

BEAR STEARNS

BEAR, STEARNS & CO. INC.

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June 3, 1991

Mr. Michael A. Macchiaroli  
Associate Director  
Division of Market Regulation  
Securities & Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549

SECURITIES AND EXCHANGE COMMISSION  
RECEIVED

JUN 04 1991

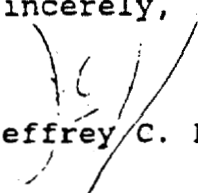
DIVISION OF MARKET REGULATION

Dear Mike:

Enclosed please find the Prime Broker Committee's follow-up letter to our September 13, 1989 letter regarding the applicability of Regulation-T to prime broker transactions. As we discussed, this letter further clarifies certain matters that were included in our previous letter and addresses others that have not yet been discussed.

If you have any questions concerning the attached, please feel free to call.

Sincerely,

  
Jeffrey C. Bernstein

Attachment

JCB/ag

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June 3, 1991

Ms. Laura M. Homer  
Securities Credit Officer  
Division of Banking Supervision and Regulation  
Board of Governors of the  
Federal Reserve System  
20th Street & Constitution Avenue, N.W.  
Washington, DC 20551

SECURITIES AND EXCHANGE COMMISSION

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DIVISION OF MARKET REGULATION

Dear Ms. Homer:

This letter is written on behalf of the Prime Broker Committee (the "Committee") as a follow-up to our September 13, 1989 letter regarding the applicability of Regulation T to prime broker transactions. The Committee consists of representatives from both prime brokers and executing brokers, including Bear, Stearns & Co. Inc., Goldman, Sachs & Co., Morgan Stanley & Co. Incorporated and Paine Webber Incorporated and the Securities Industry Association's Credit Division. As stated in our previous letter, the Committee is requesting an interpretation of Regulation T that would facilitate the continuation of the prime broker business and ensure that it is fair and equitable to all parties involved.

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The Committee was organized to review and evaluate the way in which prime broker transactions currently take place and to recommend appropriate changes to applicable regulations in order to clarify the responsibilities of the parties involved; improve the settlement process; and, reduce unnecessary risk associated with the transactions.

As stated in our September 13, 1989 letter, the Committee requests that the Board issue an opinion substantially in the form set forth below with respect to Section 220.8(c) of Regulation T:

An exception to the 90 day freeze referred to in Section 220.8(c) will be available to an executing broker who has entered into an agreement with a prime broker, substantially in the form of the proposed agreement set forth in Exhibit A (the "Proposal"), with respect to a purchased security which is delivered to a prime broker for deposit in either a cash or margin account.

As you are aware, certain members of the Committee have met with the staffs of the Federal Reserve Board (the "Board") and

the Securities and Exchange Commission (the "SEC") who have raised specific questions in connection with the Proposal. The purpose of this letter is to further clarify certain matters included in our previous letter and to address others that have not yet been discussed. Although some of these are more the concern of the SEC rather than the Board, we felt it appropriate to include them in this letter since we understand that our letters are also being used by the SEC as a basis for their review of the Proposal.

Classification of Transaction

Members of the Committee have received numerous questions concerning the crux of the Proposal, which is, the transformation of the prime broker trade from a customer transaction into a broker-to-broker transaction at the expiration of the disaffirmation period. We would like to take this opportunity to further explain this concept.

The Proposal requires that the executing broker treat the transaction as a standard customer cash transaction settling as if it were a standard delivery vs. payment ("DVP") transaction (with the additional benefit, however, of eliminating settlement uncertainty on T+2). The executing broker must

assume that it may ultimately be responsible for settling the transaction in the standard DVP fashion with the customer's custodian and must therefore ensure that the transaction is suitable at the time of the executing broker's acceptance of the order. In addition, at this point in time, the executing broker must also assume that it will be responsible for compliance with all applicable sections of Regulation T in connection with the transaction.

