



## Securities Industry Association

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June 5, 2006

### **VIA FEDERAL EXPRESS**

Nancy M. Morris, Esq.  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090

Re: Exemption from Section 11(d)(1) for Money Market Funds

Dear Ms. Morris:

The Securities Industry Association (“SIA”)<sup>1</sup> submits this application for an order pursuant to Section 36(a) of the Securities Exchange Act of 1934, as amended (“1934 Act”). In particular, as described below in greater detail, SIA requests an exemption from Section 11(d)(1) of the 1934 Act so that broker-dealers registered pursuant to Section 15 of the 1934 Act can extend to their customers immediate margin on newly purchased, fully paid shares of money market funds that are used as investment vehicles for the broker-dealers’ automatic sweep services and that are registered under the Investment Company Act of 1940, as amended (“1940 Act”).

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<sup>1</sup> The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated \$227.5 billion in domestic revenue and \$305 billion in global revenues. (More information about SIA is available at: [www.sia.com](http://www.sia.com))

We note initially that this request is supported in part by the final rules issued by the Commodity Futures Trading Commission (the “CFTC”) and the SEC on customer margin rules relating to security futures (the “Joint Final Rules”).<sup>2</sup> The Joint Final Rules permit the use of money market fund shares to satisfy margin requirements for security futures and related positions in securities and futures accounts, subject to certain conditions that assist the security futures intermediary’s ability to hypothecate or liquidate the money market fund shares to meet the customer’s clearing obligations, as necessary. In reaching this determination, the SEC and CFTC recognized that, subject to certain conditions imposed under CFTC Rule 1.25, many futures exchanges accept money market fund shares as performance bond deposits for futures and options on futures, and that Regulation T also permits creditors to extend good faith loan value to shares in money market funds carried in a securities account. We believe the Joint Final Rules support our request for relief.

In light of the Joint Final Rules, and for the additional reasons set forth below, we believe that the proposed exemption is necessary and appropriate in the public interest and is consistent with the protection of investors.

## **I. Background and Proposed Arrangement**

Broker-dealers often make available to their customers shares of money market funds which are used as investment vehicles for automatic sweep services that the broker-dealers offer to their customers (“Sweep Funds,” and each a “Sweep Fund”).<sup>3</sup> The Sweep Funds operate in accordance with the strict requirements of Rule 2a-7 under the 1940 Act in order to maintain a stable net asset value of \$1.00 per share.<sup>4</sup>

Broker-dealers do not receive sales commissions or other compensation directly linked to purchases or redemptions of Sweep Fund shares. Rather, broker-dealers typically receive an annualized asset-based fee from the Sweep Funds or their service providers for shareholder and related services. These payments are based, in part, on the expense of operating an automatic sweep program.<sup>5</sup> A Fund typically pays these fees through Rule 12b-1 plans or shareholder service

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<sup>2</sup> See Securities Exchange Act Release No. 46292 (August 1, 2002), 67 Fed. Reg. 53147 (August 14, 2002).

<sup>3</sup> Automatic sweep services enable customers to invest automatically any uninvested cash balances in their brokerage accounts into an interest bearing investment, such as a money market fund. When customers purchase other securities in their accounts, or make payments from the accounts, positions in the interest bearing investment (e.g., shares of the money market fund) are automatically liquidated to cover those transactions.

<sup>4</sup> As noted in each Fund’s prospectus, there is no guarantee that a Fund will be able to maintain a \$1.00 per share net asset value.

<sup>5</sup> Broker-dealers implement and maintain systems and processes to effect nightly “sweeps” (i.e., purchases and redemptions) into and out of the Sweep Funds designated by the client. This sweep feature helps maintain a zero cash balance in the client’s account and ensures that each client’s available cash balance remains fully invested in the money fund. In connection with the sweep program, the broker-dealer must also perform on a daily basis account reconciliation and tracking services, calculate and process the month-to-date dividends and provide same day access to month-to-date accruals. In addition to these Sweep Fund-specific functions, a broker-dealer provides the same recordkeeping, shareholder services and administrative services it performs with respect to position-traded

agreements, or it arranges for other service providers to make such payments. Although these fees vary, they tend to range from 25 basis points (0.25%) to 50 basis points (0.50%) on an annualized basis. In addition, a broker-dealer or its affiliates may provide advisory or other services to a Sweep Fund. Sweep Funds typically pay for these services through asset-based fees. Although these fees vary, they tend to range up to 50 basis points (0.50%) on an annualized basis. Thus, total asset-based fee payments to a broker-dealer and its affiliates relating to a Sweep Fund tend to be no more than 100 basis points (1.00%) per year, and they often are much lower.<sup>6</sup>

Broker-dealers extend credit to their brokerage customers to enable them to purchase or hold securities or to borrow for other permitted purposes. We believe that it is in the public interest and consistent with the protection of investors for brokerage customers to be able to use as margin collateral shares of Sweep Funds that they have owned for less than 30 days. Sweep Fund shares will automatically liquidate to cover any purchase of securities in a margin account, and consequently a broker-dealer would not be extending credit to the customer as a result of that purchase (assuming the Sweep Fund position is sufficient to cover the purchase amount).<sup>7</sup> However, as discussed below, the ability to immediately use Sweep Fund shares as margin collateral would nevertheless benefit brokerage customers.

Currently, consistent with the language of Section 11(d)(1) of the 1934 Act, if a customer purchases new shares of a Sweep Fund, that customer cannot use those shares for purposes of obtaining margin credit until 30 days after the purchase due to the regulatory limits described in the following section of this application. During this 30-day period, the customer's ability to engage in certain securities transactions—specifically, short sales and certain option trading strategies—is reduced because the value of the new Sweep Fund shares cannot be used by the customer as collateral. The requested relief will allow customers to use newly purchased Sweep Fund shares as collateral when engaging in those kinds of securities transactions while continuing to receive the yield on any cash positions invested in the Sweep Fund.

In addition, broker-dealers require margin account customers to meet certain initial margin equity positions when establishing a new margin position in their accounts. Enabling newly purchased Sweep Fund shares to be placed in the customer's margin account immediately would help customers satisfy this requirement.

Further, customers must satisfy additional regulatory and broker-dealer imposed minimum equity and option requirements with respect to options trading strategies in margin accounts. These requirements can change quickly and substantially depending upon the type and nature of the options (e.g., call or put, "covered" or "naked"), the prices of the securities underlying the options (e.g., exchange-listed or OTC company stock, government securities, foreign currencies, interest

mutual funds, such as sub-accounting, tax reporting, distribution of confirmations, prospectuses and other regulatory documents, and responding to client inquiries regarding their Sweep Fund positions.

<sup>6</sup> Certain Funds may have higher expense ratios. As described below, though, these higher expenses have no material impact on our analysis.

<sup>7</sup> The automatic liquidation functionality of Sweep Funds prevents a customer from maintaining a position in Sweep Fund shares to the extent the account has a margin debit balance.

rate contracts, various narrow or broad-based indices) and whether the purchaser of an option is “in the money” or “out of the money” with respect to the option. If the equity in an account that is using these options strategies falls below these minimum equity and option requirements, the requested relief would allow customers to use the newly purchased Sweep Fund shares to help meet those minimums.

## II. Analysis of Proposed Relief

Section 11(d)(1) of the 1934 Act restricts broker-dealers from extending credit on mutual fund shares and other “new issues” in certain circumstances. In relevant part, this provision provides that a person “who is both a dealer and broker” may not extend or arrange for “the extension or maintenance of credit to or for a customer on any security ... which was part of a new issue in the distribution of which he participated as a member of a selling syndicate or group within thirty days prior to such transaction.”

The legislative history of Section 11(d)(1) indicates that it was intended to address the conflict of interest inherent in a situation where a person acts as both a broker and a dealer. For example, one Congressional report states as follows regarding Section 11(d)(1):

There is an inherent inconsistency in a man’s acting both as a broker and a dealer. It is difficult to serve both masters. And it is particularly difficult to give impartial advice to a client if the broker-dealer has his own securities to sell, particularly when they are new securities for which there is no ready market. . . . This strikes at one of the greatest potential evils inherent in the combination of the broker and dealer functions in the same person, by assuring that he will not induce his customers to buy on credit securities which he has undertaken to distribute to the public.<sup>8</sup>

In the context of mutual fund distribution activities, the SEC has observed that “fund shares are often sold with the kinds of sales compensation that could lead to the abuse that prompted the Congress to prohibit the use of credit in the sale of new issues of securities.”<sup>9</sup>

The SEC takes the position that mutual fund shares are always a “new issue” because they are continually offered for sale.<sup>10</sup> Thus, absent an exemption, the extension of credit on mutual fund shares by broker-dealers would be prohibited.

Rule 11d1-2 under the 1934 Act provides an exemption from Section 11(d)(1) regarding the extension of credit on mutual fund shares that have been held by a customer for more than 30 days. Thus, a broker-dealer currently can extend credit on Sweep Fund shares without violating

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<sup>8</sup> H.R. Rep. No. 1383, 73d Cong., 2d Sess. at 15, 22 (1934). *See also* SEC, *Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker* at 56 (1936).

<sup>9</sup> 1934 Act Rel. No. 21577 (December 18, 1984).

<sup>10</sup> *See, e.g., id.*

Section 11(d)(1), provided such shares have been held by the customer for at least 30 days. However, we believe that in the circumstances described herein, there is no public policy reason underlying Section 11(d)(1) that should prevent the extension of such credit prior to the 31<sup>st</sup> day. In addition, certain brokerage customers could benefit by being able to margin Sweep Fund shares prior to the 31<sup>st</sup> day after their issuance. Thus, we believe that the requested relief is necessary and appropriate in the public interest and is consistent with the protection of investors.

For the foregoing reasons, SIA requests an order of exemption from Section 11(d)(1) so as to permit broker-dealers to extend to their brokerage customers margin on shares of the Sweep Funds immediately upon the sale of fully paid Sweep Fund shares to the customers.

If you have any questions regarding this application, please contact the undersigned at 212-618-0509.

Sincerely,

Michael D. Udoff  
Vice President  
Associate General Counsel and  
Secretary

cc: Catherine McGuire, Associate Director/Chief Counsel  
Brian A. Bussey, Assistant Chief Counsel  
Norman M. Reed, Special Counsel