

ALEX. BROWN

AMERICA'S OLDEST INVESTMENT BANKING FIRM
ESTABLISHED 1800

A.B. KRONGARD
CHAIRMAN
CHIEF EXECUTIVE OFFICER

410-727-1700

July 31, 1996

The Honorable Arthur Levitt
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Arthur:

As always, I enjoyed meeting you recently to discuss issues of common interest. At the end of our discussion, you suggested that I outline in writing my observations on how technological change is precipitating the need to modernize SEC regulations. I am pleased to do so.

It is axiomatic that technology will continue to change and shape every aspect of modern life at an accelerating pace. Our industry seeks to use that technology in a continuous effort to meet our customers' changing needs. We want to be able to use technology in a responsible and thoughtful way. If the regulators and the industry fail to adapt to these changes, we will find ourselves obsolete. Customers will find their needs met by other industries or will go offshore to unregulated environments. By the same token, I do not think that technology should be an excuse for any party to avoid the important protections of federal securities regulation. Any one who performs the functions of a broker-dealer or other securities professional, should be subject to the same prophylactic rules, even if they offer those services in cyberspace.

Clearly, the Commission has taken a leadership role on the technology issues in recent months. The Commission's interpretive releases on October 6, 1995 (Rel. 33-7233) and May 9, 1996 (Rel. 34-37182) were extremely helpful. The Commission's actions have clarified a number of issues. For example, the ability to deliver prospectuses electronically, as well as fostering an extremely useful discussion among self-regulators on brokerage firm communications is a major step forward. These efforts are critical milestones in an urgent process of modernizing regulation to the needs of modern technology.

SIA will soon file a comment letter on the latter release, setting forth our views in more detail. However, I want to raise with you the following general issues:

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(i) **Electronic Mail** – The industry and the regulators are making substantial progress on the need to alter the regulatory treatment of electronic mail. Until recently, the New York Stock Exchange had taken the view that firms’ supervisors had to review and approve all “e-mail” messages in advance of transmission by the broker to the customer. SIA wrote to your colleague, Commissioner Steven M. H. Wallman, and urged revisions to that rule. Without changes to SEC and SRO rules on communicating with customers and record retention, firms will effectively be blocked from using an ordinary tool of modern communication that offers benefits to customers, firms, regulators and the markets. I believe that firms should have the responsibility to police communication based on the content and audience, not the medium of transmission. The Commission’s May release discussed the issue and urged the self-regulators to address it. As a consequence, the NYSE has had useful conversations with the industry and I understand that changes are forthcoming. I hope the Commission will view this issue favorably when the NYSE files the change formally. I hope that other SROs soon will take similar action.

I also hope the Commission and the industry can work together to produce practical guidelines on retention of e-mail. Firms may have strong business incentives to archive e-mail messages and be able to retrieve them. However, any regulatory mandate regarding whether, the extent to which, and the manner in which firms must retain and retrieve e-mail messages should weigh the cost and the other burdens of such retention and retrieval against the perceived benefits.

(ii) **Record-keeping** – Although the Commission has not yet modernized its rules to accommodate optical disc record-keeping, SEC staff issued a no-action letter in 1993. In an era of optical disc, the Commission recognized that massive amounts of inaccessible and disintegrating paper files helped no one. Unfortunately, technological changes have eclipsed the Commission and the staff’s most recent pronouncements on these issues. I am encouraged by my understanding that the Commission soon will vote on rule changes that permit any technology to be used to retain records, provided certain requirements are met. Firms should have the burden and benefit of deciding whether the technology they select will meet that standard. I do not believe that the Commission should approve specific technologies. SIA has had some very useful conversations with the staff on these issues, and I look forward to a prompt resolution.

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(iii) **Prospectus Delivery** – Shortened settlement cycles, a profusion of investment products, and increasing technological capabilities lead SIA to urge a rethinking of prospectus delivery requirements. I view with increasing urgency the need for Congress to enact S. 1815/H.R. 3005, which would grant the Commission exemptive authority under the Securities Act of 1933. I believe that the Commission should reconsider from a *tabula rasa* who should receive prospectuses for what type of product and which delivery mechanism should be permissible. Certain types of investors may have different needs from other types, and the regulations should be tailored to address those differing needs.

(iv) **Net Capital** – Technological developments make it increasingly imperative that the Commission consider replacing or supplementing the current net capital rule with more sophisticated techniques for determining capital adequacy, including the use of quantitative measures of risk, such as Value-at-Risk models. While in the past the Commission's net capital rule has helped to prevent widespread market disruption in times of financial stress, market participants have developed new methods of measuring and managing risk that have largely antiquated the current rule. A number of studies by research economists have concluded that the traditional measures for judging capital adequacy are imprudent, in many cases requiring excessive capital to support a securities portfolio, while in others failing to require enough. All sorts of financial firms – banks and insurers as well as securities firms – and their customers increasingly employ VAR models as a means of introducing statistical rigor into their measurement of risk. While such models have their limitations and in all cases require the oversight of an informed and alert management, I believe that the failure of the Commission to utilize such tools is a lost opportunity to greatly improve its ability to determine broker-dealer capital adequacy. I ask the Commission to amend its regulations so as to permit the utilization of such techniques.

(v) **NASD Market Surveillance** – I also wish to mention another technological issue that may have significant cost implications for the firms. The NASD currently is proposing to enhance its market surveillance capabilities through expanded audit trail data. Although firms' systems generally capture the relevant data, marrying the data in the format that the NASD wants would require costly systems changes. SIA has formed an *ad hoc* committee to work with the NASD on this proposal. I fully support the NASD's objective of improving market surveillance. However, it is important that the NASD and the industry achieve this goal in a cost effective and

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efficient manner. I am not asking for you to intervene in this process, but merely wish to place it in the larger context of the regulatory and technological challenges facing the industry.

As you know, many of our members are poised to make substantial financial, logistical and procedural commitments to support the technology which will underpin our industry in the future. We continue to look to your leadership to provide guidance in such endeavors.

I hope that this information is helpful to you and more fully explains the points to which I alluded. SIA and I stand ready to work with you on all of these issues.

With best wishes,

Sincerely,

Buzzy

ABK:sgd