SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200, 240, 249

[Release No. 34–39454; File No. S7–30–97]

RIN 3235–AH16

OTC Derivatives Dealers

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is publishing for comment proposed rules and rule amendments under the Securities Exchange Act of 1934 that would tailor capital, margin, and other broker-dealer regulatory requirements to a class of registered dealers, called OTC derivatives dealers, active in over-the-counter derivatives markets. The proposed regulations for OTC derivatives dealers are intended to allow securities firms to establish dealer affiliates that would be able to compete more effectively against banks and foreign dealers in global over-the-counter markets. Registration as an OTC derivatives dealer under the proposed rules would be an alternative to registration as a fully regulated broker-dealer, and would be available only to entities acting primarily as counterparties in privately negotiated over-the-counter derivatives transactions.

DATES: Comments should be submitted on or before March 2, 1998.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Mail Stop 6–9, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments may also be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–30–97. This file number should be included on the subject line if E-mail is used. Comment letters received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Comment letters that are submitted electronically will be posted on the Commission's Internet web site (http://www.sec.gov).

FOR FURTHER INFORMATION CONTACT:

General: Catherine McGuire, Chief Counsel, Glenn J. Jessee, Special Counsel, or Patrice Gliniecki, Special Counsel, at (202) 942–0073, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 7–11, Washington, D.C. 20549.

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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission is publishing for comment proposed Rules 3b–12, 3b–13, 3b–14, 3b–15, 3b–16, 15a–1, 15b9–2, 15c3–4, 17a–12, 36a1–1, and 36a1–2 [1] under the Securities Exchange Act of 1934 (''Exchange Act'').[2] The Commission also proposes to amend Rule 30–3 [3] and Exchange Act Rules 8c–1, 15b1–1, 15c2–1, 15c3–1, 15c3–3, 17a–3, 17a–4, and 17a–11,[4] and to revise Form X–17A–5 (FOCUS report).[5]

I. Introduction

Privately negotiated, over-the-counter (''OTC'') derivatives transactions involving large institutions have come to occupy a prominent place in global finance. The International Swaps and Derivatives Association (''ISDA'') estimates that, as of December 31, 1996, the combined notional amount of globally outstanding interest rate swaps, currency swaps, and interest rate options has grown to $25.4 trillion.[6] This market has reached this size in a relatively short period of time. In fact, the first major swap transaction was effected between IBM and the World Bank only 16 years ago.[7]

Whether OTC derivatives transactions are structured as interest rate swaps, foreign currency swaps, equity swaps, basis swaps, total return swaps, credit derivatives, or options, they share certain characteristics.[8] For example, each has a value or return related to the value or return of an underlying asset. Asset classes can consist of securities or virtually any other financial instrument, financial measure, or physical commodity, such as interest rates, securities indices, foreign currencies, metals or petroleum, or spreads between the values of different assets. More importantly, each of these products can provide their users with a carefully tailored method for managing a variety of risks.[9]

Relying on developments in financial engineering, dealers and end-users can identify and isolate different kinds and degrees of risk present in their portfolios and not only evaluate these risks, but design derivative instruments to specifically address them. Some OTC derivatives transactions, for example, are structured to address market risk—the risk that the value of the underlying asset, rate, or index will suffer an adverse change in value. Others are designed to address asset volatility. Still others, based on two or more assets, may address risks posed by changes in the values of the assets relative to one another. This is particularly true in the case of foreign currency swaps, but may also apply where correlations exist between the performance of different assets. Recently, the financial industry has developed credit derivatives that address the risks associated with the default by, or a decline in the rating of, a particular issuer of debt or other securities.

As new products are developed as a result of dealer creativity and in response to the needs of end-users,

[1] 17 CFR 240.3b–12, 240.3b–13, 240.3b–14, 240.3b–15, 240.3b–16, 240.15a–1, 240.15b9–2, 240.15c3–4, 240.17a–12, 240.36a1–1, and 240.36a1–2.

[2] 15 U.S.C. 78a *et seq.*

[3] 17 CFR 200.30–3.

[4] 17 CFR 240.8c–1, 240.15b1–1, 240.15c2–1, 240.15c3–1, 240.15c3–3, 240.17a–3, 240.17a–4, and 240.17a–11.

[5] 17 CFR 249.617.

[6] ''ISDA Market Survey,'' ISDA Internet web site (http://www.isda.org).

[7] See Peter A. Abken, Beyond Plain Vanilla: A Taxonomy of Swaps, Financial Derivatives Reader (Robert W. Kolb, ed.) (1992) at 265.

[8] Swaps are contracts that typically allow the parties to the contract to exchange cash flows related to the value or performance of certain assets, rates, or indexes for a specified period of time. See generally Peter A. Abken, Beyond Plain Vanilla: A Taxonomy of Swaps, Financial Derivatives Reader (Robert W. Kolb, ed.) (1992). Most swaps are based on currencies or interest rates. Swaps that provide for an exchange of values based on the value or performance of equity securities make up a small, but growing, share of the swaps market. Options are instruments that generally provide the holder, in exchange for the payment of a premium, with benefits of favorable movements in the underlying asset or index with limited or no exposure to losses from unfavorable price movements. Typically, OTC options provide for cash settlement, rather than the delivery of the underlying asset, rate, or index. Credit derivatives function like options to the extent payments under the contract are made in the event of a credit event, such as a decline in an issuer's credit rating or default in performance under a debt obligation.

[9] See, e.g., Clifford W. Smith, Jr., Charles W. Smithson, and D. Sykes Wilford, Managing Financial Risk, Financial Derivatives Reader (Robert W. Kolb, ed.) (1992); Group of Thirty, Derivatives: Practices and Principles (July 1993); Financial Derivatives: Actions Needed to Protect the Financial System, United States General Accounting Office Report (May 1994).

some of these products may cross regulatory boundaries. OTC options on equity securities or on U.S. government securities, for example, are securities within the definition set forth in Section 3(a)(10) of the Securities Exchange Act of 1934 (''Exchange Act'').[10] Firms that effect transactions in these or other securities OTC derivative products are required to register as broker-dealers under Section 15(b) of the Exchange Act[11] and become subject to all of the regulations applicable to other securities brokers-dealers, including Exchange Act rules governing margin and capital. Firms that effect transactions only in non-securities OTC derivative products are not subject to U.S. broker-dealer regulation. In addition, because banks are excluded from the Exchange Act definitions of ''broker'' and ''dealer,''[12] they may engage in a broad range of securities and non-securities OTC derivatives activities consistent with guidance issued by their applicable bank regulators.[13]

The potential costs of broker-dealer regulation, as applied to OTC derivatives dealers, have affected the way U.S. securities firms conduct business in OTC derivatives markets. In many instances, U.S. firms have decided to locate segments of their OTC derivatives business in foreign financial centers. The manner in which business relationships between dealers and their counterparties are structured has also played a role in the development of offshore locations for OTC derivatives business.

For example, in order to reduce credit exposure to a single counterparty, dealers in OTC derivatives markets enter into master agreements with their counterparties that provide for netting of the outstanding financial obligations existing between the dealers and their counterparties. It makes sense, therefore, for dealers to seek to conduct both securities and non-securities OTC derivatives transactions with any counterparty through a single legal entity. To the extent a non-bank dealer's transactions include securities OTC derivative products, the federal securities laws would require this single legal entity to be a U.S. registered broker-dealer. Capital and margin requirements applicable to registered broker-dealers, however, impose substantial costs on the operation of an OTC derivatives business and make it difficult for U.S. securities firms to compete effectively with banks and foreign dealers in OTC derivatives markets.[14]

While there may be other reasons for U.S. securities firms to conduct business from foreign financial centers, U.S. securities firms should not be compelled to move business activities outside of the United States solely to address competitive disadvantages that result from Commission regulation. Accordingly, the Commission proposes to establish a form of limited broker-dealer regulation that would give U.S. securities firms an opportunity to conduct business in a vehicle subject to modified regulation appropriate to OTC derivatives markets.

This proposed structure is optional and is designed to allow U.S. securities firms to establish separate entities capable of acting as counterparties with respect to both securities and non-securities OTC derivative products. Capital, margin, and various other requirements would be tailored to the activities of these entities. These tailored requirements are intended, in part, to improve the efficiency and competitiveness of U.S. securities firms active in global OTC derivatives markets. These improvements should benefit participants in OTC derivatives markets. OTC derivatives dealers would remain subject to other rules applicable to fully regulated broker-dealers.

Registration as an OTC derivatives dealer would be an alternative to registration as a fully regulated broker-dealer under Section 15(b) of the Exchange Act, and would be available only to entities acting primarily as counterparties in privately negotiated OTC derivatives transactions. OTC derivatives dealers would also be allowed to engage in certain categories of securities activities related to conducting an OTC derivatives business. For example, OTC derivatives dealers would be able to enter into transactions for risk management purposes and to take possession of or sell counterparty collateral. They would also be permitted to issue securities, including warrants on securities, hybrid securities products, and structured notes.[15]

The Commission is concerned, however, that OTC derivatives dealers not take advantage of the modified regulatory requirements under the limited regulatory structure to engage in a significant degree of activity better suited to full broker-dealer regulation. Accordingly, the Commission proposes that OTC derivatives dealers be allowed to engage only in the securities activities described in the proposed rules, and that all securities transactions, including securities OTC derivative transactions, be effected through a fully regulated broker-dealer.

II. Description of the Proposed Rules and Rule Amendments

A. Definitions

As further detailed below, the proposed rules define five new terms: (1) OTC derivatives dealer; (2) eligible OTC derivative instrument; (3) permissible derivatives counterparty; (4) permissible risk management, arbitrage, and trading transaction; and (5) hybrid security.

1. Proposed Rule 3b–12; Definition of OTC Derivatives Dealer

The proposed definition of OTC derivatives dealer is intended to encompass those dealers that are primarily engaged in acting as counterparty in OTC derivatives transactions. The Commission recognizes, however, that it would be appropriate to permit entities that elect to become subject to the limited regulatory system also to conduct limited securities activities in

[10] 15 U.S.C. 78c(a)(10).

[11] See 15 U.S.C. 78o(b).

[12] This bank exclusion from the Exchange Act definitions of ''broker'' and ''dealer'' is available only to those banking institutions that satisfy the definition of ''bank'' set forth in Section 3(a)(6) of the Exchange Act [15 U.S.C. § 78c(a)(6)].

[13] Bank regulators have issued guidance to banks engaging in derivatives activities. See, e.g., Risk Management of Financial Derivatives, OCC Banking Circular No. 277 (Oct. 1993); OCC Bulletin 94–31, Questions and Answers For BC–277 (May 1994); OCC Bulletin 96–43, Credit Derivatives (Aug. 1996); OCC Bulletin 96–25, Fiduciary Risk Management of Derivatives and Mortgage-backed Securities (Apr. 1996).

[14] The Commission's current net capital rule [17 CFR 240.15c3–1] imposes substantial capital charges in connection with conducting an OTC derivatives business. For example, under the net capital rule, broker-dealers holding interest rate swaps must calculate two potential capital charges for each swap. First, the net capital rule considers any net interest payment due to be an unsecured receivable, subject to a 100% capital charge in computing net capital. Second, a broker-dealer must also take a deduction, or haircut, on the notional amount of the swap. The size of the haircut depends on whether the firm has offset the swap. Current margin requirements also make it difficult for registered broker-dealers to conduct an OTC derivatives business. Under Section 7 of the Exchange Act [15 U.S.C. 78g] and Regulation T [12 CFR 220.1], broker-dealers are prohibited from extending credit on securities other than margin securities. In general, this means that registered broker-dealers cannot extend credit in securities OTC derivatives transactions on terms as favorable as those offered by other dealers.

[15] ''Hybrid securities'' are securities products that typically incorporate payment features that are economically similar to options, forwards, futures, or swaps involving currencies, interest rates, commodities, securities, or indices (or any combination, permutation, or derivative of these underlying assets). The proposed definition of ''hybrid security'' is discussed in Section II.A.4. below. Structured notes are notes that, like other OTC derivative products, provide for a return that is based on the value or return of an underlying asset.

connection with their OTC derivatives business. Accordingly, proposed Rule 3b–12 would define OTC derivatives dealer to mean any dealer that limits its securities activities to (1) engaging as a counterparty in transactions in eligible OTC derivative instruments (as defined in proposed Rule 3b–13) with permissible derivatives counterparties (as defined in proposed Rule 3b–14);[16] (2) issuing and reacquiring issued securities through a fully regulated broker or dealer; or (3) engaging in other securities transactions which the Commission designates by order, and in connection with any of these activities, engaging in permissible risk management, arbitrage, and trading transactions (as defined in proposed Rule 3b–15)[17]

Typically, U.S. firms that engage in securities derivatives activities are required to register as broker-dealers under Section 15(b) of the Exchange Act[18] and become subject to all of the regulations that apply to other fully regulated broker-dealers. Registration as an OTC derivatives dealer would be an alternative to full broker-dealer registration and would afford securities firms an opportunity to elect to conduct their activities in a vehicle subject to modified regulation. OTC derivatives dealers would also be permitted to engage in any non-securities activity, subject to appropriate capital treatment, as further discussed below.

2. Proposed Rule 3b–13; Definition of Eligible OTC Derivative Instrument.

Proposed Rule 3b–13 sets forth various criteria for determining whether a particular OTC derivative instrument is part of the class of instruments in which an OTC derivatives dealer would be eligible to act as counterparty. As defined in the proposed rule, these instruments would include any agreement, contract, or transaction that is not part of a fungible class of agreements, contracts, or transactions that are standardized as to their material economic terms and that are not entered into and traded on an exchange or other similar type of facility. These instruments would be based, in whole or in part, on the value of, any interest in, any quantitative measure of, or the occurrence of any event relating to, one or more securities, commodities, currencies, interest or other rates, indices, or other assets, or involve certain long-dated forward contracts, specifically contracts to purchase or sell a security on a firm basis at least one year following the transaction date. These criteria, the Commission believes, set reasonable standards that reflect that participants in the OTC derivatives market are primarily institutions that engage in privately negotiated transactions based, in part, on an assessment of a counterparty's credit and its ability to perform under the terms of a transaction.

The types of instruments that would generally satisfy the criteria set forth in proposed Rule 3b–13 would include interest rate swaps, currency swaps, equity swaps, swaps involving physical commodities (such as metals or petroleum), OTC options on equities (including equity indices), OTC options on U.S. government securities, OTC debt options (including options on debt indices), options on physical commodities, long-dated forwards on securities, and forwards relating to other types of assets. This list, however, is not intended to be an exclusive list, and OTC derivatives dealers would be permitted to act as counterparty in any instrument that meets the requirements of the proposed rule. As noted above, although OTC derivatives dealers would be primarily engaged in transactions involving eligible OTC derivative instruments, under the proposed regulatory system, they would also be permitted to engage in a limited range of other activities. These are discussed in Section II.A.4. below.

3. Proposed Rule 3b–14; Definition of Permissible Derivatives Counterparty

Proposed Rule 3b–14 defines those entities with which OTC derivatives dealers would be permitted to act as counterparties. As noted above, one goal underlying the proposal to create a limited system of broker-dealer regulation is to accommodate an institutional business that, in many instances, is being conducted offshore and to make it feasible for U.S. securities firms to combine securities and non-securities OTC derivatives activities in one entity. Persons who would be considered to be permissible derivatives counterparties in transactions with OTC derivatives dealers would be the same persons who currently are eligible to effect transactions with swaps dealers under the Commodity Future Trading Commission's swaps exemption set forth at 17 CFR Part 35.[19] Such persons generally would include banks; investment companies; commodity pools with total assets exceeding $5 million; corporations, partnerships, proprietorships, organizations, trusts, or other entities that have total assets exceeding $10 million, or that have net worth exceeding $1 million and are entering into transactions in connection with the conduct of their business; employee benefit plans subject to the Employee Retirement Income Security Act of 1974 with total assets exceeding $5 million; governmental entities; broker-dealers; futures commission merchants; and natural persons having total assets exceeding $10 million.

The Commission is also considering whether to include an additional class of permissible derivatives counterparty, specifically natural persons having at least $5 million in total assets who enter into OTC derivatives transactions to hedge existing or anticipated assets or liabilities. Persons in this class may include, for example, persons who acquire significant holdings of equity securities as a result of starting or operating a business or who own securities with a very low basis for tax purposes, but do not want to sell their holdings at the present time. These persons would be able to reduce the risk associated with being heavily invested in one type of security and diversify their market exposure by entering into a swap or cash-settled option without selling their holdings. The Commission specifically solicits comments on whether to broaden the definition of permissible derivatives counterparty to include this class of natural persons, or other categories of institutional investors, and encourages persons who have entered into OTC derivatives transactions to comment on the risks and benefits these transactions may

[16] Transactions by an OTC derivatives dealer that involve securities OTC derivative instruments must be effected through a fully regulated broker-dealer. See infra Section II.C., discussing proposed Rule 15a–1.

[17] The Commission expects that the rules being proposed today would be used by firms that are engaged primarily in the business of engaging in transactions in eligible OTC derivative instruments with permissible derivatives counterparties. As discussed in this release, one purpose of the limited regulatory structure for OTC derivatives dealers is to make it possible for U.S. securities firms to better compete in OTC derivatives markets with banks and foreign dealers. As discussed in Section II.A.4. below, OTC derivatives dealers would be permitted to engage in certain other securities activities that are closely related to conducting an OTC derivatives business. The regulatory structure for OTC derivatives dealers is not intended to allow securities firms to move substantial securities activity out of fully regulated broker-dealers into OTC derivatives dealers in order to take advantage of the modified capital and margin requirements applicable to these entities. OTC derivatives dealers would also be prohibited from accepting or holding customer funds or securities, or acting as a ''dealer'' in securities. See infra note 24.

[18] 15 U.S.C. 78o(b).

[19] Part 35 exempts certain swap agreements from most provisions of the Commodity Exchange Act [7 U.S.C. 1 *et seq.*], provided that the transaction is conducted solely between ''eligible swap participants,'' as defined in Part 35. The Commission believes that the proposed definition of ''permissible derivatives counterparty,'' generally describes participants active in OTC derivatives markets, but requests comment on this point.

present. The Commission is also interested in commenters' views whether factors other than total assets should be considered in determining which persons should be included in the definition.

4. Proposed Rules 3b–15 and 3b–16; Definition of Permissible Risk Management, Arbitrage, and Trading Transaction; Definition of Hybrid Security

Proposed Rule 3b–15 would permit an OTC derivatives dealer to engage in a limited range of securities activities, described under the rule as risk management, arbitrage, and trading transactions, in connection with the dealer's business as a counterparty in eligible OTC derivative instruments and as an issuer of securities. As discussed above, the focus of the regulatory system for OTC derivatives dealers is on providing a regulatory vehicle that would allow securities firms to establish separate entities through which to operate an OTC derivatives business. This necessarily includes the ability of OTC derivatives dealers to take possession of and sell counterparty collateral, to invest short-term cash balances, to manage risks associated with their OTC derivatives positions or their issuance of securities, and to engage in limited financing and arbitrage transactions.

The Commission recognizes the commercial interests that drive financial enterprises and the desire to maximize revenues. The Commission, however, is also concerned that securities firms not be able to move dealer activity in cash market instruments, such as stocks and bonds, that is currently conducted through a fully regulated broker-dealer into an OTC derivatives dealer. One reason is that OTC derivatives dealers should not be provided with an unfair regulatory advantage over fully regulated broker-dealers due to the availability of modified capital and margin requirements. A second reason is the Commission's view that entities that engage in comprehensive dealer activity should be subject to full broker-dealer regulation, including the Commission's existing capital and margin requirements, and be subject to supervision by a securities self-regulatory organization (''SRO''). In this instance, the Commission believes it is possible to satisfy the commercial interests of derivatives dealers in a manner consistent with sound regulatory policy, and proposes to permit OTC derivatives dealers to engage in a limited range of securities activities.[20]

Under the proposed rule, OTC derivatives dealers would be permitted to take possession of and sell counterparty collateral and invest short-term cash balances. It is expected, however, that any securities trading activity associated with short-term cash management by OTC derivatives dealers would involve relatively small cash balances and would not involve over-capitalizing these dealers solely for the purpose of moving government securities or other trading books into an OTC derivatives dealer from a fully regulated broker-dealer.

OTC derivatives dealers would also be permitted to manage risks associated with their OTC derivatives positions. The nature of risk management activity, however, makes it difficult to determine whether particular transactions satisfy this requirement. It is no longer possible, in many instances, to show the relationship between a hedging transaction and the instrument it is intended to hedge. Instead, all of the risks in a dealer's portfolio of OTC derivative positions are aggregated and managed on a daily basis. As a result, it may be difficult to demonstrate the relationship between trading done for risk management and the different OTC derivatives positions on a dealer's books.[21] It may also be difficult to distinguish between trading done for risk management purposes and other trading activity conducted by a derivatives dealer. Therefore, OTC derivatives dealers should develop reasonable procedures for ensuring compliance with the restrictions set forth in the proposed rules and for demonstrating the relationship between their risk management activities and the OTC derivatives positions they maintain. Such procedures could include maintaining clear documentation regarding risk measurement and clearly identifying transactions effected for risk management purposes.

Other permissible securities activities would include engaging in certain financing transactions involving repurchase and reverse repurchase agreements, buy/sell transactions,[22] and lending and borrowing transactions, as well as entering into certain transactions for arbitrage purposes.[23] Such financing and arbitrage transactions, however, would have to be limited to transactions involving securities positions established through the possession or sale of counterparty collateral, cash management, or hedging activity. OTC derivatives dealers should also develop procedures applicable to these types of transactions to ensure compliance with the restrictions set forth in the proposed rules.

In some instances it may be difficult for an OTC derivatives dealer to determine and properly document whether a transaction satisfies one of the purposes set forth in the proposed rule. In order to avoid circumstances in which an OTC derivatives dealer inadvertently violates the proposed rules through its inability to properly document the purpose of a transaction, OTC derivatives dealers would also be allowed to engage in a specified number of additional securities transactions in any calendar year. These transactions would have to relate to securities positions established through the possession or sale of counterparty collateral, cash management, or hedging activity, and firms would be required to maintain and enforces written policies and procedures reasonably designed to achieve compliance with other provisions of the proposed rule.[24] The

[20] As noted above, under the proposed rules, OTC derivatives dealers would be permitted to engage in any non-securities activity, subject to appropriate capital treatment under Exchange Act Rule 15c3–1 [17 CFR 240.15c3–1].

[21] Trading volume and the instruments traded for risk management purposes also do not provide clear links to the instruments being hedged. For example, trading volume may increase as contracts mature or during times of unusual market volatility. Also, instruments based on one security may be hedged by trading other securities (or securities derivatives) where a relationship exists between the value or performance of the two securities. This relationship may change over time or under different market conditions.

[22] A buy/sell transaction is in many respects the economic equivalent of a repurchase transaction, except that title to the debt instrument that is the subject of the transaction passes to another party and it is that party, rather than the original owner, who receives payments of interest made during the term of the buy/sell transaction.

[23] Consistent with the proposed limitations on the securities activities of OTC derivatives dealers, permissible arbitrage transactions would be limited to transactions involving closely related cash market and derivative instruments that are effected close to one another in time for purposes of taking advantage of price disparities in different markets. An example would include transactions involving the purchase or sale of an equity security and the acquisition of an option on the same equity security that are effected close together in time, taking into consideration market liquidity and hours of market operation.

[24] Except to the extent expressly permitted under the proposed rules, an OTC derivatives dealer would not be permitted to engage directly or indirectly in any activity that may otherwise cause it to be a ''dealer'' as defined in Section 3(a)(5) of the Exchange Act [15 U.S.C. § 78c(a)(5)]. This would include, but not be limited to, (1) purchasing or selling securities as principal from or to customers; (2) carrying a dealer inventory in securities (or any portion of an affiliated broker-dealer's inventory); (3) quoting a market in or publishing quotes for securities (other than quotes on one side of the market on a quotations system

Continued

Commission proposes that the number of additional securities transactions be set at 150 per calendar year. The Commission requests comment on the likely uses and effects of this provision, and whether the number of allowable additional securities transactions should be more or less than 150.

As noted above, the proposed rules would also allow OTC derivatives dealers to issue and reacquire issued securities, including warrants on securities, hybrid securities, and structured notes. Proposed Rule 3b–16 defines a hybrid security as a security that incorporates payment features economically similar to options, forwards, futures, swap agreements, or collars involving currencies, interest rates, commodities, securities, or indices (or any combination, permutation, or derivative of such contract or underlying interest). As discussed in Section II.C. below, the issuance and repurchase of issued securities, such as warrants on securities, hybrid securities, and structured notes, by an OTC derivatives dealer would have to be effected through a fully regulated broker-dealer.

B. Proposed Amendment to Rule 15b1–1; Registration with the Commission

As discussed above, OTC derivatives dealers would be a part of a special class of broker-dealers that could elect to register with the Commission under a limited regulatory structure. Firms that elect to register as OTC derivatives dealers would register with the Commission by filing an application for registration on Form BD, the Uniform Application for Broker-Dealer Registration.[25] Under the proposed amendments to Exchange Act Rule 15b1–1,[26] OTC derivatives dealers would file Form BD with the Central Registration Depository, a computer system operated by the National Association of Securities Dealers, Inc. (''NASD''), in accordance with the instructions contained on the form. In completing Form BD, an OTC derivatives dealer would respond to Item 10, which asks an applicant to disclose its planned business activities, by checking ''other'' and writing in that it proposes to engage solely in the business of an OTC derivatives dealer.

C. Proposed Rule 15a–1; Transactions by OTC Derivatives Dealers

As discussed above in connection with the proposed definition of ''OTC derivatives dealer,'' the Commission expects that OTC derivatives dealers would be engaged primarily in transactions involving OTC derivative instruments for which these dealers act as counterparty. They would also be permitted to engage in any non-securities transaction, subject to appropriate capital treatment.

As discussed in Section II.A.4. above, because OTC derivatives dealers would be a class of registered broker-dealers subject to a lesser degree of regulation, the Commission believes it would be appropriate to limit the securities activities conducted by these firms. Consistent with the definition of OTC derivatives dealer in proposed Rule 3b–12, such an entity would be permitted to (i) act as counterparty in securities (and non-securities) transactions in eligible OTC derivative instruments with permissible derivatives counterparties, (ii) issue and reacquire issued securities, including warrants on securities, hybrid securities, and structured notes, through a fully regulated broker-dealer, and (iii) engage in other securities transactions as the Commission may designate by order.[27] In connection with these activities, OTC derivatives dealers would also be permitted to engage in permissible risk management, arbitrage, and trading transactions, as defined in proposed Rule 3b–15. Proposed Rule 15a–1, however, would require any securities transaction by an OTC derivatives dealer to be effected through a fully regulated broker-dealer.[28]

The requirement that securities transactions be effected through a fully regulated broker-dealer means that the dealer's counterparties in these transactions would be considered customers of the fully regulated broker-dealer. In these transactions, all applicable SRO sales practices requirements would apply. In addition, all persons having contact with counterparties would need to be properly qualified registered representatives of the fully regulated broker-dealer. For example, in a transaction involving a securities OTC derivative instrument, such as an OTC option on a U.S. government security, any person discussing the terms of the transaction with the counterparty would have to be a registered representative of the fully regulated broker-dealer. This person, however, could be a dual employee of both the fully regulated broker-dealer and the OTC derivatives

generally available to non-broker-dealers, such as a retail screen broker for government securities) in connection with the purchase or sale of securities permitted under proposed Rule 3b–15; (4) holding itself out as a dealer or market-maker or as being otherwise willing to buy or sell one or more securities on a continuous basis; (5) engaging in trading in securities for the benefit of others (including any affiliate), rather than solely for the purpose of the OTC derivatives dealer's investment, liquidity, or other permissible trading objective; (6) providing incidental investment advice with respect to securities; (7) participating in a selling group or underwriting with respect to securities; or (8) engaging in purchases or sales of securities from or to an affiliated broker-dealer except at prevailing market prices.

[25] 17 CFR 249.501.

[26] 17 CFR 240.15b1–1.

[27] The Commission is also proposing to amend Rule 30–3 [17 CFR 200.30–3] to delegate to the Director of the Division of Market Regulation its authority to designate additional securities transactions in which OTC derivatives dealers would be permitted to engage.

[28] Exchange Act Rule 10b–10 [17 CFR 240.10b–10] requires broker-dealers to send a written confirmation of each securities transaction with a customer at or before completion of the transaction, containing certain material information about the transaction. In a securities transaction between an OTC derivatives dealer and a customer, effected through a fully regulated broker-dealer, the OTC derivatives dealer and the fully regulated broker-dealer would each be responsible for sending a confirmation to the customer under the rule. Certain customers, however, could choose not to receive two confirmations for each securities transaction they enter into with an OTC derivatives dealer. Customers, therefore, could instruct the OTC derivatives dealer and the fully regulated broker-dealer effecting securities transactions on its behalf to send one joint confirmation (''joint confirmation'') to the customer on behalf of both parties.

The customer's instructions to receive a joint confirmation would have to (1) explicitly state which of the parties (the OTC derivatives dealer or the fully regulated broker-dealer) is to be responsible for sending the confirmation; (2) be a separate instrument from the basic account opening documents with the OTC derivatives dealer and the fully regulated broker-dealer; (3) not be a condition of entering into securities transactions with the OTC derivatives dealer; and (4) not be induced by differential fees or other costs based on whether such an instruction is provided.

A joint confirmation, sent on behalf of both the OTC derivatives dealer and the fully regulated broker-dealer effecting the transaction would have to disclose all of the information required of either party under the rule, including, but not limited to the identity of the security, the trade price, and the date and time of the trade, the identity of each party and its capacity in the transaction, the fact that the OTC derivatives dealer is not a member of the Securities Investor Protection Corporation, and any transaction-related compensation earned by either the fully regulated broker-dealer or the OTC derivatives dealer in connection with the transaction. Both the OTC derivatives dealer and the fully regulated broker-dealer would be considered fully responsible for the contents of the joint confirmation, regardless of which party is responsible for sending it to the customer. The customer's instruction to receive a joint confirmation would not otherwise affect the obligations of either party to the customer under the anti-fraud provisions of the federal securities laws.

OTC derivatives dealers and fully regulated broker-dealers relying upon the written instructions of their customer to send a joint confirmation would each have to obtain and preserve a copy of the customer's written instructions, for the period in which they are relying on those instructions, in an easily accessible place, and for a period of not less than two years after they no longer rely on the instructions to send a joint confirmation.

dealer, subject to appropriate supervision by both firms.[29]

The requirement that securities OTC derivatives transactions be effected through a fully regulated broker-dealer is consistent with existing regulatory requirements that apply to the purchase and sale of securities and is, in part, designed to ensure that all securities transactions remain subject to existing sales practice requirements. It is also intended to prevent an unforeseen regulatory disparity from arising between OTC derivatives dealers, which would be subject to modified capital and margin requirements, and other fully regulated broker-dealers in connection with conducting securities transactions.

D. Exemptions

1. Proposed Rule 36a1–1; Exemption From Section 7 of the Exchange Act for OTC Derivatives Dealers

OTC derivative markets are credit sensitive. Whether a dealer and a counterparty will enter into a transaction involving an OTC derivative instrument depends on their assessment of the other's ability to meet its financial obligations under the terms of the instrument. The creditworthiness of the counterparties is also a factor in determining the price of the transaction. As part of any OTC derivatives transaction, a dealer may require its counterparty to deposit collateral with the dealer to provide some assurance of the counterparty's ability to perform.

Both the ability of the dealer to collect collateral to secure payment under an OTC derivative instrument, and the amount of collateral the dealer must collect, will depend on the regulatory status of the dealer. Federal regulations that govern the collateral, or margin, that must be collected in connection with securities transactions set up certain competitive inequalities between OTC derivatives dealers that are registered broker-dealers and others, including banks. Registered broker-dealers that extend credit for the purpose of purchasing or carrying securities are required to comply with the provisions of Regulation T.[30] The margin requirements for banks are contained in Regulation U.[31]

In general, Regulation T limits the flexibility of broker-dealers to extend credit in securities OTC derivatives transactions by prohibiting extensions of credit on securities other than margin securities. Regulation U, however, offers bank dealers greater flexibility by allowing them to extend credit on collateral other than margin stock up to the ''good faith'' loan value of the collateral, as defined in Regulation U.[32] This means that under Regulation U, dealers may extend credit on securities other than margin stock, including securities OTC derivative instruments.

Compliance with the more restrictive requirements of Regulation T puts broker-dealers at a disadvantage in competing with banks and other derivatives dealers by preventing them from offering credit in securities OTC derivatives transactions on terms that are as favorable as those offered by other dealers. Applying Regulation U to extensions of credit by OTC derivatives dealers would provide sufficient safeguards against leverage, while allowing OTC derivatives dealers to extend credit on the broader range of securities OTC derivative products that make up their business.

Accordingly, under proposed Rule 36a1–1, OTC derivatives dealers would be exempted from the margin requirements of Section 7 of the Exchange Act, as well as Regulation T, in connection with any extension of credit made by the OTC derivatives dealer in securities transactions permitted under proposed Rule 15a–1. This exemption, however, would be conditioned on the OTC derivatives dealer complying with the requirements of Regulation U. The Commission believes that this exemption would result in the most appropriate margin regulation for OTC derivatives dealers and more equal treatment of banks and securities firms active in OTC derivative markets.[33] The Commission solicits commenters' views regarding the proposed margin treatment of transactions by OTC derivatives dealers.

The relief proposed under Rule 36a1–1 would apply to extensions of credit by OTC derivatives dealers. Section 7, however, would also apply to extensions of credit to OTC derivatives dealers by other lenders. Credit extended to an OTC derivatives dealer, like credit extended to a fully regulated broker-dealer, would be exempted from Section 7 if it satisfies the exemptive provisions contained in Section 7. Specifically, if a substantial part of the business conducted by an OTC derivatives dealer consists of transactions with persons other than brokers or dealers, credit extended to the OTC derivatives dealer would be exempted from Section 7 under the provisions of Section 7(d)(2)(C)(i).[34] To the extent that firms desiring to take advantage of the proposed regulations applicable to OTC derivatives dealers do not believe that they would be able to take advantage of the exemptive provisions of Section 7(d)(2), the Commission solicits further comment on the proposed business activities of OTC derivatives dealers, and whether other exemptive relief may be needed to address borrowing by these firms.

2. Proposed Rule 15b9–2; SRO Exemption for OTC Derivatives Dealers

Proposed Rule 15b9–2 would exempt OTC derivatives dealers from membership in an SRO, subject to certain conditions. In general, registered broker-dealers must become members of an SRO.[35] This SRO membership requirement ensures that securities transactions meet SRO sales practice requirements, that employees of SRO member firms who sell securities satisfy certain minimum, uniform licensing requirements, that SRO members satisfy maintenance margin and financial responsibility requirements, and that member firms adhere to certain principles of trade and business conduct.[36]

Because only a part of the business conducted by OTC derivatives dealers is expected to involve securities transactions, it is not necessary to require OTC derivatives dealers to become members of an SRO and be subject to the full range of SRO regulation. All securities transactions done by an OTC derivatives dealer would be required to be effected through a fully regulated broker-dealer, and be handled by properly qualified registered representatives of the fully regulated broker-dealer. SRO sales practice requirements would also apply to these securities transactions. The Commission, therefore, proposes to exempt OTC derivatives dealers from SRO membership, subject to certain conditions.

[29] Fully regulated broker-dealers would be responsible for supervising only the securities activities of these dual employees. They would not be responsible for supervising a dual employee's non-securities OTC derivatives activities conducted on behalf of the OTC derivatives dealer.

[30] 12 CFR 220.1.

[31] 12 CFR 221.1.

[32] 12 CFR 221.2(f).

[33] The proposed exemption from Section 7 [15 U.S.C. 78g] and Regulation T [12 CFR 220.1] would not be available to extensions of credit made directly by a fully regulated broker-dealer acting as agent in a transaction between an OTC derivatives dealer and a permissible derivatives counterparty. However, OTC derivative dealers that extend credit in transactions that are required to be effected through a fully regulated broker-dealer would still be able to rely on the exemption from Section 7 and Regulation T provided under proposed Rule 36a1–1.

[34] 15 U.S.C. 78(g)(d)(2)(C)(i).

[35] See Exchange Act Section 15(b)(8) [15 U.S.C. 78o(b)(8)].

[36] See Exchange Act Sections 15(b)(8) and 15A(g)(3) [15 U.S.C. 78o(b)(8); 15 U.S.C. 78o–3(g)(3)].

To be eligible for the exemption from SRO membership contained in proposed Rule 15b9–2, an OTC derivatives dealer would be required to enter into an agreement with the examining authority designated pursuant to Section 17(d) of the Exchange Act[37] for one or more of its registered broker-dealer affiliates. Under this agreement, the examining authority would agree to conduct a review of the activities of the OTC derivatives dealer. It would also be required to report to the Commission any potential violation of the Commission's rules, and to evaluate the dealer's procedures and controls designed to prevent violations. SRO examination of OTC derivatives dealers would provide important benefits to the Commission and the public without requiring full SRO membership. OTC derivatives dealers would also be subject to direct examination by Commission staff. The Commission solicits comment on the proposed exemption from SRO membership. Alternatively, the Commission solicits comment on whether to require OTC derivatives dealers to become members of either the NASD or the New York Stock Exchange. Under this alternative, these SROs would be authorized to inspect OTC derivatives dealers and to enforce applicable Commission rules. They would not, however, be permitted to apply or enforce existing or new SRO rules.

E. Net Capital Requirements for OTC Derivatives Dealers

1. Reasons for Amending the Net Capital Rule; Overview

The Commission proposes to amend the net capital rule, Exchange Act Rule 15c3–1,[38] as it would apply to OTC derivatives dealers. In general, the net capital rule requires every registered broker-dealer to maintain certain specified minimum levels of liquid assets, or net capital, to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal legal proceeding. The rule is designed to protect the customers of a broker-dealer from losses that can be incurred upon a broker-dealer's failure. The rule prescribes different required minimum levels of capital based upon the nature of the broker-dealer's business and whether the firm handles customer funds or securities.

When calculating its net capital, a broker-dealer must reduce its capital by certain percentage amounts, or haircuts, based on the market value of the securities it owns. Discounting the value of a broker-dealer's proprietary securities positions provides a capital cushion if the value of these securities positions were to decline. Haircuts also cover other risks faced by the firm, such as credit and liquidity risk.

The Commission has been told that few swaps and other types of OTC derivative instruments are booked in registered broker-dealers because of the way these transactions are treated under the net capital rule. There are two reasons for this. First, the current net capital rule requires a firm to subtract most unsecured receivables from its net worth when calculating its net capital. For example, for an interest rate swap, the rule requires that the current value of the next net interest payment due from a counterparty be deducted from the firm's net worth in calculating its net capital. Also, any unrealized gains on the swap would have to be deducted. Second, the rule does not allow broker-dealers to take into account positions that offset their OTC derivatives positions to the same extent as banks or foreign dealers using value-at-risk (''VAR'') models.[39] This treatment of OTC derivatives transactions often requires broker-dealers to reserve more capital with respect to these transactions than banks or foreign broker-dealers have to reserve.

The Commission is addressing the current rule's treatment of OTC derivatives transactions by proposing certain amendments to the rule to reduce the capital charges on these types of transactions. Under proposed Appendix F of Rule 15c3–1, OTC derivatives dealers would be permitted to add back to their net worth any trading gains and unsecured receivables arising from transactions in eligible OTC derivative instruments with permissible derivatives counterparties.[40] Appendix F would also allow OTC derivatives dealers to use VAR models to compute their capital charges on proprietary positions instead of taking haircuts on them as required under the current rule. As mentioned above, the current haircut approach allows limited offsetting among positions in comparison to using a VAR model to compute capital charges. Allowing OTC derivatives dealers to use VAR models to compute capital charges on OTC derivative instruments would enable these dealers to reduce their market risk capital charges to the extent that they may hold offsetting positions.

2. Reasons for Allowing OTC Derivatives Dealers To Use VAR Models

Currently, several large firms use VAR models as part of their risk management system. These firms use VAR modelling to analyze, control, and report the level of market risk from their trading activities. In general, VAR is an estimate of the maximum potential loss expected over a fixed time period at a certain probability level. For example, a firm may use a VAR model with a ten-day holding period and a 99 percentile criteria to calculate that its $100 million portfolio has a potential loss of $150,000. In other words, the firm's VAR model has forecasted that with this portfolio the firm may lose $150,000 during a ten-day period once every 100 ten-day periods (*i.e.*, with a probability of 1%).

In practice, VAR models aggregate several components of price risk into a single quantitative measure of the potential for loss. In addition, VAR is based on a number of underlying mathematical assumptions and firm specific inputs. For example, VAR models typically assume normality and that future return distributions and correlations can be predicted by past returns.[41]

The current rule permits using statistical models only for limited types of securities.[42] The Commission

[37] 15 U.S.C. 78q(d).

[38] 17 CFR 240.15c3–1.

[39] In a companion release being issued at the same time as this release, the Commission is proposing amendments to the net capital rule to recognize offsets among additional types of instruments. Exchange Act Rel. No. 39455 (Dec. 17, 1997).

[40] See *infra* Section II.E.3.b. for a discussion of proposed Appendix F.

[41] The Commission recognizes that there is a wide variety of secondary source information discussing both the positive and negative aspects of VAR. See Philippe Jorion, *Value at Risk: The New Benchmark for Controlling Market Risk* (1996) (explaining how to use VAR to manage market risk); JP Morgan, *RiskMetrics-Technical Document* (1994) (providing a detailed description of RiskMetrics, which is JP Morgan's proprietary statistical model for quantifying market risk in fixed income and equity portfolios); Tanya Styblo Beder, *VAR: Seductive but Dangerous*, Financial Analysts Journal, September-October 1995, at 12 (giving an extensive analysis of the different results from applying three common VAR methods to three model portfolios); Darrell Duffie and Jun Pan, *An Overview of Value at Risk*, The Journal of Derivatives, Spring 1997, at 7 (giving a broad overview of VAR models); Darryll Hendricks, *Evaluation of Value-at-Risk Models Using Historical Data*, Federal Reserve Bank of New York Economic Policy Review, April 1996, at 39 (examining twelve approaches to VAR modelling on portfolios that do not include options or other securities with non-linear pricing); and Robert Litterman, *Hot Spots and Hedges*, Goldman Sachs Risk Management Series (1996) (giving a detailed analysis on portfolio risk management, including how to identify the primary sources of risk and how to reduce these risks).

[42] See 17 CFR 240.15c3–1a. The Commission recently amended Appendix A to permit broker-dealers to employ theoretical option pricing models in determining net capital requirements for listed options and related positions. Exchange Act Rel. No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

believes, however, that a more flexible approach for determining capital requirements for OTC derivatives dealers would be appropriate because of the special nature of their business and the additional financial responsibility requirements that would be applicable to these firms. The proposed rule requires an OTC derivatives dealer to maintain a minimum of $100 million in tentative net capital [43] and at least $20 million in net capital. OTC derivatives dealers would also be prohibited from accepting or holding customer funds or securities or generally from owing money or securities to customers in connection with securities activities. OTC derivatives dealers would, however, be allowed to hold counterparty collateral or owe money or securities to counterparties, but only as a result of contractual commitments. Finally, OTC derivatives dealers would be required to establish risk management controls pursuant to proposed Rule 15c3–4.

The more flexible capital treatment that would be available to OTC derivatives dealers under the proposed rules reflect international efforts to standardize capital requirements. During the past few years, the Commission has actively participated in several international undertakings to gain further experience with the use of VAR models to measure market and credit risk. For example, through its membership in the International Organization of Securities Commissions (''IOSCO''), the Commission has been cooperating with the Basle Committee on Banking Supervision (''Basle Committee'').[44] In December 1995, the Basle Committee amended its Capital Accord [45] to incorporate market risk capital requirements and approved the use of proprietary VAR models to determine bank capital requirements for market risk.[46] The Capital Accord recommended a number of quantitative and qualitative conditions that should apply to a bank's use of models to ensure that VAR models are prudently used.

Rules adopted recently by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the ''U.S. Banking Agencies'') were designed to implement the Capital Accord for U.S. banks and bank holding companies.[47] Proposed Appendix F is generally consistent with the U.S. Banking Agencies' rules, and incorporates the quantitative and qualitative conditions imposed on banking institutions.

In a companion release, the Commission is considering whether it should permit VAR models to be used by broker-dealers other than OTC derivatives dealers for regulatory capital purposes.[48] By allowing OTC derivatives dealers to use VAR models in calculating their net capital requirement, the Commission would have a valuable opportunity to gain experience with the use of these models by entities within its jurisdiction. This experience would enable the Commission to reassess its current rules for determining capital charges for market risk and determine whether more intensive subjective examinations would be needed to ensure compliance with Commission regulations concerning the use of models.

3. *Discussion of Net Capital Requirements*

a. *Proposed Paragraph 15c3–1(a)(5).* Under proposed paragraph (a)(5) of Rule 15c3–1, OTC derivatives dealers would be required to maintain tentative net capital of not less than $100 million and net capital of not less than $20 million. The Commission believes the minimum of $100 million in tentative net capital is necessary to ensure against excessive leverage and risks other than credit or market risk, all of which are now factored into the current haircuts, and to provide for a cushion of capital against severe market disturbances.[49] Proposed paragraph (a)(5) would give OTC derivatives dealers the option of either taking capital charges, or haircuts, computed in accordance with paragraph (c)(2)(vi) of Rule 15c3–1 or taking capital charges for market and credit risk computed under proposed Appendix F to Rule 15c3–1. The Commission requests comment on whether the $100 million tentative net capital and $20 million net capital requirements would be adequate to ensure against excessive leverage and risks other than credit or market risk.

b. *Proposed Appendix F.* Proposed Appendix F would apply only to OTC derivatives dealers that elect to be subject to the appendix. OTC derivatives dealers that elect to be subject to Appendix F would be required to calculate specific capital charges for market and credit risk. They would also be required to maintain VAR models that meet certain minimum qualitative and quantitative requirements.

i. Market Risk. OTC derivatives dealers electing to apply Appendix F would deduct from their net worth a capital charge for market risk [50] that is computed using one of two methods. First, OTC derivatives dealers would be able to use the full VAR method to calculate capital charges for market risk exposure for transactions in eligible OTC derivative instruments and other proprietary positions of the OTC derivatives dealer. Under the full VAR method, a market risk capital charge would be equal to the VAR of its positions multiplied by a factor specified in Appendix F.[51]

OTC derivatives dealers would be required to obtain authorization from the Commission before using VAR models. An OTC derivatives dealer planning to use the full VAR method would send an application to the Commission describing its VAR model, including whether the firm has developed its own model and how the qualitative and quantitative aspects described in Appendix F are

[43] For an OTC derivatives dealer that elects to compute its market risk charges under proposed Appendix F, the term ''tentative net capital'' would mean the net capital of an OTC derivatives dealer before the application of the charges for market and credit risk as computed pursuant to proposed Appendix F and increased by unsecured receivables (unrealized gains) resulting from eligible OTC derivative instruments.

[44] The Governors of the G–10 countries established the Basle Committee in 1974 to provide a forum for ongoing cooperation among member countries on banking supervisory matters.

[45] The Basle Accord, or Capital Accord, is a common measurement system and a minimum standard for capital adequacy of international banks in the G–10 countries.

[46] In July 1995, IOSCO's Technical Committee issued a paper stating that further information and analysis was required before the Technical Committee could consider the use of internal models by securities firms to set regulatory capital standards for market risk. Due to the differences between banks and securities firms, the Technical Committee believed that more work was necessary before allowing securities firms to use VAR models to establish their capital requirements. The Implications for Securities Regulators of the Increased Use of Value At Risk Models by Securities Firms, Technical Committee of IOSCO, July 1995.

[47] