BROKER-DEALER USE OF "IDLE" CUSTOMER ASSETS: CUSTOMER PROTECTION WITH SWEEP PROGRAMS AND SECURITIES LENDING

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Equity investors, whether hedge funds or retail investors, must trade stocks through broker-dealers, and when these investors are not actively trading, their securities and uninvested cash remain with their broker-dealer. What broker-dealers do with these "idle" customer assets is a vast and largely unexamined business that is a key source of revenue for broker-dealers. This Note provides the first comprehensive examination of the trade-offs in regulating broker-dealer use of idle customer assets through case studies of broker-dealer sweeps of uninvested customer cash, broker-dealer lending of customer margin securities, and the effect of securities lending on customers' shareholder votes.

On one hand, broker-dealer use of idle customer assets potentially increases agency costs and systemic risk by increasing broker-dealer interconnectedness and allowing broker-dealers to profit off customer assets. On the other hand, proper use of idle assets can generate positive outcomes for customers through higher returns and positive social benefits for the general market. This Note proposes and examines potential reforms like increased disclosure and

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reporting requirements that provide better protection for broker-dealer customers.

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I. INTRODUCTION

Equity investors, whether hedge funds or retail investors, must trade stocks through broker-dealers, and when these investors are not actively trading, their securities and uninvested cash remain with their broker-dealer. What broker-dealers do with these "idle" customer assets is a vast and largely unexamined business that is a key source of revenue for broker-dealers. This Note provides the first comprehensive examination of the trade-offs in regulating broker-dealers' use of idle customer assets. Specifically, this Note will discuss broker-dealer sweeps of uninvested customer cash, broker-dealer lending of customer margin securities, and the effect of securities lending on customers' shareholder votes.

Broker-dealers' ability to profit from idle customer assets conflicts with the original intent of Securities and Exchange Commission ("SEC") customer protection regulation, namely "forbidding brokers and dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers."[1] With sweep programs, broker-dealers sweep uninvested customer cash into a bank or money market fund, allowing the broker-dealer and the sweep counterparty to invest and profit from customers' cash.[2] With lending of customer margin securities, broker-dealers lend securities owned by customers in exchange for a fee paid only to the broker-dealer.[3] Surprisingly, customers may not know if and when their margin securities are lent, and, even more surprisingly, a broker-dealer may not know which customer's securities it has lent.[4] With the securities lending market

1 Net Capital Requirements for Brokers and Dealers, 50 Fed. Reg. 2690, 2690 (Jan. 18, 1985) (to be codified at 17 C.F.R. pt. 240).

2 *See infra* Section II.B.

3 *See infra* Section II.C.

4 *Id.*

totaling roughly $1.9 trillion,[5] such broker-dealer practices have large ramifications for the financial sector. In addition, customers whose securities have been lent by their broker-dealer no longer have their shareholder voting rights and could have their proxy votes cancelled by their broker-dealer without their knowledge.[6] How broker-dealers count customer shareholder votes implicates larger debates about the importance of shareholder voting,[7] and previous authors have examined broker-dealer lending of customer securities from the perspective of corporate voting.[8] However, no article has examined canceling shareholder votes through the lens of broker-dealer customer protection.

Broker-dealer use of idle customer assets raises serious questions about the adequacy of current customer protection regulations. Although customers can share in the returns from their idle assets, the fact that broker-dealers and their affiliates retain a significant portion of the profits means that broker-dealer use of idle customer assets creates an agency problem in which broker-dealers may serve their own interests, rather than those of their customers.[9] Moreover, broker-dealer use of idle customer assets increases the

5 FIN. STABILITY OVERSIGHT COUNCIL, 2015 ANNUAL REPORT 56 (2015).

6 *See infra* Section II.D.

7 *See, e.g.*, Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

8 *See, e.g.*, Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1258 (2008).

9 An agency problem occurs when an agent working on behalf of a principal fails to maximize the welfare of the principal. The costs to the principal associated with the agency problem include monitoring and bonding expenditures used to align the incentives of the agent and principal, and the residual loss caused by the divergence between the agent's decisions and the decisions that would maximize the welfare of the principal. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

interconnectedness of broker-dealers and therefore may increase systemic risk. This Note argues that the SEC should require increased disclosures by broker-dealers to allow customers to know when their idle assets are used by their broker-dealer and to better understand the possible agency costs associated with broker-dealer use of their idle assets. Increased disclosure should also facilitate a better-informed market solution to the agency costs associated with these transactions by allowing customers to potentially demand a larger share of the revenue created by the use of their assets or to opt out of these arrangements entirely. This Note also argues that the SEC should collect data on these transactions in order to better understand their systemic risks. Finally, this Note explores whether more invasive regulations like caps on fees and bans on canceling customer proxy votes may be necessary.

Part II of this Note provides an overview of the current regulatory environment surrounding broker-dealer sweep programs and securities lending. Specifically, Part II reviews the SEC customer protection rule, Financial Industry Regulatory Authority's ("FINRA") proposed rules regarding sweep program disclosures, Federal Reserve and FINRA regulations on securities lending, rules about the proxy voting system, and current broker-dealer disclosures and corporate vote reconciliation practices. Part III identifies and describes potential agency costs and systemic risks associated with broker-dealer use of idle customer assets. Part IV presents potential solutions to the agency costs and systemic risks associated with broker-dealer sweep programs and securities lending. Part V offers concluding remarks.

II. BACKGROUND: CUSTOMER PROTECTION RULE, SWEEP PROGRAMS, SECURITIES LENDING, AND CUSTOMER SHAREHOLDER RIGHTS

Broker-dealer customers are protected by a myriad of regulation dating back to the 1970s. This Part examines how customer assets are currently protected by presenting the current regulatory requirements regarding broker-dealer use

of customer assets. Section II.A will provide a brief description of the policy aims underlying the adoption of the SEC customer protection rule. Section II.B will explain broker-dealer sweep programs and associated SEC and FINRA regulations. Section II.C will provide an overview of broker-dealer lending of customer securities and associated Federal Reserve, SEC, and FINRA regulations. Finally, Section II.D will briefly describe the effects on customer shareholder rights when broker-dealers lend customer securities.

A. Adoption of Rule 15c3-3—Policy Aims

SEC Rule 15c3-3, otherwise known as the customer protection rule, is the main regulatory provision that governs the relationship between a broker-dealer and its customers.[10] The key components of the customer protection rule are segregation of customer cash and the requirement that broker-dealers have possession and control of customer securities.[11] The SEC adopted Rule 15c3-3 in 1972 as part of the regulatory response to the paperwork crisis of the late 1960s.[12] The rule was based on an amendment to the

10 17 C.F.R. § 240.15c3-3 (2015).

11 *Id.*

12 Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. 25,224, 25,224–25 (Nov. 29, 1972) (to be codified at 17 C.F.R. pt. 240); Jerry W. Markham, *Custodial Requirements for Customer Funds*, 8 BROOK. J. CORP. FIN. & COM. L. 92, 100 (2013). With increasing trading volume in the 1960s, broker-dealers were unable to keep up with the physical exchange of paper stock certificates, which led to a sharp decrease in trading volume and stock prices. *See* Neal L. Wolkoff & Jason B. Werner, *The History of Regulation of Clearing in the Securities and Futures Markets, and Its Impact on Competition*, 30 REV. BANKING & FIN. L. 313, 317–18 (2010). After the paperwork crisis and the ensuing failure and prolonged bankruptcies of many broker-dealers, Congress enacted the Securities Investor Protection Act of 1970 to increase the protection for customer assets held by a broker-dealer. *See What SIPC Protects*, SEC. INV. PROTECTION CORP., http://www.sipc.org/for-investors/what-sipc-protects [https://perma.cc/7VGN-69MV] (last visited Jan. 31, 2017). Based on this general congressional directive to increase broker-dealer customer

Securities Exchange Act of 1934, which directed the SEC to adopt safeguards respecting the financial responsibility of brokers and dealers concerning customer assets.[13] Rule 15c3-3 is designed "to give more specific protection to customer funds and securities, in effect forbidding brokers and dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers."[14] In other words, SEC regulation separates customer assets from broker-dealers' proprietary trading and quickly returns customer assets should the broker-dealer fail.[15] Moreover,

protection, the SEC adopted Rule 15c3-3 in 1972. Net Capital Requirements for Brokers and Dealers, 50 Fed. Reg. 2690, 2690 (Jan. 18, 1985) (to be codified at 17 C.F.R. pt. 240); *see also* Reserves and Related Measures Respecting the Financial Responsibility of Brokers and Dealers, 36 Fed. Reg. 22,312, 22,312 (Nov. 24, 1971) (codified at 17 C.F.R. pt. 240).

13 Congress and the SEC determined that customer protection regulations were necessary for "safeguarding the handling of customer property" and "to furnish the protection for the integrity of customer funds and securities." Reserves and Related Measures Respecting the Financial Responsibility of Brokers and Dealers, 36 Fed. Reg. at 22,312; Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. at 25,224; *see* Securities Exchange Act of 1934 § 15(c)(3), 15 U.S.C. § 78o(c)(3) (2012).

14 Net Capital Requirements for Brokers and Dealers, 50 Fed. Reg. at 2690; *see also* Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. at 25,224.

15 *See* Customer Protection Rule, 50 Fed. Reg. 11,896, 11,897 (Mar. 26, 1985) (to be codified at 17 C.F.R. pt. 240) ("Rule 15c3-3 was designed to assure that customers' funds (as well as securities) held by broker-dealers are protected against broker-dealer misuse or insolvency."); Amendments to Financial Responsibility Rules for Broker-Dealers, 72 Fed. Reg. 12,862, 12,862 (Mar. 19, 2007) (to be codified at 17 C.F.R. pt. 240) ("The intent of the [customer protection] rule is to require a broker-dealer to hold customer assets in a manner that enables their prompt return in the event of an insolvency, which, in turn, increases the ability of the firm to wind down in an orderly self-liquidation and, thereby avoid the need for a proceeding under the Securities Investor Protection Act of 1970 ('SIPA')."); *Amendments to Financial Responsibility Rules for Broker-Dealers, A Small Entity Compliance Guide*, SEC, https://www.sec.gov/info/smallbus/secg/bd-financial-resp-secg.htm#P9_41 [https://perma.cc/EV4E-A4NU] (last modified Oct. 21, 2013) [hereinafter *A Small Entity Compliance Guide*] ("Rule 15c3-3 essentially requires a broker-dealer that maintains custody of customer securities and cash to segregate such securities and cash from

the first goal stated by the SEC in the 15c3-3 adopting release was:

> To insure that customers' funds held by a broker-dealer . . . and the cash which is realized through the lending, hypothecation and other permissible uses of customers' securities are deployed in safe areas of the broker-dealer's business related to servicing his customers, or to the extent that the funds are not deployed in these limited areas, that they be deposited in a reserve bank account.[16]

Put simply, either broker-dealers should use the profits from idle customer assets, for instance through the lending of customer securities, to cover the cost of servicing the customer, or broker-dealers should return that money to their customers.

B. "Idle" Customer Cash—Sweep Programs

The main protection for customer cash held by broker-dealers is SEC Rule 15c3-3(e), which requires that broker-dealers place all customer cash in a separate bank account titled the "Special Reserve Bank Account for the Exclusive Benefit of Customers" ("Special Reserve Account").[17] To further reduce the risk to this customer cash, the SEC limits the investment of funds in the Special Reserve Account to treasuries.[18] By segregating customer cash into these Special Reserve Accounts and limiting the investment of this cash, the rule bars broker-dealers from using customer cash to finance their proprietary business, and the Securities Investor Protection Corporation ("SIPC") or a bankruptcy

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the broker-dealer's proprietary activities. By segregating customer securities and cash from a firm's proprietary business activities, the rule increases the likelihood that customer assets will be readily available to be returned to customers if a broker-dealer fails.").

16 Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. at 25,224.

17 17 C.F.R. § 240.15c3-3(e) (2015).

18 17 C.F.R. § 240.15c3-3(e)(1); 17 C.F.R. § 240.15c3-3(a)(6) (2015) (definition of "qualified security").

court can quickly return customer cash in the case of a broker-dealer failure.[19]

Broker-dealers can circumvent the requirement to place customer funds into a Special Reserve Account by sweeping customer cash off their books and depositing the funds into either a bank or a money market fund.[20] Rule 15c3-3(e) no longer applies because the broker-dealer no longer holds the cash on its books.[21] Rather than holding customer funds in

19 The Special Reserve Account was designed "in the nature of a trust fund" and "to protect the integrity of customer-generated funds by insulating them against inroads from the broker-dealer's firm activities, whether they be underwriting, market making, other trading, investing or mere speculation in securities, meeting overhead or of any other nature whatever." Reserves and Related Measures Respecting the Financial Responsibility of Brokers and Dealers, 36 Fed. Reg. 22,312, 22,312 (Nov. 24, 1971) (codified at 17 C.F.R. pt. 240). *See also* Customer Protection Rule, 50 Fed. Reg. at 11,897 ("Rule 15c3-3 was designed to assure that customers' funds (as well as securities) held by broker-dealers are protected against broker-dealer misuse or insolvency."); Amendments to Financial Responsibility Rules for Broker-Dealers, 72 Fed. Reg. at 12,862 ("The intent of the [customer protection] rule is to require a broker-dealer to hold customer assets in a manner that enables their prompt return in the event of an insolvency, which, in turn, increases the ability of the firm to wind down in an orderly self-liquidation and, thereby avoid the need for a proceeding under the Securities Investor Protection Act of 1970 ('SIPA')."); *A Small Entity Compliance Guide*, *supra* note 15 ("Rule 15c3-3 essentially requires a broker-dealer that maintains custody of customer securities and cash to segregate such securities and cash from the broker-dealer's proprietary activities. By segregating customer securities and cash from a firm's proprietary business activities, the rule increases the likelihood that customer assets will be readily available to be returned to customers if a broker-dealer fails."); *see also* Net Capital Requirements for Brokers and Dealers, 50 Fed. Reg. at 2690; Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. at 25,225–26.

20 17 C.F.R. § 240.15c3-3(a)(17) (2015); 17 C.F.R. § 240.15c3-3(j)(2)(ii) (2015).

21 17 C.F.R. § 240.15c3-3(j)(2)(ii) (allowing transfer of free credit balances into a product in a sweep program); 17 C.F.R. § 240.15c3-3(e)(1) (2015) (referencing Exhibit A as the computation of the amount required to be deposited into a Special Reserve Account); 17 C.F.R. § 240.15c3-3(a) (requiring counting as a credit free credit balances in the customers'

cash or treasuries, these sweep programs allow counterparty banks and money market funds to invest customer cash in riskier assets for a higher return, and broker-dealers share in these profits by collecting fees from sweep counterparties.[22]

The widespread use of broker-dealer sweep programs led the SEC to adopt customer protection requirements in 2013.[23] Rule 15c3-3 now requires that broker-dealers get affirmative consent from a customer before sweeping their cash.[24] Prior to receiving affirmative consent, broker-dealers must make several disclosures to customers. Specifically, broker-dealers must relay the general terms and conditions of the products available through the sweep program as well as the fact that the broker-dealer maintains the option to change the products available.[25] In exchange for sweeping their cash, customers receive a few basis points of return[26]

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security accounts and no longer treating swept funds as free credit balances in the customers' security account).

[22] 17 C.F.R. § 240.15c3-3(e)(1); *see* SEC Office of Investor Education and Advocacy, *Investor Bulletin: Bank Sweep Programs*, INVESTOR.GOV (June 5, 2014), http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-bank-sweep-programs [https://perma.cc/8WS8-K446] [hereinafter SEC, *Investor Bulletin*] ("Most broker-dealers keep a portion of the interest paid by the bank(s) as a fee for providing bank sweep services.").

[23] Financial Responsibility Rules for Broker-Dealers, 78 Fed. Reg. 51,824, 51,839–42 (Aug. 21, 2013) (to be codified at 17 C.F.R. pt. 240).

[24] 17 C.F.R. § 240.15c3-3(j)(2)(ii)(A); Financial Responsibility Rules for Broker-Dealers, 78 Fed. Reg. at 51,839–42. The SEC gave temporary relief from enforcement of this requirement as long as a customer specifically consented to sweeping their cash and the broker-dealer received affirmative written consent within ninety days. Securities Industry and Financial Markets Association ("SIFMA"), SEC No-Action Letter, 2014 WL 767976 (Feb. 26, 2014). This temporary relief was originally granted from March 3, 2014 through March 3, 2015. *Id*. This temporary relief was subsequently extended until September 30, 2015. Securities Industry and Financial Markets Association ("SIFMA"), SEC No-Action Letter, 2015 WL 496395 (Feb. 5, 2015).

[25] 17 C.F.R. § 240.15c3-3(j)(2)(ii)(A).

[26] For example, on January 27, 2017, the annual percentage yield paid by Fidelity on funds swept into a bank was 0.07%, and the 7-day yield on funds swept into a government money market fund was 0.19%. *Interest*

and Federal Deposit Insurance Corporation ("FDIC") protection for funds swept into a bank.[27] Additionally, these sweeps can be returned to the broker-dealer on demand by customers subject to any restrictions on withdrawal by the bank or money market fund.[28] Upon sweeping customer funds, the broker-dealer must make quarterly disclosures regarding the balance in the bank deposit account or the amount of shares held in the money market fund and must state that the customer can liquidate the balance or shares on demand.[29] In short, current SEC rules regarding sweep programs protect customers by ensuring that they are

Rate for the Fidelity Cash Management Account, FIDELITY INVESTMENTS, fidelity.com/FCMACoreRates [https://perma.cc/SS4M-DVE9] (last visited Jan. 27, 2017).

27 *See* SEC, *Investor Bulletin*, *supra* note 22 ("Cash swept into deposit accounts through bank sweep programs is covered by FDIC insurance up to the $250,000 limit per customer at each FDIC-Insured bank that participates in the bank sweep program.").

28 Withdrawals could be barred after a failure of the bank money market fund. In addition, based on the recent SEC money market fund reform, money market funds can bar redemptions or place a fee on redemptions in times of stress. *See Frequently Asked Questions Concerning the Amendments to Certain Broker-Dealer Financial Responsibility Rules* SEC, https://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-financial-responsibility-rule-faq.htm [https://perma.cc/359L-MJUT] (last modified Mar. 6, 2014) [hereinafter *SEC FAQ Concerning Amendments*]. ("A broker-dealer that sweeps a customer's free credit balances to a money market mutual fund must instruct the fund to redeem the customer's investment when ordered to do so by the customer and, when the broker-dealer receives the proceeds, return them to the customer's account or remit them to the customer. The redemption itself, however, is subject to the terms and conditions of the money market mutual fund and to applicable law and regulation."); Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47,736, 47,736 (Aug. 14, 2014). (to be codified at 17 C.F.R. pts. 230, 239).

29 17 C.F.R. § 240.15c3-3(j)(2)(ii)(B) (2015). In addition, the broker-dealer must give thirty days notice before changing the terms and conditions of the sweep program, changing the terms and conditions of products currently available through the sweep program, changing the products available through the sweep program, or changing the customer's investment through the sweep program. *See SEC FAQ Concerning Amendments, supra* note 28.

informed about the sweep program before their funds are swept.

Although FINRA has not finalized its rules regarding broker-dealer sweep programs, in June of 2015 it announced proposed rule changes that would supplement the current requirements for broker-dealers.[30] As proposed, all future letters to customers regarding transferring customer funds into a sweep program or between products in a sweep program would have to include the current interest rates applicable to the sweep program, the manner by which future interest rates will be determined, and the nature as well as the extent of SPIC and FDIC insurance available.[31] Moreover, these letters would be required to state the entity that the customer should contact should the customer wish to gain access to his or her funds and any conflicts of interest relating to the sweep program, including whether the broker-dealer receives compensation or other benefits for customer balances held at a bank or money market fund.[32] A broker-dealer would also have to post on its website the applicable bank and money market fund interest rates and information regarding any conflicts of interest relating to its sweep

30 *See* FINRA, REGULATORY NOTICE 15-22, DISCRETIONARY ACCOUNTS AND TRANSACTIONS (2015), http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory_Notice_15-22.pdf [https://perma.cc/5ASK-Z8F3].

31 *Id.* at 30–31 (see Proposed FINRA Rule 3260(c)(1)(E)(iv)).

32 *Id.* In addition, in the letters required when a broker-dealer changes terms or products of their sweep program, broker-dealers would be required to describe the options available to the customer if the customer does not accept the new terms or products. *Id.* at 30 (see Proposed FINRA Rule 3260(c)(1)(E)(i)). In letters to customers regarding the transfer of the customer's beneficial interest from one money market fund to another money market fund, the broker-dealer must include a tabular comparison of the nature and amount of the fees charged by each money market fund, a comparative description of the investment objectives of the fund and a prospectus of the money market fund to be purchased. *Id.* The proposed FINRA rule also requires that broker-dealers maintain detailed individual customer balances on their books and records for customer balances swept into a bank on an omnibus basis. *Id.* at 31 (see Proposed FINRA Rule 3260(c)(1)(E)(vi)).

program.[33] These proposed rules would strengthen the existing SEC customer protection requirements by requiring that the customers know the most important terms of the sweep products, namely the interest rate and the sweep counterparty.[34] However, the proposed FINRA rules would not require the broker-dealer to disclose a compensation figure that is segmented by each sweep product or counterparty.[35] One criticism is that merely providing the customer with a consolidated compensation figure is insufficient to enable the customer to understand the full conflict of interest of a broker-dealer because the customer cannot determine what products were most lucrative for the broker-dealer.

Customer protection with sweep programs is incredibly important because broker-dealers often present these programs to customers as the default option for managing uninvested cash.[36] Although these sweep programs have grown in size and importance over the past decade, the size of the broker-dealer sweep market is unknown because the SEC does not require broker-dealers to report the size of their sweep programs, the counterparties involved in their sweep programs or the amount of funds swept to each counterparty.[37] However, based on the history of broker-dealer sweep programs, broker-dealers likely sweep hundreds of billions of dollars of customer funds into affiliated banks and money market funds.[38]

33 *Id.* (see Proposed Rule 3260(c)(1)(E)(v)).

34 *See id.*

35 *Id.* at 30–31 (see Proposed Rule 3260(c)(1)(E)(iv)).

36 *See* SEC, *Investor Bulletin*, *supra* note 22 ("Many bank sweep programs are the 'default' option for managing cash in a brokerage account . . . .").

37 *See* SEC Form X-17A-5 Part I (2015); SEC Form X-17A-5 Part II (2015); SEC Form X-17A-5 Part IIA (2015); *see also* 17 C.F.R. § 240.17a-5 (2015) (describing the reporting requirements for broker-dealers).

38 In 2000, Merrill Lynch was one of the first broker-dealers to offer a sweep program that would sweep excess customer funds into an affiliated bank. *See* Paul T. Clark, *Just Passing Through: A History and Critical Analysis of FDIC Insurance of Deposits Held by Brokers and Other*

C. "Idle" Customer Securities—Securities Lending

In addition to regulations that protect customer cash, regulatory rules also protect customer securities by limiting which of the customer's securities broker-dealers can lend and under what circumstances broker-dealers can lend those securities. Generally, securities lending is a practice whereby ownership of a security is given to another for a set duration or until demanded back by the lender in return for a fee given to the lender.[39] All rights associated with a lent stock, like the right to vote or receive a dividend, pass to the borrower of the stock, although borrowers are often contractually obligated to return the economic benefits to the lender.[40]

Broker-dealers are allowed to lend certain customer securities in part because securities lending is key to many market functions. For example, borrowing securities is necessary for short selling because it allows a financial

Custodians, 32 REV. BANKING & FIN. L. 99, 103 (2012). Within two years of beginning its bank sweep program, deposits in just one of Merrill Lynch's two affiliate banks rose from $3.6 billion to over $55 billion, and within six years, Merrill Lynch's banks held $80 billion in deposits. *Id.* at 103, 153; Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 CONN. L. REV. 1539, 1591 (2007). Within a few years of Merrill Lynch introducing its bank sweep program, Lehman Brothers, Smith Barney, Charles Schwab, UBS, E*Trade, and Morgan Stanley introduced similar bank sweep programs. Clark, *supra*, at 153–54. Due to a rise in the use of sweep programs in the early 2000s, a 2004 study estimated that $350 billion was now in FDIC-insured deposits that would have otherwise been held by broker-dealers in retail money market funds. George Pennacchi, *Deposit Insurance, Bank Regulation, and Financial System Risks*, 53 J. MONETARY ECON. 1, 15 (2006) (citing 2004 study by Crane and Krasner).

39 *See* Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1719 (2011); *see also* ASS'N OF BRITISH INSURERS ET AL., SECURITIES LENDING: AN INTRODUCTORY GUIDE 2 (2010), http://www.bankofengland.co.uk/markets/Documents/gilts/sl_intro_green_9_10.pdf [https://perma.cc/CU83-KRKV].

40 *See* Omarova, *supra* note 39, at 1719; *see also* ASS'N OF BRITISH INSURERS ET AL., *supra* note 39, at 2.

entity to borrow a security in order to sell it in the market.[41] Short selling provides an opportunity for investors to profit off of a decline in the price of a security, whether for hedging or speculative purposes.[42] In addition, securities lending is closely tied to the market for securities repurchase agreements ("repos"), which serve as the main source of short-term financing for broker-dealers.[43] With repos, one party sells securities to another party for cash and agrees to repurchase the same securities at a future date (usually the following day) for a slightly higher price.[44] Repos are a key

41 *See Division of Market Regulation: Reponses to Frequently Asked Questions Concerning Regulation SHO*, SEC, http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm [https://perma.cc/9BJG-73DH] (last updated Oct. 15, 2015) [hereinafter *SEC Responses to FAQ Concerning Reg SHO*] ("A short sale is the sale of a security that the seller does not own and any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. In order to deliver the security to the purchaser, the short seller will borrow the security, usually from a broker-dealer or an institutional investor."). If a financial entity wants to sell a stock short and does not own the stock currently, the entity must borrow the stock to sell it now. Later, the financial entity would repurchase the stock in the market and return the stock to the lender. If the stock price has decreased in the interim, the short seller can repurchase the stock at a lower price and can pocket the profits. SEC Regulation SHO generally prohibits "naked" short selling in which investors sell a stock short without borrowing the security to make delivery. *See id.* ("A 'naked' short sale generally refers to selling short without having borrowed the securities to make delivery."); 17 C.F.R. § 242.203(b) (2015).

42 *SEC Responses to FAQ Concerning Reg SHO*, *supra* note 41 ("In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of an economic long position in the same security or in a related security."). Short selling is often a key part of trading strategies and a derivatives business. For example, Bank of America and Wachovia Bank in the mid-2000s borrowed securities from affiliated broker-dealers in order to facilitate the banks' derivatives trading business. *See* Omarova, *supra* note 39, at 1722–23.

43 *See* Omarova, *supra* note 39, at 1720.

44 *See id.* at n.151. Repos allow the seller of securities to, in effect, borrow cash from the purchaser of the securities, and the purchaser of the

source of short-term financing for broker-dealers because the parties typically roll over the one-day repos to craft longer-term loans.[45]

One rule that limits the risk to customers when a broker-dealer lends their securities is Regulation T ("Reg T"). Reg T limits when broker-dealers may borrow or lend securities, whether customer securities or securities owned by the broker-dealer.[46] Reg T states, "[A broker or dealer] may borrow or lend securities for the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations."[47] In other words, Reg T requires that the borrowing of equity securities be related to a delivery of

securities, in effect, extends a loan collateralized with the purchased securities. *Id.*

45 *See* Jose Gabilondo, *Leveraged Liquidity: Bear Raids and Junk Loans in the New Credit Market*, 34 J. CORP. L. 447, 458 (2009).

46 The Reg T purpose test only applies to borrowing and lending of equity securities. Non-equity securities are only subject to good faith loan value requirements under Reg T and margin requirements adopted by self-regulatory organizations. *See* Securities Credit Transactions; Borrowing by Brokers and Dealers, 63 Fed. Reg. 2806, 2810–12 (Jan. 16, 1998) ("With the adoption of the good faith account, Regulation T restrictions on the borrowing and lending of securities will only apply to those securities not entitled to good faith loan value. . . . the Board proposed to grant good faith loan value to all non-equity securities. . . . The Board is amending Regulation T as proposed to permit broker-dealers to extend good faith credit against all non-equity securities."); *see also* 12 C.F.R. § 220.6 (2015); 12 C.F.R. § 220.12(b) (2015); FINRA, RULE 4210 (2010), https://www.finra.org/sites/default/files/Industry/p122203.pdf [https://perma.cc/VHY7-G57B].

47 12 C.F.R. § 220.10(a) (2015); *see also* 12 C.F.R. § 220.2 (2015) (defining "creditor" as "any broker or dealer (as defined in sections 3(a)(4) and 3(a)(5) of the [Securities Exchange Act of 1934]), any member of a national securities exchange, or any person associated with a broker or dealer (as defined in section 3(a)(18) of the [Securities Exchange Act of 1934])."). The Federal Reserve Board regulates borrowing and lending securities in large part to prevent customers from circumventing margin requirements by recharacterizing a margin loan as a lending of securities by the customer to the broker-dealer. Securities Credit Transactions; Borrowing by Brokers and Dealers, 63 Fed. Reg. at 2810.

equity securities in connection to a specific transaction that has already occurred or is in immediate prospect.[48] Therefore, Reg T allows broker-dealers to profit from lending customer securities to other financial institutions, as long as that financial institution needs the securities to facilitate settlement of a transaction.

Beyond Reg T, Rule 15c3-3 and associated FINRA rules provide the greatest protection to customer securities by placing strict requirements on the lending of most customer securities. In general, SEC Rule 15c3-3 requires that broker-dealers have physical possession or control of all customer fully paid and excess margin securities.[49] Securities bought

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48 *See* 12 C.F.R. § 220.103 (2015) ("However, the borrowing must be related to an actual delivery of the type specified—a delivery in connection with a specific transaction that has already occurred or is in immediate prospect. The provision does not authorize a broker to borrow securities (or make the related deposit) merely in order that he or some other broker may have the securities 'on hand' or may anticipate some need that may or may not arise in the future."). Broker-dealers that lend equity securities to other financial institutions do not need to be a party to the transaction for which the borrowed securities are used. *See id*. Some situations that do not comply with the permitted purpose requirement are borrowing equity securities immediately prior to a dividend record date to collect a dividend and take advantage of a reduced price under a dividend reinvestment plan, and borrowing and lending of equity securities in a chain of connected transactions in which only some of the lent securities are used for a permitted purpose. *See* FED. RESERVE BD., *Regulation T: Credit by Brokers and Dealers*, in FEDERAL RESERVE REGULATORY SERVICE: SECURITIES CREDIT TRANSACTIONS §§ 5-615.01, 5-615.12, Bk. Compl. Gd. (CCH), 2015 WL 6148948 (2016). In addition, borrowing equity securities to get more corporate votes would also likely fail the permitted purpose requirement. SEC, Transcript of Securities Lending and Short Sale Roundtable at 200 (Sept. 29, 2009), https://www.sec.gov/news/openmeetings/2009/roundtable-transcript-092909.pdf [https://perma.cc/CK4L-GJ89] (Statement of Leslie Nelson, Managing Director, Global Securities Lending, Goldman Sachs) ("And I would just add that Reg T is quite clear in the United States that it is not a permitted purpose for us to borrow securities in order to permit non-owners to vote those shares.").

49 17 C.F.R. § 240.15c3-3(b) (2015); 17 C.F.R. § 240.15c3-3(c) (2015) (defining "control of securities"); *see also* Onnig H. Dombalagian, *Substance and Semblance in Investor Protection*, 40 J. CORP. L. 599, 607–

"on margin" are securities partially purchased with a loan from a broker-dealer.[50] SEC rules define excess margin securities as securities with a market value greater than 140% of a customer's debit balance, or, in other words, the amount the customer owes the broker-dealer for the margin loan.[51] In effect, the SEC allows broker-dealers to easily lend customer securities up to 140% of the amount that the customer owes to the broker-dealer on their margin loans.[52] The SEC explained that 140% was "fair and reasonable in light of the indebtedness of the customer on such securities."[53]

There are strict requirements on broker-dealers who lend fully paid or excess margin securities from customers. At or before lending any fully paid or excess margin securities, the broker-dealer and the customer must enter into a written

608 (2015). At the same time, SEC rules *do not* require that broker-dealers have possession or control of customer margin securities, which allows these securities to be lent. *Id.*

50 Buying securities on margin allows customers to increase their leverage and make a higher return (or a greater loss). Reg T places limits on the amount of credit that broker-dealers can extend to customers to purchase securities. Broker-dealers can lend at most 50% of the initial market value of purchased securities. 12 C.F.R. § 220.12(a) (2015). Different initial margin requirements apply to selling short. 12 C.F.R. § 220.12(c) (2015). Once a customer purchases securities on margin, the value of the equity in their account as a percentage of the loan given by the broker-dealer rises and falls with the price of the purchased securities. FINRA rules require that customers must maintain equity in their margin accounts of at least 25% of the current market value of all purchased securities. FINRA, RULE 4210(c) (2010), https://www.finra.org/sites/default/files/Industry/p122203.pdf [https://perma.cc/VHY7-G57B].

51 17 C.F.R. § 240.15c3-3(a)(5) (2015); *see also* U.S. GEN. ACCOUNTING OFFICE, GAO-98-153, RISK-BASED CAPITAL: REGULATORY AND INDUSTRY APPROACHES TO CAPITAL AND RISK 137 n.21 (1998).

52 *See* Dombalagian, *supra* note 49, at 607. For example, if a customer bought $200 on 25% margin, a broker-dealer could lend up to $70 worth of securities (140% of the $50 lent to the customer).

53 Reserves and Related Measures Respecting the Financial Responsibility of Brokers and Dealers, 36 Fed. Reg. 22,312, 22,313 (proposed Nov. 24, 1971) (to be codified at 17 C.F.R pt. 240).

agreement that states the basis of compensation for the lending of the securities, the rights and liabilities of the parties as to the borrowed securities, the securities actually borrowed, and the fact that SIPA may not protect the lent customer securities.[54] In addition to these disclosures, the broker-dealer must provide the customer with collateral of cash or treasury bonds which fully secures the loan of securities and must mark-to-market the loaned securities at least daily to ensure that the loan remains fully collateralized.[55] FINRA rules also require that broker-dealers disclose additional risks and financial impact associated with the customer's loan of securities in a document separate from the general account or margin agreement signed by the customer.[56] In short, customers who lend their fully paid and excess margin securities know that their broker-dealer has lent their securities, know which securities have been lent, know they have lost their voting rights, are fully collateralized by cash or treasury bonds, and may be compensated for the lending of their securities.

In contrast to the requirements for lending customer fully paid and excess margin securities, the SEC customer protection rule does not set forth any requirements for lending customer margin securities.[57] In addition, FINRA

54 17 C.F.R. § 240.15c3-3(b)(3) (2015).

55 *Id.*

56 *See, e.g.*, SEC. INDUS. & FIN. MKTS. ASS'N, IMPORTANT RISK DISCLOSURES WITH RESPECT TO FULLY PAID OR EXCESS MARGIN SECURITIES LENDING TRANSACTIONS (2015), http://www.sifma.org/services/standard-forms-and-documentation/securities-lending/ (follow "Securities Lending Customer Risk Disclosure Document" hyperlink) [https://perma.cc/7PRM-MY9P]. These additional disclosures include, but are not limited to, the loss of voting rights, risks to collateral, tax implications, any limits on customers' ability to sell the loaned securities or liquidate the transaction, the amount of compensation received by the broker-dealer and the customer, and the factors that determine that compensation. *See* FINRA, RULE 4330(b)(2)(B) (2014), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=11316 [https://perma.cc/E23C-SME6].

57 *See* 17 C.F.R. § 240.15c3-3 (2015).

has only one requirement for lending customer margin securities, namely that, "[n]o member shall lend securities that are held on margin for a customer and that are eligible to be pledged or loaned, unless such member shall first have obtained a written authorization from such customer permitting the lending of such securities."[58] Based on a FINRA interpretation of this rule, broker-dealers can and usually do meet this requirement simply by including this authorization as part of the larger customer account or margin agreement.[59] Therefore, broker-dealers do not need to

58 FINRA, RULE 4330(a) (2014), http://finra.complinet.com/ en/display/display_main.html?rbid=2403&element_id=11316 [https://perma.cc/E23C-SME6].

59 *See* FINRA, RULE 4330.02 (2014), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=11316 [https://perma.cc/E23C-SME6]; *see, e.g.*, CHARLES SCHWAB & CO., SCHWAB ONE ACCOUNT AGREEMENT 46 (2016), http://www.schwab.com/public/file/P-641707/Account_Agreement_Schwab_One_7.2016_REG18162-16.pdf [https://perma.cc/LTE9-2ABK] ("Certain securities and other assets now or hereafter held in your Margin and Short Account may be pledged, repledged, or otherwise used. In such event, we may receive compensation for the use of such securities. The value of the Securities and Other Property we pledge or repledge may be greater than the amount you owe us. Securities that are fully paid for or are deemed 'excess margin securities' under applicable securities laws may not be pledged, repledged, or used unless you have signed a separate written agreement that gives us the right to do so."); *E*TRADE Customer Agreement*, E*TRADE § 9(b) (Oct. 3, 2016), https://us.etrade.com/e/t/estation/contexthelp?id=1209031000 [https://perma.cc/FM3B-UVBQ] ("I authorize E*TRADE to lend either to itself or to others any Collateral to the extent permitted by Applicable Laws. I understand that, within the limitations imposed by Applicable Laws, all of my Collateral may be pledged and repledged and hypothecated and rehypothecated or otherwise used by E*TRADE, with all the attendant rights of ownership (including the right to vote the securities), for the sum due to E*TRADE, or for a greater sum and for a period of time longer than the obligations to which such Collateral was pledged by you, and without retaining in its possession and control a like amount of similar Collateral and (b) to use or invest cash Collateral at its own risk. In the event that E*TRADE pledges, repledges, hypothecates or rehypothecates any Collateral, E*TRADE may receive and retain certain benefits to which the Customer will not be entitled. . . . In certain

notify their customers if and when their margin securities are lent, nor do they need to disclose the compensation received by the broker-dealer for those securities.

Since broker-dealers do not need to disclose when they lend customer margin securities, broker-dealers do not need to track which customer margin securities they have lent. Rather, broker-dealers hold and lend these customer securities in a "fungible bulk."[60] The fact that broker-dealers

circumstances, I may not be able to exercise voting rights of the securities that are lent by me or which have been pledged, repledged, borrowed, hypothecated or rehypothecated by E*TRADE. . . . Any such pledge, repledge, hypothecation or rehypothecation of any Collateral can occur without my being notified, either separately or together with other Securities and/or Other Property of other customers of E*TRADE, for any amount due E*TRADE in any Account in which I have an interest . . ."); FIDELITY INVESTMENTS, THE FIDELITY ACCOUNT: CUSTOMER AGREEMENT AND ADDITIONAL INFORMATION 11 (2015), https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/brokerage-account-customer-agreement.pdf [https://perma.cc/SX8S-NWGW] ("Note that property in a margin account may be pledged or repledged, hypothecated (loaned) or rehypothecated, either separately or in common with any other property, for as much as your obligation to us or more, without our having to retain a like amount of similar property in our control for delivery. . . . As permitted by law, we may use certain securities for, among other things, settling short sales and lending securities for short sales and as a result may receive compensation in connection therewith."). For more examples of agreements, see MERRILL LYNCH, THE MARGIN LENDING PROGRAM CLIENT AGREEMENT 2 (2014), https://olui2.fs.ml.com/publish/content/application/pdf/gwmol/marginclient agreement.pdf [https://perma.cc/3J4X-7JZ6]; PERSHING ADVISORY SOLUTIONS L.L.C., TERMS AND CONDITIONS OF YOUR CASH AND MARGIN ACCOUNTS 7 (2016), https://www.pershing.com/_global-assets/pdf/disclosures/pas-terms-and-conditions.pdf [https://perma.cc/HD2K-5QTF]; SCOTTRADE, INC., BROKERAGE ACCOUNT AGREEMENT 9 (2016), https://www.scottrade.com/documents/alt/111_BrokAccAgreement.pdf [https://perma.cc/8R2S-ZP9Y]; TD AMERITRADE, INC., CLIENT AGREEMENT 7 (2016), https://www.tdameritrade.com/retail-en_us/resources/pdf/AMTD182.pdf [https://perma.cc/3AY4-LDYS].

[60] Kahan & Rock, *supra* note 8, at 1258; *see also Roundtable on Proxy Voting Mechanics*, SEC (May 23, 2007), https://www.sec.gov/spotlight/proxyprocess/proxyvotingbrief.htm [https://perma.cc/5UY5-QYMN] [hereinafter *SEC Proxy Voting*

hold customer securities in "fungible bulk" is consistent with the Uniform Commercial Code's ("UCC") definition of the actual property interest of broker-dealer customers, namely a pro rata interest in all like securities held for customers by the broker-dealer.[61] Therefore, customers do not in fact have a property interest in a specific security that they purchased through their broker-dealer, and the pooling of all like securities by a broker-dealer helps explain why broker-dealers can lend customer margin securities without specifically identifying the customer who is the beneficial owner.[62]

Roundtable] ("The broker-dealer holds all its shares in fungible bulk, so it does not match loaned shares with any particular margin customer.").

61 *See* U.C.C. § 8-503(c)–(e) (AM. LAW INST. & UNIF. LAW COMM'N 2014); Kahan & Rock, *supra* note 8, at 1242 ("[UCC] Section 8-503 makes clear that the interest of the customers who hold a certain security is not an interest in any particular item of property, but rather is a pro rata interest in all like securities of the intermediary held in common by all other customers who own the same security.").

62 Related to lending of securities, broker-dealers can use customer margin securities as collateral for broker-dealer borrowing in a process known as rehypothecation. Customers pledge or hypothecate their margin securities as collateral for margin loans, and the UCC allows broker-dealers to repledge this collateral as collateral to third parties. *See* U.C.C. § 9-207(c)(3) (AM. LAW INST. & UNIF. LAW COMM'N 2014); Kenneth C. Kettering, *Repledge Deconstructed*, 61 U. PITT. L. REV. 45, 51, 175 (1999) (providing full history of UCC and regulatory treatment of repledging assets, including margin securities). Rehypothecation allows broker-dealers to pledge margin securities in order to borrow money to replenish their cash supply after extending a margin loan. *See* Manmohan Singh & James Aitken, *The (Sizable) Role of Rehypothecation in the Shadow Banking System* 3 (IMF Working Paper No. 10/172, July 2010); SEC, Transcript of Securities Lending and Short Sale Roundtable, *supra* note 48, at 21 (statement of Irv Klubeck, Managing Director, Pershing L.L.C.). Unlike outright lending of securities, customers retain title in their margin securities and therefore their right to vote as long as the broker-dealer has not defaulted on the loan to which the customer margin securities are pledged as collateral. *See Hypothecate*, BLACK'S LAW DICTIONARY (10th ed. 2014). Although rehypothecation presents agency and systemic problems similar to the problems with other uses of idle customer assets described in this Note, other articles have examined the history and trade-offs associated with rehypothecation, therefore an

D. "Idle" Customer Shareholder Rights

Broker-dealers' ability to lend customer margin securities with less stringent regulatory requirements has important implications for corporate voting.[63] First, the Depository Trust Company ("DTC") holds the shares of all broker-dealers as a custodian, whether the broker-dealer or a customer beneficially owns the shares.[64] The DTC is the record owner of all shares and lists the broker-dealer as the owner of the shares in the DTC's ownership records.[65] Under Delaware corporate law, the entity with record ownership (the DTC) rather than the beneficial owner (the customer) is entitled to notice of corporate votes.[66] Therefore, when an issuer holds a shareholder vote, the issuer contacts the DTC to get a list of participant custodians (i.e. broker-dealers) who hold shares of the issuer, and the issuer provides proxy

extensive discussion of rehypothecation is beyond the scope of this Note. *See, e.g.*, Christian A. Johnson, *Derivatives and Rehypothecation Failure: It's 3:00 P.M., Do You Know Where Your Collateral Is?*, 39 ARIZ. L. REV. 949 (1997); Kettering, *supra* note 62; Singh & Aitken, *supra* note 62; Mariya Deryugina, Note, *Standardization of Securities Regulation: Rehypothecation and Securities Commingling in the United States and the United Kingdom*, 29 REV. BANKING & FIN. L. 253 (2009) (although overstating the protection afforded by SEC rules for customer securities); David Andolfatto, Fernando Martin & Shengxing Zhang, *Rehypothecation and Liquidity* (Fed. Reserve Bank of St. Louis Working Paper 2015-003B, 2015), https://research.stlouisfed.org/wp/2015/2015-003.pdf [https://perma.cc/72TC-NCAK].

63 Kahan & Rock, *supra* note 8, at 1227.

64 *See id.* at 1237–38; U.C.C. art. 8 prefatory note (AM. LAW INST. & UNIF. LAW COMM'N 2014).

65 Kahan & Rock, *supra* note 8, at 1237–38; *Overview*, DTCC, http://www.dtcc.com/matching-settlement-and-asset-services/issuer-services/how-issuers-work-with-dtc [https://perma.cc/6PXX-YWC4] (last visited Jan. 31, 2017).

66 *See* DEL. CODE ANN. tit. 8, § 219 (2015); Kahan & Rock, *supra* note 8, at 1233; *see also* David Brooks, *Depository Trust Company and the Omnibus Proxy: Shareholder Voting in the Era of Share Immobilization*, 56 S. TEX. L. REV. 205, 209–211 (describing the evolution of the indirect holding system).

materials to the broker-dealers.[67] Therefore, broker-dealers ultimately are responsible for distributing proxy statements to their customers, receiving their voting instructions, tabulating those votes, and sending those votes to the issuer's tabulator.[68]

When a security is lent, the owner loses the right to vote since the owner no longer has title to the security.[69] When a broker-dealer lends customer margin securities, the shares are transferred out of the broker-dealer's account at the DTC, and the total votes to which the broker-dealer and its customers are entitled is decreased.[70] However, as described earlier, the broker-dealer does not know which customer's securities it has lent.[71] Therefore, when the broker-dealer receives voting instructions from a corporation, it often sends proxy materials to all of its customers who own shares according to the books and records of the broker-dealer, even if the broker-dealer has lent a portion of customer securities.[72] Generally, broker-dealers rely on systematic under-voting by shareholders to avoid the problem of over-voting.[73] However, broker-dealers risk having more votes than they are entitled and therefore risk having all of their

[67] *See* Kahan & Rock, *supra* note 8, at 1243–48.

[68] *See id.*

[69] Kahan & Rock, *supra* note 8, at 1256; *see also SEC Proxy Voting Roundtable*, *supra* note 60 ("The standard stock loan agreement transfers the right to vote proxies to the borrower. If the broker-dealer has loaned shares in that stock, some margin customers' right to vote their securities may have been transferred to the borrower.").

[70] *See* Kahan & Rock, *supra* note 8, at 1239.

[71] *See supra* notes 60–62 and accompanying text.

[72] *See* Kahan & Rock, *supra* note 8, at 1259.

[73] *See SEC Proxy Voting Roundtable*, *supra* note 60 ("Some send a VIF to all customers holding a securities position in that issue, because many customers do not respond. . . . Most broker-dealers take the position that the practical reality of any imbalance is relatively small for purposes of voting because only a small percentage of their retail customers actually vote.").

customers' votes invalidated.[74] In the case of over-voting, the broker-dealer is responsible for reducing the number of votes, thereby cancelling customer votes without their knowledge.[75]

There is no industry or legally required standard for broker-dealers to reconcile corporate votes. Some broker-dealers utilize post-mailing reconciliation, where the broker-dealer reconciles the votes only if it received more voting instructions than it is entitled to based on its shares at the DTC.[76] With post-mailing reconciliation, some broker-dealers reduce the number of votes by first reducing the firm's votes based on its proprietary position, while some reduce all customer votes or margin customer votes by a certain percentage or based on a lottery system.[77] Post-mailing reconciliation allows over-votes to occur and allows broker-dealers to cancel customer votes without informing the customer.[78] Other broker-dealers use a pre-mailing reconciliation process where the broker-dealer determines which customers can vote before sending out voter instructions forms.[79] However, since broker-dealers do not know which customers' securities were lent, votes are not assigned based on which customer actually retained ownership of their stock. Rather, broker-dealers often allocate votes to customers with fully-paid securities, and the remaining votes are divided amongst margin customers either based on a lottery or a pro rata method.[80] Finally, some broker-dealers use a hybrid method in which margin

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74 *See* Kahan & Rock, *supra* note 8, at 1236, 1259; *see, e.g.*, *Seidman & Assocs. v. G.A. Fin., Inc.*, 837 A.2d 21, 24, 28 (Del. Ch. 2003) (invalidating proxy votes of 233,376 shares from The Bank of New York due to an over-vote of 824).

75 *See SEC Proxy Voting Roundtable, supra* note 60 ("If there is an over-vote, the broker-dealer will have to decrease the customers' vote but the customers will never know some or all of their votes did not count.").

76 *See SEC Proxy Voting Roundtable*, *supra* note 60.

77 *Id.*

78 *Id.*

79 *Id.*

80 *Id.*

customers can contact the broker-dealer and say they want to vote their shares, and those customers will be assigned votes before other margin customers.[81] Broker-dealers that use post-mailing reconciliation are more likely to have a larger number of retail clients and contend that the system maximizes the amount of customers that can vote.[82] Broker-dealers that use pre-mailing reconciliation appropriately allocate votes to their customers, provide additional transparency about who can actually vote, and ensure that votes that are cast are actually counted.[83] However, pre-mailing reconciliation is relatively more expensive and does not maximize the number of customers that can vote.[84] The lack of industry or legally mandated standards for broker-dealers to reconcile corporate votes gives additional discretion and power to broker-dealers over customer shareholder votes.

III. ISSUES WITH BROKER-DEALER USE OF IDLE CUSTOMER ASSETS: AGENCY PROBLEMS AND SYSTEMIC RISK

Broker-dealer use of idle customer assets is a critical component of the broker-dealer business today and has advantages and disadvantages for the customer. While the benefits of these arrangements are relatively well understood, the potential costs are not. Despite the original purpose of the SEC customer protection rule, broker-dealers are *not* forbidden from using customer assets to finance their business unrelated to servicing securities customers.[85] Broker-dealer profits derived from using idle customer assets create agency problems, and the increase in broker-dealer interconnectedness potentially increases systemic risk. Section III.A will discuss both the benefits of sweep

81 *Id.*

82 *Id.*

83 *Id.*

84 *Id.*

85 *See supra* Sections II.A, II.B.

programs, like increased returns on customer cash and potential effects on market liquidity, and the costs, like agency problems and systemic risks. Section III.B will explain the benefits and costs of lending customer margin securities, specifically the necessity of securities lending for key market functions, the increased counterparty risks for customers, the lack of direct customer compensation for the lending of their securities, potential systemic risks, and the loss of customer shareholder voting rights.

A. Sweep Programs—Benefits and Costs

Broker-dealer sweep programs increase the return to customers and may increase equity market liquidity by encouraging additional deposits into broker-dealers. However, even after the recent amendments to Rule 15c3-3 that strengthened the regulation of broker-dealer sweep programs,[86] questions still remain about agency costs and systemic risks associated with these sweeps. These amendments did not address the potential conflicts of interest of broker-dealers nor the potential systemic risks associated with a rapid unwinding of a sweep program.

1. Sweep Program Benefits—Increased Returns and Effects on Market Liquidity

Sweep programs benefit customers by increasing the return on their idle cash. Without sweeps into a bank or money market fund, customers would likely have zero return on their idle cash. Sweep programs also increase returns for broker-dealers, which could be passed on to customers through lower commissions and lower interest rates on margin loans. In addition, swept cash that would otherwise be held in the Special Reserve Account increases the amount of funds invested by banks and money market funds, which could decrease borrowing costs for bank customers and

[86] Financial Responsibility Rules for Broker-Dealers, 78 Fed. Reg. 51,824, 51,839–42 (Aug. 21, 2013) (to be codified at 17 C.F.R. pt. 240).

issuers of debt held by money market funds. Finally, sweeps into a bank may increase the security of customer cash by giving broker-dealer customers access to FDIC insurance.[87]

Sweep programs could encourage additional deposits into broker-dealers, which could increase the amount invested in securities and increase equity market liquidity. Sweep programs could encourage increased deposits in broker-dealers by giving additional cash management options for customers and giving broker-dealer customers access to FDIC insurance. Without sweep programs, customers who wanted FDIC insurance and small returns on their cash pending equity investment would need to withdraw their idle cash from their broker-dealer and deposit it into a bank. The additional time, effort, and potential monetary costs required to move funds between a bank and broker-dealer could discourage moving these funds. Therefore, without sweep programs, customers may deposit fewer funds into their broker-dealer in the first place, and customers also may be less likely to redeposit funds into their broker-dealer after they remove them from their bank. By facilitating quick transfers into and out of FDIC-insured accounts and money market funds with nearly no transaction costs, sweep programs give customers more options to quickly change investment strategies, which facilitates increased deposits with broker-dealers and may in turn increase investment in equity markets. However, sweep programs could decrease the amount of funds invested in equity markets by slightly increasing returns on uninvested cash and decreasing the opportunity cost of not investing cash in stock. Therefore, it

[87] However, it is unclear whether FDIC insurance provides additional protection compared to unswept customer funds, which are held in the fully segregated Special Reserve Account that holds only cash or treasury bonds. *See supra* notes 17–18 and accompanying text. Unlike FDIC insurance, the protection afforded by the Special Reserve Account is not limited to $250,000. *See* SEC, *Investor Bulletin*, *supra* note 22 ("Cash swept into deposit accounts through bank sweep programs is covered by FDIC insurance up to the $250,000 limit per customer at each FDIC-Insured bank that participates in the bank sweep program.").

is unclear whether sweep programs increase or decrease market liquidity.

2. Sweep Program Agency Problems

An agency problem exists between customers and broker-dealers involving decisions about whether and where to sweep customer cash because broker-dealers also profit from these decisions. Broker-dealers profit from these decisions because they are usually paid fees by banks and money market funds to sweep customer cash, and sweeping to affiliates can increase the profit of the broker-dealer's holding company. Broker-dealers have the incentive to encourage customers to take part in the sweep program even if sweeping uninvested cash is not in the best interest of the customer. Depending on a customer's risk aversion, the few basis point return for the customer may not adequately compensate them for the counterparty risk created by sweeping the cash.[88] As stated previously, sweep programs are often the default option given by a broker-dealer for managing uninvested customer cash, suggesting that broker-dealers encourage all customers to take part in the sweep program regardless of a customer's risk preferences and investment strategy and even if the sweep program is not in the customer's best interest.[89] The default nature of sweep programs is especially worrisome in light of the original intent of Rule 15c3-3 to forbid broker-dealers from using customer cash to finance their business.[90]

Once a customer decides to take part in a sweep program, the broker-dealer has the incentive to sweep the customer cash into the bank or money market fund that will make the

88 This problem may matter more for sweeps into money market funds because customers are protected by FDIC insurance when they sweep their funds into a bank.

89 *See supra* note 36.

90 *See* Net Capital Requirements for Brokers and Dealers, 50 Fed. Reg. 2690, 2690 (Jan. 18, 1985) (to be codified at 17 C.F.R. pt. 240); *see also* Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. 25,224, 25,224 (Nov. 29, 1972) (to be codified at 17 C.F.R. pt. 240).

largest return for the broker-dealer and its affiliates. Although customers have the authority to decide where to sweep their funds from the options available in a sweep program, broker-dealers have the power to select which bank and money market fund products will be available to customers in the sweep program.[91] Broker-dealers could choose banks and money market funds that pay higher fees to broker-dealers but lower returns to customers when compared to the industry.[92] Moreover, broker-dealers could choose to sweep into affiliates in order to maximize the profit for its holding company. Potential agency problems are exacerbated with sweeps into affiliates because of the large difference in return for the broker-dealer compared to the customer. The broker-dealer usually pays the customer a few basis points, while an affiliate bank and broker-dealer can split the multiple percent return expected from bank loans.[93]

Most counterparties in sweep programs are affiliates of the broker-dealer, suggesting that broker-dealers may be selecting these counterparties based in part on trying to maximize profits for themselves and their affiliates.[94] It is

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91 17 C.F.R. § 240.15c3-3(j)(2)(ii)(A)(2) (2015).

92 *See, e.g.*, Press v. Quick & Reilly, Inc., 218 F.3d 121, 123–24 (2d Cir. 2000) (affirming dismissal of 10b-5 lawsuit based on allegations that a broker-dealer swept customer funds into one of the poorest performing money market funds in the industry in return for undisclosed payments to the broker-dealer).

93 *See supra* note 26 and accompanying text.

94 *E.g.*, CHARLES SCHWAB & CO., HOW YOUR ASSETS ARE PROTECTED AT SCHWAB (2010), https://www.schwab.com/public/file/P-4257132/mkt45080int.pdf [https://perma.cc/8S7Y-JAH7] ("If the cash feature in effect for your Schwab brokerage account is the Bank Sweep Feature, your cash balances are automatically swept to deposits at Schwab Bank and are FDIC-insured."); *Schwab Money Market Funds*, CHARLES SCHWAB, http://www.schwab.com/public/schwab/investing/accounts_products/investment/cds_money_markets/money_market_funds [https://perma.cc/9YRR-JXDX], (describing Sweep Money Market Funds for uninvested cash in a customer's brokerage account and linking to Schwab Money Market Funds Monthly Performance Summary Report which only lists money market funds sponsored by Schwab); *Options for Your Uninvested Cash*, E*TRADE,

unlikely that affiliate money market funds and banks always give the highest return to customers. In addition, some authors argue that broker-dealers prefer sweeps into affiliate banks over money market funds because FDIC-insured deposits pay lower interest rates to customers and have higher return on investment compared to the rates and investment spread of uninsured money market funds, allowing broker-dealers and their affiliated banks to increase profits.[95] In short, the potential agency problem of broker-dealers maximizing their own profits could cause customers to suffer the agency costs of sweeping their excess cash when sweeping may not be consistent with their risk preferences and sweeping into products that have higher risks or lower returns.

Customers lack the information to combat this agency problem because broker-dealers are not required to disclose the compensation they receive for sweeping customer funds.

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https://us.etrade.com/e/t/prospectestation/pricing?id=1907000000 [https://perma.cc/88SE-9YRF] (listing the 9 options for sweeping customer cash, 5 of which sweep into affiliated entities); TD AMERITRADE, INC., SUMMARY OF CASH BALANCE PROGRAMS 1 (2016), https://www.tdameritrade.com/retail-en_us/resources/pdf/TDA7002.pdf [https://perma.cc/7ZCC-HS92] ("The Insured Deposit Account serves as the primary cash sweep vehicle for earning income on cash balances in TD Ameritrade brokerage accounts and is the default cash sweep vehicle unless you make an alternate sweep election. Excess cash is swept to TD Bank, N.A. ('TD Bank') or TD Bank USA, N.A. ('TD Bank USA'), or both (collectively, 'the Banks'), which are FDIC-insured . . . ."); TD AMERITRADE, INC., MONEY MARKET FUND SWEEP REQUEST 1 (2016), https://www.tdameritrade.com/retail-en_us/resources/pdf/TDA1836.pdf [https://perma.cc/DFW2-UHZU] (listing 5 money market funds sponsored by TD Ameritrade); MERRILL LYNCH, UNDERSTANDING YOUR CASH SWEEP OPTIONS 1 (2014), https://www.mymerrill.com/Publish/Content/application/pdf/GWMOL/CashSweepsRetailEdge272564-9-printready.pdf [https://perma.cc/TEL7-MEBV] ("This cash may be automatically 'swept' to bank deposit accounts with one or more Merrill Lynch Affiliated Banks: Bank of America, N.A. ('BANA'), Bank of America California, N.A. ('BA-CA') or Merrill Lynch International Bank Limited ('MLIB') . . . .").

