Public Statement

Joint Statement on No-Action Relief for Non-Compliance with the Customer Protection Rule

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Oct. 23, 2020

Last night, a no-action letter was issued relating to apparent non-compliance by certain broker-dealers with Rule 15c3-3,[1] which is aptly named the "Customer Protection Rule."[2] In short, certain broker-dealers' failure to comply with the Customer Protection Rule puts retail customer funds and securities at risk, and the no-action letter purports to allow this misconduct to continue for up to six additional months.[3] The letter clearly states that these practices are not consistent with the requirements of the Customer Protection Rule. On that point we agree, and it is critical that registrants heed that message.

No-action relief, however, is not the appropriate method to communicate the message in these circumstances. No-action relief is a mechanism that allows registrants to obtain certain assurances when their conduct may touch upon a gray area of regulation, or even may be technically proscribed, but does not raise the policy concerns underlying a particular rule. It is designed to give market participants comfort in continuing a particular course of conduct in areas where clarity is lacking, or participants face potentially conflicting requirements.[4] It should not provide a grace period for compliance with clear violations of law -- especially violations that put investor funds directly at risk. Here, the potential harm to customers arising from the conduct goes to the very heart of the Customer Protection Rule and should be remediated without delay.

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The Commission has become aware that certain broker-dealers are operating programs in which they borrow securities from their retail customers without complying with the specific requirements designed to protect those customers in the event of the broker-dealer's failure.[5] In particular, rather than transferring actual physical possession of collateral to customers, some broker-dealers are seeking to minimize their costs by depositing the required collateral into accounts at the broker-dealer or in omnibus accounts at a bank in the name of the broker-dealer.[6] In the event of a broker-dealer's failure, the firm's control over the collateral means that it may not be

readily accessible by the customer.[7] More importantly, the provisions of the Securities Investor Protection Act ("SIPA"), which are designed to protect customers in the event of a failure, may not apply to the collateral in these circumstances.[8]

Whether these arrangements violate Rule 15c3-3 is not a close call. When a broker or dealer borrows a customer's securities, Rule 15c3-3(b)(3) requires that the broker or dealer deliver collateral which fully secures the loan of securities.[9] In the Adopting Release for this provision, the Commission stated that it "[r]equires the physical possession of the collateral be transferred to the lender or to his appointed agent."[10] Likewise, the Commission stated that the rule will "compel the firm to turn over the collateral physically to the lender."[11] The Commission's focus on physical delivery of collateral in these transactions was meant to prevent the very risk presented by broker-dealers' current practices.

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We appreciate the focus on addressing compliance with the Customer Protection Rule and informing registrants of the need for remediation. We also appreciate and consistently rely upon the depth of experience and expertise of the staff with respect to broker-dealer compliance. However, this is not about declining to defer to the judgment of the staff, because there is no question regarding the violation of the Customer Protection Rule. We would, of course, give serious weight to the staff's views regarding any particular broker-dealer's conduct and how best to handle it. But the question here is whether an extended, across-the-board grace period for such violations should be granted, and that decision falls within the discretion of the full Commission.

In the midst of a historically volatile year for the nation's markets, acquiescing to the continuation of this conduct for up to six months presents an unacceptable risk to investors. This does not mean that enforcement actions are the only, or even the best, option. It may well be appropriate to decline to take action against those who promptly and in good faith remediate. The Commission's longstanding position on this issue could have been re-emphasized in a Risk Alert reminding registrants of the importance of adhering to the Customer Protection Rule and ensuring that retail investor funds receive the full protections afforded under SIPA.

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[1] *See* Letter from Elizabeth Baird to Kris Dailey re: Broker-Dealers Borrowing Fully Paid and Excess Margin Securities from Customers (October 22, 2020), *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-fpl-20201022-15c3-3.pdf ("No-Action Letter).

[2] When the Commission first adopted Rule 15c3-3 in 1972, it stated that its requirements were "well fashioned to furnish the protection for the integrity of customer funds and securities." *See* Broker Dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 9856, 37 Fed. Reg. 25224 (Nov. 29, 1972).

[3] *See* No-Action Letter, *supra* note 1, at 2.

[4] For example, the staff of the Division of Investment Management provided time-limited relief where efforts by broker-dealers to come into compliance with the requirements of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, as implemented by the European Union member states ("MiFID II") might result in non-compliance with the Investment Advisers Act of 1940. *See* Letter from Elizabeth G. Miller to the Securities Industry and Financial Markets Association (October 26, 2017); *see also* Letter from Elizabeth G. Miller and Erin Loomis Moore to the Securities Industry and Financial Markets Association (November 4, 2019) (extending prior relief). In that case, the letter noted that the relief would provide the staff with "time to better understand the evolution of business practices after the implementation of MiFID II…and assess the impact of MiFID II's requirements on the research marketplace and affected participants in order to ascertain whether more tailored or different action is necessary." *Id.* However, in this case, there are no such conflicting requirements, and the rules at issue are well-established and have been in place for several decades.

[5] *See* No-Action Letter, *supra* note 1, at 2. In 2013, the Commission reiterated the general purpose of the Customer Protection Rule, stating that its requirements "are designed to protect customers by segregating their securities and cash from the broker-dealer's proprietary business activities. If the broker-dealer fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed broker-dealer is liquidated in a formal proceeding under the Securities Investor Protection Act of 1970 ('SIPA'), the securities and cash would be isolated and readily identifiable as 'customer property' and, consequently, available to be distributed to customers ahead of other creditors." *See* Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 70072 at 8-9 (July 30, 2013).

[6] *See* No-Action Letter, *supra* note 1, at 1-2. This allows broker-dealers to avoid incurring the expense and challenges associated with, for example, holding the collateral in a third-party account for the benefit of the customer.

[7] *Id.* at 2 ("In either case, during the term of the loan, the collateral must be accessed through the broker-dealer and the broker-dealer has the operational ability to transfer or liquidate the collateral. The written agreement underlying such a program gives the broker-dealer control over the collateral.").

[8] For example, collateral held in a bank account in the name of the broker-dealer may be subject to seizure by a trustee in a SIPC liquidation for distribution to the broker-dealer's creditors. Likewise, by its terms, SIPA protects cash deposited into a brokerage account "for the purpose of purchasing securities." *See* 15 U.S.C. 78lll(2)(B)(i). Cash credited to a customer's account at a broker-dealer as a collateral may not qualify for protection under this definition.

[9] *See* 17 C.F.R. 240.15c3-3(b)(3).

[10] *See* Net Capital Requirements for Brokers and Dealers, Securities Exchange Act of 1934 ("Exchange Act") Release No. 18737 (May 13, 1982), 47 FR 21759, 21768 (May 20, 1982).

[11] *Id.*