UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

May 3, 1985

Mr. David Marcus
Executive Vice President
New York Stock Exchange, Inc.
55 Water Street
New York, NY 10041

Mr. John E. Pinto, Jr.
Senior Vice President
National Association of Securities
Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

Dear Messrs. Marcus and Pinto:

It has come to our attention that certain broker-dealers have entered into agreements with their clearing entities that may be in violation of the Commission's hypothecation rules, Securities Exchange Act Rules 8c-1 and 15c2-1 (17 CFR §§240.8c-1 and 15c2-1).

Paragraph (a)(2) of each rule prohibits "...the direct or indirect hypothecation by a broker or dealer, or his arranging for or permitting, directly, or indirectly, the continued hypothecation of any securities carried for the account of any customer under circumstances... that will permit such securities to be commingled with securities carried for the account of any person other than a bona fide customer of such broker or dealer under a lien for a loan made to such broker or dealer...." This provision is, of course, primarily designed to prevent a broker-dealer from pledging his customers' securities and his own securities to secure the same loan.

Broker-dealers that do business with clearing banks or other entities normally maintain two borrowings with the same lender. The customer loan is used to finance the extension of credit by the broker-dealer to its customers. Customer securities are pledged under the customer bank loan. The firm bank loan is used to finance firm activities and is collateralized by firm securities.

While most broker-dealers provide separate collateral for each loan, we understand that some broker-dealers have entered into clearing agreements whereby the clearing organization has recourse to all securities and other property within that organization's possession or control. This "cross-lien" language makes customer securities available to the clearing entity if the broker-dealer defaults on the firm loan and thus constitutes a violation of the hypothecation rules.

The Commission specifically prohibited this practice when it adopted the hypothecation rules. In Securities Exchange Act Release No. 2690 the Commission noted that in order to avoid such violations of Rules 8c-1 and 15c2-1, "brokers who pledge customers' securities with any pledgee from whom they are also borrowing on their own securities must see to it that the pledgee, whether it be a bank, another broker or any other lender, does not obtain a general or so-called "cross-lien" on customers' securities as additional collateral for other loans which it has made to the broker on his own securities or those of his partners or other broker-dealers. In other words, where a broker pledges customers' securities as well as his own securities with a single pledgee to secure several loans, one or more of which are made against the broker's own securities, it will be necessary that the pledgee does not have a lien upon customers' securities for any loan except other loans also made against securities carried for the account of customers of the same broker."

Any lien of a clearing corporation or other department of a national securities exchange or a registered national securities association for a loan made and to be repaid on the same calendar day which is incidental to the clearing of transactions in securities or loans through the entity is not subject to these restrictions. See, paragraph (e) of the Rule relating to so-called one-way liens.

Furthermore, it will be necessary to see that the lender, unless he is a broker-dealer subject to these Rules, does not have a right to rehypothecate customers' securities commingled with those of the broker or to rehypothecate customer's securities for a sum greater than the loans against those securities.

It should also be noted that where a bank has access to securities carried for the account of customers, the broker-dealer must ensure that the bank may assert no lien against these securities by virtue of a loan to the broker-dealer which is purportedly unsecured or is secured by firm assets other than firm securities.

Please bring these matters to the attention of your members and your examination staff. If you have any questions, please feel free to call.

Sincerely,

Michael A. Macchiaroli
Assistant Director