The Proposal contemplates that the transaction will thereafter be transformed from a customer transaction into a broker-to-broker transaction on the books of the executing broker and the prime broker at a set period in time, i.e., when the disaffirmation period has expired. As stated in the Proposal, the disaffirmation period expires at 5 p.m. New York time, on the second business day after the prime broker receives the executing broker's ID System confirmation. It is at this point that absent disaffirmance, the executing broker will be relieved from its Regulation T responsibility and will thereafter properly look to the prime broker, rather than the customer, to fulfill settlement obligations. If the trade is disaffirmed within the required time period, it will remain a customer transaction with the executing broker.

In summary, if the Proposal is adopted we simply have a customer transaction in which the executing broker is responsible for full Regulation T compliance and is only relieved of such responsibility when the prime broker assumes responsibility for settling the transaction.

We believe this concept provides appropriate protection to the executing broker while staying within the spirit and framework of Regulation T.

#### DSRO Registration

The Committee appreciates that the policy underlying section 220.8(c) of Regulation T is to prevent "free riding" in a cash account. Additionally, the Committee shares the concerns of the staff that there be some means to assure that prime brokers understand and carry out their Regulation T responsibilities with respect to all trades accepted for settlement by the prime broker. For this reason, we propose that, as a condition to utilizing the new procedure, prime brokers register as such with their Designated Self-Regulatory Organization ("DSRO"). In this way, DSRO's can assure that prime brokers adopt policies and procedures designed to comply with applicable regulations and can also review member firm's

compliance therewith. The Committee intends to work with DSRO's on this aspect of the program.

### Short Sales

In formulating the Proposal the Committee was cognizant of the concerns raised by the SEC and the NYSE relating to the allocation of responsibility for compliance with short sale rules. We have therefore included specific requirements in the Proposal which we believe clarify the respective responsibilities of both the prime and executing brokers regarding short sales.

The Proposal requires that an executing broker, before executing a short sale, ensure that either he or the prime broker can borrow the securities and that the trade execution conforms to all applicable regulations. The executing broker will be required to include on the ID System confirmation a notation as to whether the sale is a short or long sale. The prime broker will then be required to notify the executing broker whenever there is a discrepancy between the information indicated on the ID confirmation and the information received from the customer.

Customer Confirmations

Members of the Committee have received several questions concerning compliance with Rule 10b-10, the customer confirmation rule. Since Rule 10b-10 requires disclosure of information which, in many instances, is known only by the executing broker, the Committee believes that the executing broker should be responsible for sending the confirmation. Of course, the executing broker may satisfy the Rule by sending a confirmation directly to the customer or, based on the instructions of the customer, to the customer's attention at another address.

Net Capital and Customer Protection Rules

Although our previous letter did not address the treatment of prime broker transactions under the net capital and customer protection rules, we would like to take this opportunity to describe how we believe these transactions should be treated.

It is our view that once the transaction is transformed from a customer transaction into a broker-to-broker transaction (i.e., after the disaffirmation period has expired), the executing and prime brokers should treat these transactions as



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either a fail to receive or deliver transaction, as applicable, with all the attendant consequences thereof, as specified by applicable SEC rules. This will be a logical consequence of the transformation process and will enable both the executing broker and prime broker to more readily comply with applicable regulations. Thereafter, in accordance with Rule 15c3-3, the prime broker will be responsible for reducing fully-paid or excess margin securities to its possession or control and for effecting compliance with Rule 15c3-3(m) with regard to sales by the customer.

Conclusion

The Committee hopes that this letter further clarifies the Proposal which we believe appropriately details the responsibilities of the executing broker and the prime broker with respect to both settlement and regulatory compliance obligations in a prime broker transaction.

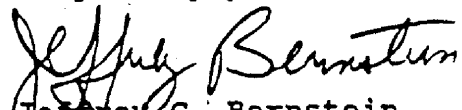
The Committee's goal is to improve business practices in an area which has developed to fill legitimate customer needs with few, if any, problems to date. We believe this goal will be

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realized by the regulatory clarifications sought through the combination of the Board's issuing the opinion requested herein and the issuance of appropriate guidance by the SEC and DSRO's.

The Committee will be happy to discuss the above with you and the SEC in more detail at your convenience.

Very truly yours,

  
Jeffrey C. Bernstein  
On Behalf of the Committee

cc: Securities and Exchange Commission  
William H. Heyman  
Mark D. Fitterman  
Michael A. Macchiaroli

New York Stock Exchange, Inc.

Edward A. Kwalwasser  
Salvatore Pallante  
Raymond J. Hennessy  
Donald van Weezel  
Richard J. Nowicki

Enclosure

JCB/ag

(PRIME BROKER STATIONERY)

Date: \_\_\_\_\_

TO: \_\_\_\_\_  
(Executing Broker)

Our mutual customer \_\_\_\_\_ ("Customer"), your account number (Executing Broker's Customer Account No.), has selected (Prime Broker's Name) ("Prime Broker") as its prime broker. This letter sets forth the terms and conditions upon which we will act as prime broker for Customer.

All orders by Customer must comply with NYSE Rule 387, if applicable. In furtherance thereof, delivery and receipt instructions must specify the Agent Bank No.: (Prime Broker's Number) and our Institution Number: (Prime Broker's Number). The custodial account for Customer is account number (Prime Broker's Customer Account No.). The Tax I.D. number for your customer account shall be our Tax I.D. number: (Prime Broker's Tax I.D.).

We will assume responsibility for settling trades executed by you on behalf of Customer, following receipt of your ID System confirmation, unless written notice of disaffirmance is delivered by hand to you at the address indicated below or transmitted to you by facsimile sending device by 5 p.m., New York time, on the second business day after receipt of your confirmation. If, after our receipt of your ID System confirmation, notice of disaffirmance is not so delivered, both parties will be obligated to settle transactions affirmed by Prime Broker.

As long as this agreement is in effect, and you have complied with your obligations hereunder, we shall be responsible for ensuring that all transactions which we have affirmed and are obligated to complete hereunder, and accordingly appear on our books in either a cash or margin account for Customer, conform to Regulation T and any other applicable margin requirements. Therefore, these transactions are exempt from Section 220.8(c)(1) of Regulation T. In addition, we will be responsible for ensuring that all such transactions are in compliance with Section 11(d)(1) of the 1934 Act.

You will confirm to us, on the ID System confirmation, whether sales executed by you on behalf of Customer are short sales or long sales. We will notify you whether there is a discrepancy between the information we receive from you and the information we receive from Customer. Before you execute a short sale on behalf of Customer, you must ascertain that you or the Prime Broker can borrow such securities and that the trade execution conforms to all applicable regulations governing short sales.

All buy-ins will be executed by either you or us, depending upon which party is failing to receive the securities from the other party, in accordance with the National Association of Securities Dealers Inc.'s broker-to-broker buy-in regulations.

We may terminate this agreement for any reason at any time immediately upon oral or written notice to you. Such termination shall apply with respect to all trades effected after your receipt of such notice. Any oral notice of termination shall be promptly confirmed in writing.

This letter does not affect your obligations with respect to "know your customer", suitability or similar rules relating to customer accounts.

We represent that we have registered, as necessary, with our designated self-regulatory organization, the (Prime Broker's SRO), as a prime broker.

Kindly acknowledge receipt of this letter and acceptance of the terms herein by signing the duplicate in the space provided. A return envelope is enclosed for your convenience.

All prior letters and undertakings in respect of Customer's account are hereby revoked.

Very truly yours,

[Prime Broker's Name]

\_\_\_\_\_  
[Authorized Individual's  
Name and Title]

Accepted and agreed to:

By:

\_\_\_\_\_  
(Authorized Individual's Signature)

\_\_\_\_\_  
(Date)

\_\_\_\_\_  
(Authorized Individual's Name)

\_\_\_\_\_  
(Date)

\_\_\_\_\_  
(Executing Broker's Mailing Address)

\_\_\_\_\_  
(Executing Broker's Facsimile Number)