risk that customers would need to be made whole through the Securities Investor Protection Act (“SIPA”), which established the Securities Investor Protection Corporation (“SIPC”) and directed SIPC to establish a fund to satisfy the claims of customers of a failing broker-dealer (“SIPC Fund”). In the event that a broker-dealer failed and was unable to return all the cash owed to customers, the broker-dealer would be liquidated under SIPA, and SIPC would be required to advance money from the SIPC Fund to make customers whole. The Proposal’s determination to increase the frequency of the calculation of funds owed to customers that must be deposited into the special reserve account decreases the risk that SIPC would need to advance funds from the SIPC Fund to satisfy customers’ claims.

For much of its existence, the Customer Protection Rule has proven effective in achieving its mission. But, as the Commission recognizes, the rule must be updated so that it continues to protect investors. The Commission should adopt the Proposal’s requirement that broker-dealers calculate the net cash owed to customers daily and, to the extent the calculation reveals that the funds owed to customers exceed the funds in the reserve account, deposit funds necessary to ensure that the funds in the reserve account meet the funds owed to customers by the next business day. The Commission should also expand the Proposal. The Proposal would require that only broker-dealers with average total credits for the prior twelve months of at least \$250 million perform the required computation daily; the Commission should extend this requirement to all broker-dealers.

BACKGROUND

The Commission adopted the Customer Protection Rule in 1972. It did so in response to the so-called “Paper Work Crisis” that occurred at the end of the 1960s. Over 100 New York Stock Exchange firms failed during that crisis as a result of their inability to deal with increased trading volumes.⁵ The surge in trading volumes created more paper and paperwork than could be handled by the industry.⁶ Broker-dealers were unable to keep up with the physical exchange of paper stock certificates, which led to a sharp decrease in trading volume and stock prices.⁷ The ensuing failure and prolonged bankruptcies of many broker-dealers revealed that many brokerage

⁵ Jerry W. Markham, *Custodial Requirements for Customer Funds*, 8 BROOK. J. CORP. FIN. & COM. L. 92, 100 (2013).

⁶ Walter Werner, *The SEC as Market Regulator*, 70 VA. L. REV. 755, 770 (1984).

⁷ George Tepe, Note, *Broker-Dealer Use of “Idle” Customer Assets: Customer Protection with Sweep Programs and Securities Lending*, 2016 COLUM. BUS. L. REV. 823, 828 n.12 (2017).

firms had lost control of their customers' securities and had used their customers' free credit balances for their own purposes.⁸ As a result, customer securities and funds were lost when the broker-dealers failed.⁹ Investors protected against fraud learned that they were not protected against broker-dealer insolvency. This shook investor confidence in the securities markets.¹⁰

The Paper Work Crisis hastened the development of electronic and centralized clearance and settlement of securities trades. The wave of broker-dealer failures during that period also prompted Congress to enact SIPA, which established SIPC and the SIPC Fund.¹¹ SIPA created a form of insurance for customers to protect them against losses caused by their broker-dealer's insolvency. In the event that a failing broker-dealer does not have sufficient customer funds to return all of the net cash owed to customers, SIPA authorizes SIPC to pay make payments to the customers from the SIPC Fund. The SIPC Fund is funded by assessments on broker-dealers. Although the claims of general creditors of a failing broker-dealer are subordinated to the claims of the broker-dealer's customers, SIPA limits the payments that may be made to each customer of a failing broker-dealer to \$250,000 for cash claims.¹²

Congress also directed the SEC to adopt rules to protect customer funds in the custody of broker-dealers.¹³ These rules "were necessary for 'safeguarding the handling of customer property' and 'to furnish the protection for the integrity of customer funds and securities.'"¹⁴ As a result, the Commission adopted the Customer Protection Rule, which was designed to "insure that customers' funds held by a broker-dealer . . . are deployed in safe areas of the broker-dealer's business relating to servicing his customers, or to the extent that the funds are not deployed in these limited areas, they should be deposited in a reserve bank account."¹⁵ In other words, the Customer Protection Rule gives "specific protection to customer funds" and forbids "broker-dealers from using customer assets to finance any part of their business unrelated to servicing securities customers."¹⁶ So the rule requires that broker-dealers segregate cash from the broker-dealer's proprietary business activities.¹⁷ In this way, customer cash should be readily available to be returned to the customers in the event that a broker-dealer fails financially.¹⁸

⁸ *Id.*; Markham, 8 BROOK. J. CORP. FIN. & COM. L. at 100.

