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December 24, 2009

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, D.C. 20006

Re: Regulatory Notice 09-63:
Discretionary Accounts and Transactions

Dear Ms. Asquith:

We are responding to the request of the Financial Industry Regulatory Authority ("FINRA") for comments on a proposal to adopt NASD Rule 2510, with some modifications, as FINRA Rule 3260 ("Proposed Rule 3260").

Seward & Kissel represents a number of member firms that offer deposit accounts at depository institutions insured by the Federal Deposit Insurance Corporation ("FDIC") to their customers as an automatic investment, or "sweep," option for customer free credit balances (each a "Bank Deposit Program"). We are concerned that Proposed Rule 3260 does not address bulk transfers between money market mutual funds ("MMFs") offered as sweep investments and deposit accounts offered through a Bank Deposit Program and request that FINRA modify the Proposed Rule 3260 to permit such bulk transfers, subject to appropriate notice and disclosure.

Rule 2510 generally prohibits a member firm from exercising investment discretion over a customer's account without proper authorization from the customer. Section 2510(d) contains an exception for bulk exchanges of customer funds between MMFs used as a sweep investment. Such transfers may be accomplished by a negative response letter sent 30 days prior to the exchange. The letter is required to contain a tabular comparison of the fees charged by each MMF, comparative descriptions of the investment objectives of each MMF and a prospectus of the MMF to be purchased.

FINRA is proposing to adopt Section 2510(d) without substantive change from its current form. If this occurs, Rule 3260 would not address bulk transfers from an MMF to a Bank Deposit Program.

During the last ten years, member firms have added Bank Deposit Programs as a sweep option for customers and, in many cases, replaced MMFs with a Bank Deposit Program as the primary sweep option. Unfortunately, no reliable data exists on the amount of funds swept by member firms through their Bank Deposit Programs, though $500 billion would be a conservative estimate.[1] In addition, our clients uniformly indicate that the amount of funds in their Bank Deposit Programs has increased dramatically since the Fall of 2008, particularly after the net asset value of the Reserve Primary Fund, the Reserve Yield Plus Fund and the Reserve International Liquidity Fund (the "Reserve Funds") dropped below $1.00.

The National Association of Securities Dealers, Inc. ("NASD"), the New York Stock Exchange, Inc. ("NYSE"), the Securities and Exchange Commission ("SEC") and FINRA have acknowledged the prevalence of Bank Deposit Programs. In 2005, the NYSE issued Information Memo 05-11, which addressed issues involving the adoption of new cash sweep programs, including Bank Deposit Programs, and set forth certain procedures concerning the initiation of such programs (*see* "the NYSE IM," below).

In 2006, the staffs of the NASD, NYSE and SEC prepared draft "guidelines" for Bank Deposit Programs to meet the requirements of SEC Rule 15c3-3. The last draft in public circulation is dated August, 2006. The SEC staff is revising these guidelines and has promised to circulate a new draft for review.

In 2007, the SEC proposed amendments to Rule 15c3-3 that would permit bulk transfers from an MMF sweep investment to a Bank Deposit Program (*see* "Proposed SEC Rule," below).

In 2008, FINRA permitted bulk transfers from the Reserve Funds to Bank Deposit Programs without prior customer notice in order to protect customer funds.[2]

Customer Free Credit Balances and Sweep Investments

A customer's free credit balances are funds that have been deposited in the customer's brokerage account by the customer or credited to the account as a result of interest or dividend payments or the sale of securities and that the customer has not directed to a new investment. Rule 15c3-3 under the Securities Exchange Act of 1934 ("Exchange Act") was adopted by the SEC in 1972 in response to market studies that concluded that broker-dealers were using customer free credit balances in their businesses without appropriate protections for

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1 The federal bank regulatory agencies collect quarterly financial data from banks, including data on "brokered deposits" – deposits placed by a "deposit broker" with a bank. This reporting category includes time deposits, savings deposits and transaction accounts. It is, therefore, a broader category of deposits than deposits received through a broker-dealer sweep arrangement. In addition, the FDIC has granted an exception to the definition of brokered deposit to certain broker-dealer sweep programs. As a result, these deposits are not reported as 'brokered" on the quarterly reports and cannot be separately identified.

2 *See* FINRA Regulatory Notice 08-48 (September 2008).

the client.[3] Rule 15c3-3 sets forth specific requirements with respect to how a broker-dealer must maintain customer free credit balances.

Neither Rule 15c3-3, nor any SEC staff interpretation of that Rule, requires a registered broker-dealer to offer a sweep investment option for customer free credit balances or, if a sweep investment option is offered, require the sweep investment to pay a particular rate of return or offer other specific feature.[4] Member firms that offer sweep investments do so as a service to their customers. Some member firms have chosen not to offer sweep investments to their customers.

NASD Rule 2510(d)

In 1992, the NASD, with SEC approval, adopted subsection (d) as an amendment to Rule 2510. The rationale for this amendment can be found in the SEC release approving the amendment, which stated:

> The NASD believes that the use of negative response letters in connection with [the situations described in 2510(d)] should be exempted from the provisions of [Rule 2510] because investment performance is not the primary reason for the fund exchange, and alternative administrative procedures can be extraordinarily burdensome. The NASD believes that the above-described situations are not usually related to the enhancement of the account's financial performance. Abuses of discretion and overreaching, which [Rule 2510] addresses, are therefore unlikely to occur in the three above-described bulk fund exchanges. The NASD also recognizes that it is often necessary to notify hundreds and, sometimes, several thousand money market mutual fund shareowners of an impending money market fund exchange. It may be an extremely difficult, if not impossible, administrative task to contact each of the customers who have failed to respond, and to solicit their approval of the fund exchange. At best, such an individual contact and approval process results in considerable time delays and added cost in effecting the fund exchange.[5]

The SEC and the NASD recognized that a sweep investment is a service provided by a broker-dealer to its customers and that "investment" or "financial" performance are not the

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[3] *See* Exchange Act Release No. 34-9856 (Nov. 10, 1972).

[4] In a related context, the payment of interest by a broker-dealer on client free credit balances, the SEC has stated: "The Commission believes that the payment of interest by broker-dealers on free credit balances that arise as an incidence of customer securities activities is a business matter between a broker-dealer and its customers and normally will not raise regulatory concerns." Exchange Act Release No. 34-18262 (Nov. 17, 1981).

[5] Exchange Act Release No. 34-31558 (Dec. 3, 1992).

primary purposes of sweep investments. For example, the payment of a lower yield by a new MMF does not preclude reliance by a member firm on Rule 2510(d) to conduct a bulk exchange between MMFs. In addition, Rule 2510(d) does not require a member firm to inform customers of other available sweep investment options or whether they can object to the proposed transfer. The SEC and the NASD also recognized that broker-dealers could incur substantial expenses in seeking positive consent from customers. In the context of changing sweep investment options, they concluded that such expense was not warranted.[6]

In 2003, the NASD responded to a request from the Metropolitan Life Insurance Company seeking exemptive relief from Rule 2510 with respect to a proposed bulk exchange between an MMF sweep investment and a deposit account sweep investment.[7] The NASD staff stated that the NASD does not have "general exemptive authority" with respect to NASD Rule 2510 and that the proposed bulk transfer did not fit within the specific terms of Rule 2510(d)(2). The staff stated that it was unable to interpret the exchange of MMF assets described in 2510(d) to include a transfer from an MMF to a Bank Deposit Program because the Rule by its terms did not cover an MMF to Bank Deposit Program transfer.

The NYSE IM

The NYSE did not have a counterpart to Rule 2510(d). However, in 2005, it addressed certain issues related to sweep investments in Information Memo 05-11 (the "IM").

The IM provides guidance concerning the adoption of new cash sweep programs, including Bank Deposit Programs, and is designed to "set out best practices" under NYSE Rules, including Rule 401 (Business Conduct), Rule 472 (Communications with the Public) and equitable principles of trade under Rule 476(a)(6).

The IM addresses a number of issues, including customer disclosure, conflicts of interest, training and record maintenance. The IM also establishes certain conditions for the use of "prior or negative consent" to adopt or amend a sweep plan. The NYSE defines prior or negative consent to mean reliance on "contractual language in customer agreements, which may have been signed before the active implementation of the new program . . ." The IM goes on to state:

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[6] The SEC has also approved the use of a "negative consent" procedure to, *inter alia*, seek the consent of advisory clients to the continuation of an investment advisory contract upon its assignment. *See* Jennison Associates Capital Corp. (Dec. 2, 1983) and Scudder, Stevens & Clark (Feb. 15, 1985). Also, Rule 30d-1 under the Investment Company Act of 1940, which permits "householding" with respect to the delivery of shareholder reports, permits the use of "implied consent" if adequate advance notice is given to investors and they do not object. The NASD permitted members to use negative response letters to conduct the annual verification of an account's status required by NASD Rule 2790 (now FINRA Rule 5130), which restricts the purchase and sale of IPO securities. *See* Notice to Members 03-79 (December 2003).

[7] Letter to Marc A. Cohn, Assistant Vice President, Metropolitan Life Insurance Company, from Sarah J. Williams, Assistant General Counsel, NASD (Feb. 3, 2003).

> The propriety of prior or negative consent depends upon the specific terms of the initial customer agreement and effective subsequent disclosure in view of the nature of the changes being proposed. Changes substantially detrimental to the interests of the customer require more extensive and specific explanation and disclosure than purely ministerial ones. Each change from the original plan must be considered in light of the specific disclosures made and the nature of the proposed changes.

The IM is at odds with Rule 2510(d) and other permissible uses of negative consent, which are not grounded in specific provisions of the customer agreement. [8] The NASD did not issue similar interpretive guidance concerning sweep programs.

Proposed SEC Rule

In March of 2007, the SEC published for comment proposed amendments to its financial responsibility regulations.[9] The proposal included an amendment to Rule 15c3-3 that would add a new section (j) titled "Treatment of Free Credit Balances" (the "Proposed SEC Rule"). The Proposed SEC Rule, if adopted, would permit a broker-dealer to bulk transfer customer funds from an MMF to a Bank Deposit Program using negative consent if certain conditions are met. The Proposed SEC Rule would impose different requirements with respect to customers who have brokerage accounts with a firm before the adoption of the Proposed SEC Rule and customers who open brokerage accounts on or after the adoption of the Proposed SEC Rule. As to both sets of customers:

1. The broker-dealer must provide customers on an ongoing basis with all disclosures and notices regarding the sweep investment required by the self-regulatory organizations;

2. The broker-dealer must provide a notice as part of a customer's quarterly statement that the sweep investment can be liquidated and held as a free credit balance; and

3. The broker-dealer must provide at least 30 calendar days' notice before transferring customer balances from one sweep investment to another. The notice must describe the new sweep investment and how the customer can notify the broker-dealer if the customer chooses not to have the balances transferred to the new sweep investment.

As to new customers (i.e., customers opening accounts after the adoption of the Proposed SEC Rule), the customer must have previously affirmatively consented to the investment of free credit balances and "the applicable terms and conditions that will apply" if the

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[8] *See* footnote 6, *supra*.

[9] Exchange Act Release No. 34-55431 (Mar. 9, 2007).

broker-dealer changes the sweep investment. The broker-dealer would not have to comply with this requirement for customers with accounts at the time the Proposed SEC Rule was adopted.

The Securities Industry and Financial Markets Association ("SIFMA") submitted a comment letter in support of the Proposed SEC Rule as it applies to bulk transfers, but objected to the proposed disclosure on periodic statements. SIFMA stated that the disclosure suggests that a sweep investment is inferior to free credit balances, when in fact sweep investments are intended to offer more favorable returns. In addition, the disclosure implies that customers always have the option of holding their funds as a free credit balance. SIFMA noted that some firms do not offer this option to certain, or all, of their customers. We agree with SIFMA's comments.

The comment period for the Proposed SEC Rule ended on June 18, 2007. To date, the SEC has not acted on the Proposed SEC Rule.

Proposed Rule 3260

It is clear from the above summary that the policies of the NYSE, NASD and SEC concerning bulk transfers between sweep investments are not entirely in harmony. The NASD Rule addressed only transfers among MMFs, and the NASD felt constrained in its interpretive authority despite the broad policy statement in the adopting release. The NYSE imposed limitations on changes to cash sweep programs that were rooted in part in the contract between the firm and its customers and in part on the disparity, if any, in economic terms between the two investments.

In contrast, the SEC's views on these issues, as set forth in the materials accompanying the adoption of Rule 2510(d) and the Proposed SEC Rule, recognize that sweep investments are not the primary financial investment of a firm's customers and are not based on investment performance. The SEC's proposal to permit bulk transfers between an MMF sweep investment and a Bank Deposit Program using negative consent reflects these views.

The same considerations that motivated the adoption of Rule 2510(d) support modification of Proposed Rule 3260 to permit the bulk transfer of MMF assets to a Bank Deposit Program by negative consent:

- Sweeping customer free credit balances to a Bank Deposit Program is a service offered by member firms that they are not required to provide.

- Bank Deposit Programs, like MMFs, offered as a sweep investment are not a customer's primary investment or related to the enhancement of a customer's financial performance.

- The cost to a member firm of obtaining positive consent to a change in sweep investments would be excessive.

In addition, we believe that member firms and their customers need the certainty of a settled policy. Some firms have engaged in bulk transfers solely based on specific provisions of their customer agreements. Other firms have relied on advice from their Financial Coordinators, and different Financial Coordinators have provided different advice. There is no public policy reason for prohibiting a bulk transfer from an MMF sweep investment to a Bank Deposit Program, and every reason for FINRA to eliminate any uncertainty surrounding these transfers while establishing a prudential framework for conducting them.

Due to the difference between an MMF investment and FDIC-insured deposit accounts, we believe that member firms should be required to provide different information to customers in connection with a transfer from an MMF to a Bank Deposit Program, or a transfer from a Bank Deposit Program to an MMF, than in a transfer from an MMF to an MMF. For example, we believe that the member firms should be required to provide a description of the terms and conditions of the Bank Deposit Program and the fees received by the member firm. We also believe it is appropriate to disclose any alternative available sweep investments.

For your convenience we have attached suggested revisions to Proposed Rule 3260 that we ask you to consider adopting. We would be pleased to discuss our views on Proposed Rule 3260 with you, or provide you with additional information.

Thank you for the opportunity to submit these comments.

Very truly yours,

Paul T. Clark

Revision to Proposed Rule 3260

Add the following as 3260(c) and renumber 3260 C as 3260 D.

(C) Effect a transfer of assets from a fund at net asset value to bank deposit accounts used in sweep accounts, or from bank deposit accounts to a fund used in sweep accounts, utilizing negative response letters, provided:

(i) the letter describes the terms and conditions of the deposit account sweep or a copy of the prospectus of the fund to be purchased, as appropriate;

(ii) the letter provides a tabular comparison of the nature and amount of the fees charged by the fund or paid to the firm by the bank or banks;

(iii) the letter discloses alternative available sweep investments, if any, and how the customer can object to the transfer; and

(iv) the negative response feature will not be activated until at least 30 days after the date on which the letter was mailed.

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