

April 11, 2008

Michael A. Macchiaroli, Esq.
Associate Director
Securities and Exchange Commission
Division of Trading and Markets
100 F Street, NE
Washington, DC 20549

Dear Mr. Macchiaroli,

As previously discussed with you, FINRA recently issued *Regulatory Notice 08-08* (www.finra.org/Notices/08-08) (the *Notice*) that temporarily increases margin maintenance requirements on Auction Rate Securities (ARS) backed by fixed income products. As stated in the *Notice*, ARS are long-term, variable rate bonds generally issued through a Dutch auction, with interest rates that reset at short-term intervals (usually 7, 28 or 35 days). Although they are issued as long-term bonds, ARS are priced and traded similarly to short-term instruments due to the liquidity that has historically been provided as a result of the periodic interest rate resets. Most ARS are highly rated by at least one Nationally Recognized Statistical Rating Organizations (NRSRO).

FINRA issued the *Notice* in response to recent developments in the market for such securities. Specifically, the auctions for these securities have been failing, as investors, concerned about the current credit market environment, have not been willing to participate in the auctions. As a result, holders of these securities have not been able to liquidate their positions. Due to concerns about the reduced liquidity in these securities, the *Notice* requires member firms to impose a maintenance margin requirement of 25 percent of the current market value for all fixed income ARS, irrespective of whether or not such securities are deemed to be investment grade. Furthermore, with respect to Auction Rate Preferred Securities (ARPS) issued by closed end funds, the *Notice* reminded member firms that such securities are not margin eligible under Regulation T and, hence, 100 percent maintenance margin is required on such securities.

To the extent that member firms choose to extend non-purpose credit to their customers using ARS as collateral, the *Notice* reminds member firms that they must consider the applicable percentage of required maintenance margin when determining any maintenance excess or deficiency in an account. Pursuant to NYSE Rule 431(e)(7)(C), NASD Rule 2520(e)(7)(C), SEC Rules 15c3-1(c)(2)(iv)(B) and 15c3-1(c)(2)(xii), the amount of any deficiency between the equity in the account and the margin required shall be deducted in computing the net capital of the member firm. Based on the foregoing, the amount of any credit extended by a member firm to a customer through a non-purpose

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loan collateralized by ARPS would result in a 100 percent net capital charge for the member firm.

Through discussions with FINRA and your office, SIFMA and member broker-dealers have identified the need to provide liquidity to customers holding ARPS as critical, given the current market conditions, and have requested regulatory relief from the 100 percent margin requirements stated in the *Notice* for ARPS and the requirements of SEC Rule 15c3-1, with respect to the net capital charges required for margin deficiencies. During these discussions, SIFMA and member broker-dealer representatives have made the following arguments and representations in support of their request:

- Due to the current liquidity crisis in the markets, customers who are in need of cash are unable to liquidate their positions in ARPS and will not be able to satisfy their short-term, cash-related obligations (payment of taxes, tuition, etc.).
- Due to the 100 percent margin requirement applicable to ARPS, resulting from their non-margin eligible status, broker-dealers are constrained from extending credit to their customers through non-purpose loans, where the collateral for such loans would be ARPS. This is because they would incur a net capital charge equal to 100 percent of such credit extended, pursuant to FINRA rules and SEC Rule 15c3-1, as previously outlined above. Furthermore, such non-purpose loans would not be includable as a debit item in the customer reserve formula computation.
- Although currently there is limited liquidity in the markets, the underlying credit quality of most issuers has not been affected and the securities are highly rated. Furthermore, member firms stated that banks are willing to extend collateralized loans to broker-dealers, and to receive ARPS as collateral for such loans.

Based upon the foregoing representations, SIFMA and member firm representatives have stated that the requested relief from the requirements of FINRA rules and SEC Rule 15c3-1 is necessary and warranted.

Based on our subsequent discussions with you, it is our understanding that SEC staff is in agreement that FINRA member firms will not be required to apply a net capital charge of 100 percent for, nor to exclude from the customer reserve formula computation (as a debit item), non-purpose loans made to customers that are collateralized by ARPS, provided that all of the following requirements and conditions are met:

1. The ARPS pledged as collateral by the customer to the broker-dealer for the non-purpose loan must be rated in the highest rating category by a NRSRO and must not be subject to credit review by a NRSRO at the time that such credit is extended;
2. The aggregate amount of credit extended on such non-purpose loans to customers is not greater than 25 percent of the broker-dealer's excess net capital, computed

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as of the most recent month end and adjusted for any subsequent material decrease, at the time that such credit is extended;

3. The non-purpose credit extended to any single customer does not exceed 50 percent of the value of the ARPS pledged by the customer as collateral to such loan;
4. A bank loan(s) is obtained by the lending broker-dealer for the aggregate amount of non-purpose loan(s) made to customers to finance the ARPS pledged as collateral by such customers.¹ Such bank loan(s) may only be collateralized by the ARPS pledged by the customer(s). Further, any/all bank loan(s) obtained pursuant to the foregoing must have a remaining maturity term of no less than six months at the time that such credit is extended;
5. The aggregate of all such non-purpose loans shall be considered as a scheduled capital withdrawal under NYSE Rule 326 and NASD Rule 3130, unless otherwise deducted in the computation of net capital;
6. The aggregate amount of the non-purpose loans extended to customers on ARPS that are financed by bank loans as per condition #4 above, should be included as a debit and a credit item in the customer reserve formula computation required by SEC Rule 15c3-3;
7. A broker-dealer must report on a monthly basis to FINRA the aggregate dollar amount of credit extended on these non-purpose loans to customers collateralized by ARPS.

We understand that this relief will be temporary and will be reviewed in consultation with your office for amendment or reconsideration, if and as circumstances may warrant.

Very truly yours,



Krisoula Dailey

¹ As a reminder, pursuant to Section 220.3(g) of Regulation T, a broker-dealer may arrange for the extension of credit to or for any customer, by any person provided the broker-dealer does not willfully arrange credit that violates Regulation U or Regulation X of the Federal Reserve.