⁹ Markham, 8 BROOK. J. CORP. FIN. & COM. L. at 100.

¹⁰ Werner, 70 VA. L. REV. at 770.

¹¹ Markham, 8 BROOK. J. CORP. FIN. & COM. L. at 100; Werner, 70 VA. L. REV. at 770.

¹² Markham, 8 BROOK. J. CORP. FIN. & COM. L. at 101.

¹³ Tepe, 2016 COLUM. BUS. L. REV. at 828-29; Markham, 8 BROOK. J. CORP. FIN. & COM. L. at 100.

¹⁴ Tepe, 2016 COLUM. BUS. L. REV. at 829 n.13 (citation omitted).

¹⁵ Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. 25,224, 25,224 (Nov. 29, 1972).

¹⁶ Release at 45,837.

¹⁷ *Id.*

¹⁸ *Id.*

A. The Customer Protection Rule attempts to ensure that broker-dealers segregate the cash owed to customers to protect them against loss in the event the broker-dealer fails.

The Customer Protection Rule attempts to ensure that customer cash is available to be returned to customers in the event that a broker-dealer fails financially by requiring that a broker-dealer maintain a reserve of funds or qualified securities in an account at a bank that is at least equal in value to the net cash owed to customers. The account must be titled “Special Reserve Account for the Exclusive Benefit of Customers.” The amount of net cash owed to customers is computed weekly as of the close of the last business day of the week pursuant to a formula set forth in the rule. Basically, the broker-dealer adds up customer credit items and then subtracts from that amount customer debit items. If credit items exceed debit items, the net amount must be on deposit in the customer reserve bank account in the form of cash or qualified securities.¹⁹

If the weekly computation shows that the amount required to be on deposit in the customer reserve bank account is greater than the amount currently on deposit in the account, then the broker-dealer must make a deposit into the customer reserve bank account by 10 am of the second business day following the “as of” date of the new computation. Conversely, if the computation shows that the amount required to be on deposit in the customer reserve bank account is less than the amount currently on deposit in the account, the broker-dealer may withdraw the difference. A broker-dealer is required to make and maintain a record of each computation.²⁰

Through these calculations and deposits, the cash or qualified securities held in the customer reserve bank account should equal or exceed the net cash owed to customers. However, activity subsequent to the customer reserve computation date can result in the broker-dealer having large amounts of additional credit items that do not get accounted for until the next customer reserve computation and that do not get reserved for until the next deposit into the customer reserve bank account. This can lead to a mismatch between the net amount of cash owed to customers and the amount currently on deposit in the customer reserve bank account.²¹

B. The Customer Protection Rule’s current requirement that broker-dealers calculate the cash owed to customers weekly risks a mismatch between the cash on deposit in the reserve bank account and the cash actually owed to customers.

Broker-dealers receive customer cash inflows in connection with various securities transactions, including cash proceeds received from the sales of securities, cash deposited by customers for the purposes of purchasing securities, and monthly or quarterly dividends received on behalf of customers. Cash credited to customers is often quickly reinvested by the customer in securities such as money market mutual funds or securities held by the customer that are subject to dividend reinvestment plans, and it may also be swept out of the customer’s securities account

¹⁹ *Id.* at 45,838.

²⁰ *Id.* at 45,839.

²¹ *Id.*

to a bank or money market mutual fund as part of a program in which customers' free credit balances are automatically invested in the mutual fund or bank deposit product on the prior authorization of the customer. When customers use their free credit balances to invest in securities or bank deposit products, the amount of cash held by the broker-dealer is reduced, and therefore the broker-dealer need not increase the amount on deposit in the reserve bank account.²²

However, broker-dealers may receive large cash inflows that are not deployed for or on behalf of their customers prior to the next required customer reserve computation and the next deposit into the customer reserve bank account. In this situation, the value of the cash or qualified securities in the reserve bank account may not equal the net cash owed to customers for a period of time. For example, if a broker-dealer performs its reserve computation on Monday, and the broker-dealer receives cash inflows on Tuesday, these inflows would not be accounted for until the broker-dealer performs the next reserve computation the following Monday. Consequently, for a number of days, the net amount of cash owed to customers could be greater than the amounts deposited into the reserve bank account. This mismatch poses a risk that during this time the broker-dealer could fail financially and be unable to return all the cash owed to its customers.²³

In this situation, the broker-dealer would be liquidated under SIPA, and SIPC would have to advance money from the SIPC Fund if the fund of customer property was insufficient to make customers whole. The amount that can be advanced to each customer is capped at \$250,000 for cash claims. Therefore, if the mismatch between the amount of net cash owed to customers and the amount on deposit in the reserve bank account is sufficiently large, customers' claims may not be satisfied in full. Such a situation could lead to widespread harm and substantial losses. It could also deplete the SIPC Fund, which could result in the need to increase assessments on SIPC's broker-dealer members to replenish it, with costs potentially being passed on to investors.²⁴

OVERVIEW OF THE PROPOSAL

To address the risk of a mismatch between the amount of net cash owed to customers and the amount on deposit in a broker-dealer's reserve bank account, the Proposal requires broker-dealers with large amounts of total credits to perform the customer reserve computations daily rather than weekly. Specifically, the Proposal requires that a broker-dealer with average total credits for the prior twelve months that are equal to or greater than \$250 million perform the computation necessary to determine the amounts required to be deposited in the customer reserve bank account daily as of the close of the previous business day.²⁵ A broker-dealer that needed to

²² *Id.* at 45,841-45,842.

²³ *Id.* at 45,842.

²⁴ *Id.* at 45,842-45,843.

²⁵ The Proposal provides that a broker-dealer will determine its average total credits by calculating the arithmetic mean of the sum of total credits in the customer reserve computation reported in the twelve most recently filed month-end Financial and Operational Combined Uniform Single ("FOCUS") Reports. *Id.* at 45,844.

make a deposit into the reserve bank account as a result of the computation would have to do so by one hour after the opening of banking business on the next business day.²⁶

COMMENTS

A. The Commission should adopt the requirement that broker-dealers with average total credits equal to or greater than \$250 million perform the reserve computation daily.

1. The daily computation requirement would reduce the risk that broker-dealers would fail financially and be unable to return funds to their customers.

The Proposal recognizes that the Customer Protection Rule needs to be updated. The rule provides crucial protections to the customers of broker-dealers by requiring that broker-dealers segregate the cash owed to their customers from other areas of the broker-dealer's business. In this way, the rule is designed to ensure that broker-dealers can return the funds owed to their customers even if the broker-dealer fails financially. But the rule accomplishes its goal only if broker-dealers know how much cash they owe their customers and therefore how much cash they must segregate in their reserve bank accounts. The Proposal's requirement that broker-dealers with average total credits equal to or greater than \$250 million perform the reserve computation daily reduces the risk that these broker-dealers will have insufficient funds in their reserve bank accounts because these broker-dealers would have to calculate the amount of funds required in their reserve bank accounts every day and make deposits if the daily calculations reveal a shortfall.

No basis exists for not updating the Customer Protection Rule in the way the Proposal envisions. The Commission adopted the weekly computation requirement in 1972. It did so as a result "of a compromise between the industry and the SEC."²⁷ This compromise meant that "customer money balances generally only need[ed] to be segregated weekly."²⁸ But this compromise "was struck in an era of physical securities settlements and has not been updated since."²⁹ The technological advances in securities trading since 1972 mean that broker-dealers no longer need a week to perform the required computations. And because money balances kept at a broker-dealer are exposed to risk until the broker-dealer completes the segregation required by the Customer Protection Rule,³⁰ a requirement that broker-dealers perform the required calculations and complete the required segregations more frequently reduces the potential for customer harm.

The Commission has long recognized the risks inherent in the Customer Protection Rule's current requirement that broker-dealers calculate the net cash owed to their customers only weekly. As far back as 1982, which was only ten years after the Commission first adopted the rule, the Commission acknowledged that there were "serious theoretical and practical limitations" to the

²⁶ *Id.*

²⁷ ABE MASTBAUM, A PRACTICAL GUIDE TO CAPITAL MARKETS, CHAPTER 11 (2016).

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

use of the rule as an adequate measure of a broker-dealer's financial responsibility.³¹ Chief among these limitations were the facts that "the [reserve] computation is made only once a week" and that as a result "the period between one computation and the next required deposit" could be greater than one week.³² The Proposal provides the Commission with the opportunity to mitigate the risk that the Customer Protection Rule's weekly computation requirement creates for customers of broker-dealers; it is in fact overdue, as it comes more than 50 years after the Commission first adopted that requirement and over 40 years after the Commission first recognized that risk. The Commission should adopt the Proposal so that the Customer Protection Rule can accomplish its goal of protecting customers from the failure of their broker-dealers.

2. The daily computation requirement would reduce the risk that customers of a failed broker-dealer would need to be compensated through the SIPC Fund, and that they would receive potentially incomplete recovery as a result.

The Proposal would also help ensure that, in the event a broker-dealer fails financially, customers are made whole through the broker-dealer's own assets, rather than through the SIPC Fund. So long as the assets in the failing broker-dealer's special reserve account are sufficient to return to customers their net cash owed, recourse to the SIPC Fund is unnecessary. This prevents the SIPC Fund from being depleted.³³ And the SIPC Fund needs to be protected because "multibillion dollar claims on SIPC could impair its ability to facilitate the transfer and resolution of securities accounts in a time of crisis"—for example, "a well-capitalized SIPC Fund arguably contributed to the efficient liquidation of Lehman Brothers and MF Global."³⁴ The SIPC Fund must be viewed as a last resort for returning funds owed to customers of failing broker-dealers.

Additionally, even if it were desirable to satisfy customers' claims through the SIPC Fund, it would not always be possible to do so. SIPA only authorizes payments from the SIPC Fund of up to \$250,000 per customer for cash claims. So if the funds in a broker-dealer's special reserve account were insufficient to return all of the net cash owed to customers, and the shortfall exceeded \$250,000 for certain customers' cash claims, those customers would suffer uncompensated losses.

As a result, the Proposal ensures that the SIPC Fund remains a backstop for unsatisfied customer claims rather than the primary means for repaying customers in the event of a broker-dealer failure. This comports with the legislative history of SIPA, which indicates that Congress "considered the SIPC fund less important than industry reform."³⁵ The House Report on the bill stated: "It is clear that the protections to investors provided by the proposed SIPC fund are really only an interim step. The long-range solution to these problems confronting the industry today is going to be found in the ultimate raising of the financial responsibility of the brokerage

³¹ *Net Capital Requirements for Brokers and Dealers*, 47 Fed. Reg. 3512-01, 3514 (Jan. 25, 1982).

³² *Id.*

³³ Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1097 n.136 (1999).

³⁴ Onnig H. Dombalagian, *Substance and Semblance in Investor Protection*, 40 J. CORP. L. 599, 600 (2015).

³⁵ Joo, 72 S. CAL. L. REV. at 1098.

community.”³⁶ The Customer Protection Rule was one of the ways in which the Commission sought to elevate broker-dealers’ financial responsibility. The Proposal represents an important update to the rule so that broker-dealers are financially responsible in a way that protects investors.

B. The Commission should apply the daily computation requirement to all broker-dealers.

The Proposal states that the \$250 million threshold in average total credits is designed to apply the daily computation requirement to broker-dealers that have large amounts of total credits, because these broker-dealers are the ones more likely to experience a mismatch between the net cash owed to customers and the amounts they have on deposit in their reserve bank account.³⁷ But the customer protection rationale for the Proposal applies equally to clients of both large and small broker-dealers. A broker-dealer with less than \$250 million in average total credits that performs the required computation weekly could receive an inflow of funds on the day after it made the computation that would not be accounted for in the amount the broker-dealer was required to have on deposit in its reserve bank account until the next computation the following week, which could result in a mismatch between the net cash owed to customers and the amount on deposit in the reserve bank account for a period of days. This mismatch places the customers of these broker-dealers at risk if the firm fails financially. These customers should not be left in a vulnerable position simply because they have accounts at smaller broker-dealers. Indeed, customers of smaller broker-dealers may be more vulnerable than those of larger broker-dealers, and thus more in need of the protection of the rule, since smaller broker-dealers may be more likely to experience financial stress and therefore the prospect of failing financially. The Commission should adopt the requirement that broker-dealers calculate the reserve computation daily to all broker-dealers.

Requiring that all broker-dealers calculate the reserve computation daily has the advantage of eliminating the need for broker-dealers to monitor their average total credits over a twelve-month period to determine whether they need to perform the computation daily. The Proposal provides that broker-dealers that exceed the \$250 million threshold but then subsequently fall below that threshold may elect to revert to weekly computations after 60 days. But the Proposal provides further that a broker-dealer that exceeds the \$250 million threshold, subsequently falls below the threshold, and then exceeds the threshold again subsequently would have to perform the reserve computation daily. A uniform daily computation requirement avoids the need for broker-dealers to monitor their average total credits and avoids the possibility of vacillating between daily and weekly reserve computations. A uniform daily computation requirement also better protects customers who need the protection that a daily computation provides regardless of whether their broker-dealer is just below or just above the \$250 million threshold.

Applying the daily computation requirement only to brokers that satisfy the bright-line \$250 million threshold (or any threshold) also is a less reliable approach, one that might even prompt evasion. The Proposal notes that, to the extent broker-dealers that are just above the \$250

³⁶ *Id.* (quoting H.R. Rep. No. 91-1613 (1970), reprinted in 1970 U.S.C.C.A.N. 5254, 5266).

³⁷ Proposal at 45,844.

million threshold decide to alter their business to fall below the threshold, the potential benefits of the proposal may be mitigated.³⁸ A uniform requirement that all broker-dealers perform the reserve computation daily eliminates this possibility.

The Proposal acknowledges that switching back and forth between daily and weekly computations for broker-dealers that fluctuate around the \$250 million threshold may be confusing for customers of these broker-dealers, but it states that this concern may be trivial as many customers may be unaware of or unconcerned by the switch.³⁹ That may be, but these customers would undoubtedly be concerned if they suffered losses because their broker-dealer did not have to make daily reserve computations during the period that it was below the \$250 million threshold. Indeed, customers need the protection that a daily reserve computation provides whether or not their broker-dealers hover around the threshold or even fall well below it.

Finally, there can be no credible objections to the Proposal based on feasibility concerns. The plain fact is that broker-dealers, regardless of size, no longer need a week to perform the reserve computation, as they did when the Commission first adopted the Customer Protection Rule in 1972.⁴⁰ The Commission applied that weekly computation requirement to all broker-dealers, and it should do the same with the updated daily requirement.

CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,



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³⁸ Proposal at 45,854.

³⁹ Proposal at 45,855.

⁴⁰ Jamroz, 57 BUS. LAW. at 1096.

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