95 *See, e.g.*, Wilmarth, *supra* note 38, at 1591–92; Pennacchi, *supra* note 38, at 15–16.

Proposed FINRA rules would only require broker-dealers to disclose whether they received compensation or other benefits for customer balances held at a bank or money market fund.[96] Customers would likely need to know the actual fees received by the broker-dealer broken down by product as well as the broker-dealer fees associated with the products that the broker-dealer chose not to include in the sweep; this would help customers to assess whether their broker-dealer was choosing sweep products based on broker-dealer fees instead of what would maximize the return to customers.

Broker-dealer sweep programs also raise questions about whether customers are fully informed about the risks associated with the sweeps. The onus is on the customer and not the broker-dealer to understand the risks associated with the sweep program. An SEC investor bulletin in June of 2014 advised customers that they should "be aware that most broker-dealers place the responsibility on you to monitor your cash level so that you do not lose FDIC insurance coverage" by exceeding the $250,000 cap on FDIC insurance.[97] Moreover, an SEC interpretation of Rule 15c3-3 in March of 2014 stated that although a broker-dealer must instruct a money market fund to redeem the customer's investment when ordered to do so by the customer, such redemption is "subject to the terms and conditions of the money market mutual fund and to applicable law and regulation."[98] Therefore, in light of the recent SEC money market reforms, the customer must also monitor the terms of sweep program money market funds to know if the funds have the right to bar or place a fee on redemptions.[99] It is

96 *See* FINRA, REGULATORY NOTICE 15-22, DISCRETIONARY ACCOUNTS AND TRANSACTIONS, *supra* note 30, at 30–31 (*see* Proposed Rule 3260(c)(1)(E)(iv)).

97 SEC, *Investor Bulletin*, *supra* note 22.

98 *SEC FAQ Concerning Amendments*, *supra* note 28.

99 Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47,736, 47,736. (Aug. 14, 2014) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274, 279).

unclear whether the broker-dealer is required to give the current terms of the money market fund to customers when cash is swept.[100]

3. Sweep Program Systemic Risks

In addition to agency problems, there are potential systemic risks associated with broker-dealer sweeps of customer cash due to the increased interconnectedness between a broker-dealer and sweep program counterparties. If a broker-dealer failed, SIPC would immediately unwind the entire sweep program in order to return customer cash. Even if a full SIPC liquidation was avoided and a different broker-dealer purchased customer accounts, the new broker-dealer would likely still unwind the sweep program in order to sweep customer cash into that broker-dealer's affiliates and other sweep counterparties. The banks and money market funds that are part of the sweep program would potentially lose tens of billions of dollars overnight. In other words, the unwinding of a broker-dealer sweep program could act like a run by immediately demanding potentially significant amounts of liquidity.[101] The risk to sweep program counterparties is exacerbated with sweeps to affiliates because affiliated institutions would already suffer reputational damage caused by the failure of their broker-dealer. In short, large broker-dealer sweep programs

100 *See* 17 C.F.R. § 240.15c3-3(j)(2)(ii)(A)(1) (2015) (requiring broker-dealers to notify the customer of the "general terms and conditions of the products available through the Sweep Program" prior to receiving affirmative consent to sweep).

101 In addition, because of the risk of liquidity crises, money market funds may bar redemptions in advance of a failure of a broker-dealer, which would slow the return of customer assets. *See* Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47,736 ("The SEC also is adopting amendments that will give the boards of directors of money market funds new tools to stem heavy redemptions by giving them discretion to impose a liquidity fee if a fund's weekly liquidity level falls below the required regulatory threshold, and giving them discretion to suspend redemptions temporarily, i.e., to 'gate' funds, under the same circumstances.").

increase the likelihood that other financial institutions and affiliates could become illiquid and fail following the failure of a broker-dealer.

Beyond situations where a broker-dealer fails, the systemic risk of sweep programs would depend on whether the amount of funds invested in a sweep program is procyclical or countercyclical. If the amount of funds swept is procyclical, customers will withdraw their funds from sweep programs in times of economic stress, which would decrease the liquidity of the sweep program counterparties. Since customers have the ultimate authority to decide if and where to sweep their funds, the cyclicality of sweep programs would depend on the actions of broker-dealer customers.

With regards to money market funds, cyclicality likely depends on whether the money market fund is a prime fund that generally invests in either short-term commercial or bank debt or a government fund that invests in U.S. government debt.[102] Prime money market funds experienced net outflows during the 2008 financial crisis and during the 2011 Eurozone sovereign debt crisis, while government money market funds have historically experienced inflows during times of stress.[103] Therefore, sweeps into prime money market funds would likely be procyclical, while sweeps into government money market funds may be countercyclical. Sweeps into a bank would likely be countercyclical because customers can get FDIC protection by sweeping their funds into a bank.[104] In addition to

102 *See* Money Market Fund Reform; Amendments to Form PF, 78 Fed. Reg. 36,834, 36,836 (proposed June 19, 2013).

103 Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. at 47,792; Money Market Fund Reform; Amendments to Form PF, 78 Fed. Reg. at 36,843–45; *see also* DIV. OF RISK, STRATEGY, & FIN. INNOVATION, SEC, RESPONSE TO QUESTIONS POSED BY COMMISSIONERS AGUILAR, PAREDES, AND GALLAGHER 6–13 (2012), http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf [https://perma.cc/5FMA-HWMF].

104 *See* SEC, *Investor Bulletin*, *supra* note 22 ("Cash swept into deposit accounts through bank sweep programs is covered by FDIC

choosing to sweep funds into a bank rather than a money market fund, customers may choose to increase the amount of their funds swept in order to gain FDIC protection instead of less-robust SIPC protection.

Therefore, in times of financial stress, customers may choose to decrease the amount swept into prime money market funds and instead choose to sweep more funds into banks, up to the maximum amount protected by the FDIC. This outcome suggests that broker-dealer sweep programs may decrease systemic risk for banks by encouraging capital inflows into banks during times of stress. In addition, the recent SEC money market fund reforms that strengthened regulation on money market funds could decrease the incentive for customers to remove funds from prime money market funds in times of financial stress.[105] However, this outcome assumes that customers understand the regulatory intricacies of broker-dealer sweep programs. Specifically, retail customers must understand that they gain FDIC protection when they sweep their funds into a bank and that the protection would not be jeopardized by a failure of their broker-dealer. If customers during times of financial panic operate under the belief that the funds presented to them on their broker-dealer statements are in fact held by the broker-dealer, they still may withdraw their funds from the broker-dealer to place them in their normal bank accounts or, in extreme cases, under their mattress. Moreover, retail customers themselves may suffer from illiquidity due to the financial and economic downturn and may withdraw their funds to deposit them into a bank so that they can use a debit card or checks to pay everyday expenses. In that scenario, sweep programs would be procyclical, with customers withdrawing some or all of their funds from their broker-dealer, and broker-dealers in turn unwinding their

insurance up to the $250,000 limit per customer at each FDIC-Insured bank that participates in the bank sweep program.").

[105] *See generally* Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47,736, 47,736. (Aug. 14, 2014) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274, 279).

sweep program and decreasing the liquidity of sweep program counterparties.

The SEC and prudential regulators currently do not monitor the potential systemic risks associated with sweep programs because broker-dealers are not required to disclose the size of or the counterparties associated with their sweep programs.[106] Without knowing the size of broker-dealer sweep programs, it is unclear whether sweep programs are large enough to cause liquidity crises for sweep program counterparties. However, the fact that broker-dealers likely sweep hundreds of billions of dollars means that liquidity drains on sweep program counterparties could be significant.[107]

B. Lending Customer Margin Securities—Benefits and Costs

Like broker-dealer sweep programs, broker-dealer lending of customer margin securities could benefit customers through lower borrowing costs, but may increase agency problems and systemic risks. As stated previously, securities lending is necessary for key market functions like short selling and could benefit customers if broker-dealers pass some of the profits to customers through lower commissions and lower interest rates on margin loans. On the other hand, lending margin securities increases counterparty risks for customers, and securities lending generally increases systemic risk.[108] Customers do not know if or when their margin securities are lent and therefore are likely unable to negotiate for a direct share in the proceeds

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[106] *See supra* note 37 and accompanying text.

[107] *See supra* note 38 and accompanying text.

[108] *See* OFFICE OF FIN. RESEARCH, ASSET MANAGEMENT AND FINANCIAL STABILITY 1 (2013), http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf [https://perma.cc/3DGU-FSXQ]; Joshua S. Wan, Note, *Systemically Important Asset Managers: Perspectives on Dodd-Frank's Systemic Designation Mechanism*, 116 COLUM. L. REV. 805, 822 (2016); Deryugina, *supra* 62, at 264.

from their lent assets and do not know when they no longer have their shareholder votes. Broker-dealers have the incentive to lend out all customer margin securities in order to maximize their profits, while a customer may not want to lend out all or any of their margin securities if the customer is highly risk averse or if they place a high value on their shareholder voting rights.[109] Therefore, lending customer margin securities could lead to an agency problem in which broker-dealers lend too many customer margin securities, which causes agency costs of higher counterparty risks, higher systemic risks, and a higher likelihood that the broker-dealer will cancel customer votes.

1. Securities Lending Necessary for Key Market Functions

Broker-dealer lending of customer margin securities helps facilitate market functions like short selling by increasing the supply of lent securities. Regulation SHO requires that broker-dealers borrow securities in order to effect a short sale for itself or a customer.[110] Any increase in regulatory requirements on broker-dealer lending of customer margin securities could decrease the amount of lending of customer securities. A decrease in the lending of customer securities would increase the cost of borrowing securities and could increase the cost of short selling, which in turn would hurt some broker-dealer customers. Therefore, the ability of

109 In a perfectly competitive market in which broker-dealers compete for margin customers based on the interest rate on margin loans, broker-dealers have the incentive to lend out all margin securities in order to offer the lowest possible interest rate. Even in a market that is not perfectly competitive, broker-dealers have the incentive to lend out all customer margin securities in order to maximize their own profit. Customers cannot opt out of having their margin securities lent and may never realize any costs of lending their securities because they still can immediately sell their securities and take part in shareholder votes. Therefore, broker-dealers generally do not need to worry that they will lose customers if they lend all of their margin securities.

110 17 C.F.R. 242.203(b) (2015).

broker-dealers to lend customer margin securities increases the liquidity of the securities lending market and decreases the cost of short selling.

Additional regulation of lending customer margin securities may not be necessary because customers can opt into stricter requirements on broker-dealer lending of their securities by not using a margin loan and instead holding only fully paid securities. If the customer only held fully paid securities, the broker-dealer would need to execute a separate written agreement with the customer if it wanted to lend any of the customer's securities.[111] However, the current paradigm creates an explicit trade-off where customers must exchange leverage in order to ensure that their securities are always in the possession and control of their broker-dealer.[112] The inability to be leveraged and simultaneously retain constant possession of securities and shareholder votes is a cost to customers and could decrease overall leverage, the amount of securities purchased, and equity market liquidity.

2. Securities Lending Counterparty Risks And Customer Compensation

Lending customer margin securities introduces new counterparty risks for customers since the counterparty that borrowed the margin security may fail to return the customer margin securities at the end of the loan.[113] Prior to 1998, the Federal Reserve required that broker-dealers hold 100% collateral against lent securities, with the collateral limited to cash and cash equivalents.[114] However, broker-dealers are no longer required to hold 100% collateral against these loans, although the Federal Reserve explained,

111 *See supra* notes 54–56 and accompanying text.

112 *See supra* note 50 (discussing how purchasing securities on margin allows increased leverage for the customer).

113 *See* ASS'N OF BRITISH INSURERS ET AL., *supra* note 39, at 4–5 (describing risks associated with securities lending).

114 Securities Credit Transactions; Borrowing by Brokers and Dealers, 63 Fed. Reg. 2806, 2810 (Jan. 16, 1998).

"the Board believes requiring 100 percent liquid collateral is consistent with prudent securities lending practices."[115] Today, the SEC net capital rule requires that broker-dealers deduct from net capital the market value of a stock loaned in excess of the value of any collateral received.[116] Therefore, customers rely on any collateral received by their broker-dealer and the broker-dealer's net capital to reduce the counterparty risk associated with the lending of their margin securities. However, 100% cash collateral serves as better protection than relying on a broker-dealer's net capital, especially in times of financial stress where a broker-dealer's net capital is strained due to financial losses. In extreme financial stress, counterparties may not be able to return lent margin securities, and broker-dealers' net capital may not be able to cover the losses to customers. Therefore, customers still bear some counterparty risk.

Customers are not compensated directly for lending their margin securities, while broker-dealers profit off these loans. Customers are likely unable to negotiate a share of the profits derived from lending their margin securities because they do not know how often their margin securities are lent.[117] Customer statements and online account portals do not state if a broker-dealer has lent any margin securities, while customers retain the ability to immediately sell all of their margin securities. Moreover, customers usually still receive proxy statements as if the broker-dealer had possession and control of their margin securities even if the broker-dealer has lent those securities.[118] Therefore, customers may believe that their margin securities are lent

115 *Id.*

116 17 C.F.R. 240.15c3-1(c)(2)(iv)(B) (2015).

117 This problem is exacerbated by the fact that broker-dealers do not know which customer's securities they have lent since broker-dealers hold and lend customer margin securities in fungible bulk. *See supra* notes 58–62 and accompanying text.

118 *See supra* notes 76–78 and accompanying text.

much less frequently than they are and may underestimate the costs associated with the lending of their securities.[119]

Customers may indirectly profit from the lending of their margin securities through lower commissions and lower interest rates on margin loans. In a perfectly competitive market in which broker-dealers compete for margin loan customers largely based on margin loan interest rates, broker-dealers should decrease the interest charged on margin loans by the amount they can profit from lending margin securities. However, broker-dealers likely do not pass all of the profits from lending margin securities to customers in part because customers probably underestimate the amount that their margin securities are lent. Therefore, customers bear uncompensated counterparty risk. The facts that customers bear such risk and broker-dealers have the incentive to lend all customer margin securities mean that customers may be exposed to more counterparty risk than they prefer.

Moreover, the fact that broker-dealers retain some profits from lending customer securities contravenes the first stated goal of Rule 15c3-3.[120] The SEC specifically stated that revenue that is realized through the lending of customer securities should either be used to cover the costs of servicing customers or it should be returned to customers by depositing the cash in the special reserve account.[121] The fact that broker-dealers profit off of lending customer margin securities undermines both this first stated goal of Rule

119 Kahan & Rock, *supra* note 8, at 1273 (describing margin-account holders as "blissfully unaware whether and how often their shares are lent out").

120 *See supra* note 16 and accompanying text (explaining the first SEC goal in adopting Rule 15c3-3 as insuring that, "customer funds held by a broker-dealer . . . and the cash which is realized through the lending, hypothecation and other permissible uses of customers' securities are deployed in safe areas of the broker-dealer's business related to servicing his customers, or to the extent that the funds are not deployed in these limited areas, that they be deposited in a reserve bank account.").

121 *Id.*

15c3-3 and customer protection by forcing customers to bear uncompensated counterparty risk.

3. Securities Lending Systemic Risks

Economic literature has explored the systemic risks associated with securities lending generally.[122] Securities lenders receive collateral in exchange for the lent securities and are allowed to reinvest this collateral.[123] Most securities lending transactions are "open," meaning either party can decide to terminate the loan on demand.[124] Therefore, reinvestment of collateral into longer-term and more illiquid assets can cause a liquidity mismatch that may increase systemic risk.[125] In times of financial stress and market deleveraging, securities borrowers will likely return borrowed securities and demand their cash collateral back from the lender.[126] The lender may be unable to liquidate the invested collateral for the full amount owed and therefore would take losses in order to return the full amount of collateral to the borrower.[127] Decreases in the value of the assets in which the lender reinvested the collateral would

122 *See, e.g.*, Gary Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, 104 J. FIN. ECON. 425 (2012); Frank M. Keane, *Securities Loans Collateralized by Cash: Reinvestment Risk, Run Risk, and Incentive Issues*, 19 CURRENT ISSUES IN ECON. & FIN. 1 (2013); TOBIAS ADRIAN ET AL., FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS, REPO AND SECURITIES LENDING, STAFF REPORT NO. 529 (2013), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr529.pdf [https://perma.cc/8T44-NCW5]; TOBIAS ADRIAN & ADAM B. ASHCRAFT, FED. RESERVE BANK OF NEW YORK, SHADOW BANKING: A REVIEW OF THE LITERATURE, STAFF REPORT NO. 580 (2012), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr580.pdf. [https://perma.cc/77PT-6FQA].

123 ADRIAN ET AL., *supra* note 122, at 1; Keane, *supra* note 122, at 2.

124 ADRIAN ET AL., *supra* note 122, at 4; Keane, *supra* note 122, at 2.

125 ADRIAN ET AL., *supra* note 122, at 10. However, the cash collateral is usually placed in liquid and safer assets like money market funds, repos, or deposits. Keane, *supra* note 122, at 2.

126 *See* ADRIAN ET AL., *supra* note 122, at 10–11.

127 *See id.*

further exacerbate this problem. Such risks would affect broker-dealers when they lend customer margin securities and could increase risks of broker-dealer failures. However, this risk is not special to margin securities lending and would not create additional risks to customers beyond giving broker-dealers additional securities to lend and collateral to reinvest.

Securities lending could also make it harder to return customer assets if a broker-dealer fails. Securities loans for a pre-specified term of a week or one month would slow down the return of customer assets in a SIPC liquidation.[128] Moreover, customers may be unable to locate their securities after a failure of a broker-dealer if the broker-dealer lent their securities and kept poor books and records. For example, customers of Lehman Brothers in the United Kingdom experienced significant delays in receiving their hypothecated securities[129] after Lehman Brothers declared bankruptcy due to their inability to locate and establish claims on their assets.[130] The United States has stricter requirements on commingling of customer funds when hypothecating, which significantly decrease the risk that customers will be unable to locate and make a claim on their

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128 A SIPC Trustee works to restore securities and cash to customers "as soon as possible." *See How a Liquidation Works*, SEC. INV. PROTECTION CORP., http://www.sipc.org/cases-and-claims/how-a-liquidation-works [https://perma.cc/E9H9-EV6N] (last visited Jan. 31, 2017). SIPC explains that the disorganized books and records of the broker-dealer can slow down the process by weeks or months. Lent securities would add additional complexity when dealing with poor books and records because not only would a SIPC Trustee need to first identify where the customer securities were lent, but also it would then need to ensure that the counterparty returned the securities. *See id.*; *Cases & Claims Deadlines*, SEC. INV. PROTECTION CORP., http://www.sipc.org/cases-and-claims/deadlines [https://perma.cc/ZSP9-VAC2] (last visited Jan. 31, 2017).

129 Hypothecation is similar to outright lending, except a broker-dealer pledges a customer security as collateral for a loan instead of lending the security outright. *See supra* note 62 for a definition and description of hypothecation.

130 Deryugina, *supra* note 62, at 273–76.

assets.[131] However, the ability of broker-dealers to easily pledge or lend customer margin securities means that broker-dealer customers could face delays in regaining their margin securities if the broker-dealer did not maintain adequate books and records.[132]

4. Loss of Shareholder Votes

In addition, by lending customer margin securities, broker-dealers are taking and trading customer shareholder votes without directly compensating customers. Shareholder voting rights may have value to customers separate from holding the security for investment purposes, especially for activist investors who may purchase or borrow securities in order to increase their number of votes.[133] Reg T bars broker-dealers from lending customer stocks to activist investors for the sole purpose of increasing their number of votes.[134] However, activist investors are customers of broker-dealers who would likely not want their votes lent under a Reg T permitted purpose.[135] As explained previously, broker-dealers rely on systematic under-voting by shareholders to avoid the problem of over-voting, and in the case of over-voting, broker-dealers are responsible for reducing the number of votes by cancelling customer votes.[136]

The fact that there is no industry or legally mandated standard for broker-dealers to reconcile corporate votes adds to the complexity and confusion about which customers are

131 *See id.* at 282.

132 *Contra id.* at 267–68, 282 (failing to recognize that broker-dealers can profit from lending and rehypothecating customer margin securities).

133 Onnig H. Dombalagian, *Can Borrowing Shares Vindicate Shareholder Primacy?*, 42 U.C. DAVIS L. REV. 1231, 1234–35 (2009); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 816–817 (2006).

134 *See* discussion *supra* note 48.

135 *See supra* notes 47–48 and accompanying text. Activist investors highly value their shareholder votes since they want to influence a corporation's corporate governance and decision-making.

136 *See supra* text accompanying notes 73–75.

actually entitled to vote. Under post-mailing reconciliation, pre-mailing reconciliation, or a hybrid system, a mismatch remains between expectations of customers about their right to vote and the reality of whether they can vote or if their vote is actually counted. Under a post-mailing reconciliation process, customers likely expect their vote will be counted once they submit a proxy statement, yet broker-dealers can cancel those votes without informing the customer.[137] With pre-mailing reconciliation, a customer may believe based on their account statements that their broker-dealer has possession of their margin securities, yet the customer may never receive proxy voting instructions.[138] The lack of a consistent, industry-wide method to reconcile over-voting situations raises questions about whether customers understand the mechanics behind voting their margin securities and how their broker-dealer can take away their voting rights. Moreover, questions remain about how far the current paradigm has moved away from the basic principle of "one shareholder, one vote" because customers who no longer have title in their stock are allowed to vote.

Kahan and Rock suggest ways to address the problems of over-voting and determining which individuals are entitled to vote. They describe a proposal from the Business Roundtable to remove brokers and banks from the process of collecting proxy instructions by having brokers and banks generate and deliver lists of beneficial owners directly to the corporate vote tabulator.[139] This proposal would allow the tabulator to send proxy materials directly to beneficial owners who actually own shares, and broker-dealers would

137 *SEC Proxy Voting Roundtable*, *supra* note 60 ("If there is an over-vote, the broker-dealer will have to decrease the customers' vote but the customers will never know some or all of their votes did not count.").

138 *See supra* notes 79–80 and accompanying text.

139 Kahan & Rock, *supra* note 8, at 1271–72; Bus. Roundtable, Request for Rulemaking Concerning Shareholder Communications, Petition 4-493 (Apr. 12, 2004), http://www.sec.gov/rules/petitions/petn4-493.htm [https://perma.cc/W8FJ-3JS9].

no longer be able to cancel customer votes.[140] Customers would benefit from this arrangement because "brokers would have to identify which shares have been lent out. This could lead margin-account holders (who at present are blissfully unaware whether and how often their shares are lent out) to demand a share of the fees generated."[141]

Alternatively, Kahan and Rock suggest implementing a direct registration clearing and settlement system in which current beneficial owners actually take and hold title in securities in their own name, allowing the DTC to know the names of the beneficial owners.[142] Either of these reforms could alleviate the problems identified above by removing broker-dealers from the role of counting and canceling customer proxy votes and by allowing customers to know whether their shares have been lent. However, broker-dealers would still be allowed to easily lend customer margin securities. Moreover, such a complete restructuring of the proxy voting system decreases the likelihood that the SEC would implement such reforms.[143]

140 Kahan & Rock, *supra* note 8, at 1272.

141 *Id.* at 1273.

142 *Id.* at 1273–77.

143 Barrett suggests a smaller change of creating an affirmative duty on boards of directors to ensure unimpaired effectiveness of shareholders' voting power in any corporate election, which would pressure the securities industry to implement technical and procedural improvements. Richard W. Barrett, Note, *Elephant in the Boardroom?: Counting the Vote in Corporate Elections*, 44 VAL. U. L. REV. 125, 177–79 (2009). Moreover, Barrett argues for stricter enforcement of agency duty to ensure that broker-dealers follow the voting instructions of their customers. *Id.* at 180. Such stricter enforcement could allow courts to ban broker-dealers from canceling customer proxy votes, which would spur reform. Unfortunately, such duties still would allow broker-dealers to easily lend customer margin securities, and the broad acceptance that broker-dealers can lend customer securities and cancel customer proxy votes without informing customers decreases the likelihood that a court would find that this industry practice violates agency duties.

IV. RECOMMENDATIONS

Additional regulation is likely needed to reduce the agency costs and systemic risks associated with broker-dealer use of idle customer assets. At a basic level, the SEC needs the necessary information about sweep programs in order to properly analyze potential systemic risks and agency costs. Beyond proper reporting requirements, additional disclosures to customers about their broker-dealer's profits from their idle assets and when their securities are lent could allow customers to better understand both their broker-dealer's conflicts of interest and when they are actually entitled to a shareholder vote. Increased disclosures by broker-dealers would allow a better-informed negotiation between customers and broker-dealers, which could lead to market solutions to agency problems. Finally, more invasive regulations like caps on fees and bans on canceling customer proxy votes may be necessary to fully address the agency problems associated with broker-dealer use of idle customer assets.

Section IV.A will advocate for sweep program reporting requirements. Section IV.B will discuss potential reforms to reduce agency problems with sweep programs. Section IV.C will examine increased disclosure and collateral requirements for margin securities lending. Section IV.D will analyze different methods to standardize broker-dealer reconciliation of customer shareholder votes and ensure that customers know when they are entitled to vote.

A. Addressing Sweep Program Systemic Risks—Sweep Program Reporting Requirements

The SEC should require broker-dealers to report the size of their sweep programs broken-down by counterparty. This data would allow the SEC to better track the counterparty and systemic risks associated with these sweep programs and to share this data with other U.S. regulators. The current lack of data hinders research into sweep program systemic risks because regulators and researchers must

know the size of sweeps to each counterparty in order to conduct analysis about whether a quick unwinding of these sweeps could threaten the viability of each counterparty. Moreover, knowing the size of sweeps broken down by counterparty would help the SEC and SIPC better understand where customer funds are held, which in turn could help the return of customer funds more quickly after a broker-dealer failure. Broker-dealers likely already have this sweep information available and would not need to report the sweeps broken down by customer. Therefore, this reporting requirement would likely not have a high cost for broker-dealers and would be very beneficial for necessary research into the systemic risk associated with sweep programs.

B. Reducing Sweep Program Agency Problems—Disclosure of Compensation and Cap on Broker-Dealer Fees

The SEC or FINRA should require that broker-dealers disclose to customers the compensation the broker-dealer receives for each product in a sweep program. The current proposed requirement that broker-dealers only disclose whether they received compensation is likely insufficient to understand the full conflict of interest of a broker-dealer because the customer would not know which products paid the broker-dealer the largest fees for sweeping customer cash.[144] However, the broker-dealer agency costs arise through the broker-dealers' choice of which products to include in a sweep program.[145] Therefore, to understand whether their broker-dealer chose sweep products with higher fees and lower returns, customers would also need to know the fees and returns on sweep products not included in the program. Requiring that broker-dealers present customers with the fees and returns on all sweep products in the financial market would inundate the customer with

144 *See supra* notes 31–35, 96 and accompanying text.

145 *See supra* notes 91–94 and accompanying text.

information. It may not be worth the effort for customers to parse through this information in hopes of increasing their return by only a few basis points. Moreover, retail customers may not have the bargaining power to pressure the broker-dealer to include additional or different sweep products that may have a higher return or lower risk.

Alternatively, the SEC could require that the fees paid to broker-dealers for customer sweeps be no greater than the interest paid to customers. This requirement would better align the incentives of the broker-dealer with the customer, thereby reducing agency problems. Broker-dealers would have the incentive to maximize returns for customers in order to maximize returns for themselves. Moreover, a hard cap may better align with the original aim of Rule 15c3-3 to forbid broker-dealers from using customer assets to finance their business unrelated to servicing customer securities because broker-dealers would not be able to retain outsized profits off of customer sweeps.[146] However, in a perfectly competitive market, this rule may not be necessary because customers would capture all returns on their assets above the costs of the services provided by the broker-dealer.[147] In addition, broker-dealers may still be incentivized to sweep into riskier products in order to increase return since the customer holds the ultimate counterparty risk. Nevertheless, extremely risk averse customers could still choose to not sweep their idle cash; further, capping broker-dealer fees at the return for customers would better align the incentives of broker-dealers and customers.

Sweeps into affiliates exacerbate the agency problem and could circumvent a cap on broker-dealer returns by allowing the broker-dealer holding company to realize a higher return than the broker-dealer customers. The SEC could prohibit sweeps into affiliates, but this would likely be too blunt of a regulatory intervention. Affiliates may offer the highest return to customers because the entire return off the

146 *See supra* Section II.A.

147 *See supra* Part I.

investment of customer funds is retained within a single financial entity rather than split between a sweep counterparty and a competing broker-dealer. In addition, a ban on sweeps into affiliates would cause broker-dealers to become more interconnected with other financial entities, spreading the potential systemic risks of sweep programs throughout the financial system. Finally, this prohibition would limit the investment options of customers themselves. Therefore, the SEC should not ban sweeps into affiliates.

C. Addressing Securities Lending Counterparty and Systemic Risks—Disclosure and Collateral Requirements

The SEC could mandate that broker-dealers disclose to customers when they lend their margin securities. This disclosure requirement would ensure that customers know that their securities are lent and that they have lost their shareholder voting rights. The current disclosures in margin loan agreements likely fail to actually alert customers that broker-dealers lend their securities.[148] This new disclosure requirement would allow a better-informed market solution in which customers who place a high value on their shareholder rights or have a low risk tolerance for counterparty risks could negotiate with their broker-dealer to not lend their margin securities. Broker-dealers would likely charge these customers a higher interest rate on their margin loan, but giving customers the information necessary to opt out of having their margin securities lent may better empower customers to limit what broker-dealers do with their idle securities. This mandate would result in broker-dealers bearing the higher administrative and compliance costs associated with disclosures. Moreover, broker-dealers would have to identify which customers' securities they have lent.[149] These additional costs could be passed on to

148 *See supra* note 59 and accompanying text.

149 *See supra* notes 60–62 and accompanying text.

customers through higher commissions and interest rates on margin loans.

In order to decrease systemic risk associated with reinvestment of collateral from securities loans, the SEC could require 100% collateral on loans of customers' securities and limit reinvestment of this collateral into relatively safe and liquid assets like treasury bonds. Requiring 100% collateral would protect customers more than the current rule, which relies in part on broker-dealer net capital for customer protection.[150] Customers would not need to worry that a failing broker-dealer would exhaust its net capital before a customer would be paid in full for its lent securities. Limits on where collateral could be reinvested would also decrease systemic risk that a broker-dealer could not return the full collateral during times of deleveraging.[151] Broker-dealers still would be able to profit from fees from lending customer margin securities, but the limit on reinvesting collateral could decrease broker-dealer profits.

Finally, the SEC could offer an explicit interpretation of Rule 15c3-3 that states that broker-dealers must document and prove that the fees from lending customer securities are either used to cover the cost of servicing customer securities or are returned to the customer. This interpretation and subsequent enforcement actions would be entirely consistent with the first stated aim of Rule 15c3-3[152] and would minimize agency problems associated with the lending of customer margin securities by stopping outsized broker-dealer profits.

150 *See supra* Section III.B.2.

151 *See supra* notes 125–127 and accompanying text.

152 Broker-Dealers; Maintenance of Certain Basic Reserves, 37 Fed. Reg. 25,224, 25,224–25 (Nov. 29, 1972) (to be codified at 17 C.F.R. pt. 240) ("To insure that customers' funds held by a broker-dealer . . . and the cash which is realized through the lending, hypothecation and other permissible uses of customers' securities are deployed in safe areas of the broker-dealer's business related to servicing his customers, or to the extent that the funds are not deployed in these limited areas, that they be deposited in a reserve bank account.").

D. Standardization for Reconciling Corporate Votes

With regards to shareholder votes, the SEC could mandate corporate vote reconciliation methods for broker-dealers in order to ensure that customers understand how broker-dealers can affect their voting rights. Shareholder rights are too important for broker-dealers to be able to cancel customer votes without informing customers. Legitimacy in any democratic institution depends on voters believing that their vote actually counts once they cast their ballot. Currently, margin customers should not have faith that corporations actually count their votes because they cannot be sure that their broker-dealer has not canceled their vote. Any regulatory intervention should strive to maximize the number of customers who can vote while ensuring transparency about when a customer can actually vote and have their vote counted.

Instead of explicitly mandating vote reconciliation methods, the SEC could bar broker-dealers from canceling customer votes once the customer has submitted their voting instructions. This would force broker-dealers and the market to determine the most efficient solution to the problems of over-voting and canceling customer votes. With this mandate, broker-dealers would never want over-voting because that would cause the DTC to cancel all of its customers' votes. In effect, this mandate may force broker-dealers to do a form of pre-mailing reconciliation. Broker-dealers could allow some over-voting by customers; however, they would be forced to cancel the broker-dealer's proprietary votes in order to avoid having all of their votes invalidated. This system would allow all customers to know whether or not they are allowed to vote and to have confidence that their votes will count. This system, however, would increase costs on broker-dealers, which in turn could be passed on to customers through higher commissions or interest rates on margin loans. In addition, because of systematic under-voting, fewer votes would be transmitted to corporations, which could hinder corporations from gaining quorum.

Alternatively, the SEC could require broker-dealers to inform their customers if they cancel customer votes. This system would allow broker-dealers to still choose either post-mailing reconciliation or pre-mailing reconciliation. The costs of post-mailing reconciliation, however, would increase due to the required disclosure of a cancelled vote. With this mandate, customers would know whether their vote was counted and would still have the information necessary to negotiate an agreement with their broker-dealer not to lend their margin securities. However, if customers are currently ignorant about the fact that their shareholder votes may be canceled, this system may exacerbate problems with systematic under-voting because customers would know that their votes may not always count, thereby reducing the incentive to take the time to vote in the first place. Nevertheless, this mandate is preferable to an outright ban on canceling customer votes because this system would not force costly pre-mailing reconciliation, would give more customers the opportunity to cast their vote, and would still ensure that customers fully understand how and when their voting rights are affected by the lending of their margin securities.

Finally, the SEC could apply the stricter lending requirements on fully paid and excess margin securities to margin securities, thereby treating all customer securities the same.[153] This reform would require a broker-dealer to always enter into separate agreements with customers any time that it wanted to lend a customer security.[154] Getting affirmative consent from customers would be costly and the number of customer securities available for lending would decrease. This reform might significantly increase the costs of margin loans by removing a key source of revenue for broker-dealers and by hindering broker-dealers' ability to rehypothecate and replenish their cash supply after giving a

153 *See supra* text accompanying notes 50–62.

154 *Id.*

margin loan.[155] The SEC would need to conduct additional research about the cost of this reform, but such research could justify why having fewer requirements on securities lending up to 140% of a margin loan is "reasonable."[156]

V. CONCLUSION

Protecting customer assets is a critical component of SEC broker-dealer regulation. Segregation, possession, and control of customer assets continue to form the basis of broker-dealer customer protection, yet sweep programs and securities lending allow broker-dealers to profit from no longer segregating or possessing idle customer assets. The ability of broker-dealers to profit from customer assets goes against the original spirit of the customer protection rule and is especially troublesome when these uses of customer assets take away customer rights and increase the risk that the assets may not be quickly returned to the customer. Potential systemic risks associated with broker-dealer use of idle customer assets adds additional urgency for continued SEC review of the customer protection rule. The SEC should keep in mind the benefits to customers and key market functions associated with sweep programs and securities lending. However, the SEC must ensure that customers are fully informed about the location of their assets, the conflict of interests of their broker-dealers, and if and when their rights are affected. Increased disclosure to customers and the SEC would allow a better-informed market solution in which customers could capture a larger share of the profit derived from their idle assets or demand that their idle assets always remain with their broker-dealer. Confidence in the financial system requires that customers have confidence that their broker-dealer will act responsibly with their assets, and broker-dealer customers may not feel confident if they fully understood the many ways in which broker-dealers profit off their assets. Broker-dealers will continue to search for new

155 *See supra* note 62.

156 *See supra* note 53 and accompanying text.

sources of revenues, but the SEC must ensure that broker-dealer revenue streams do not hinder the protection of customer assets.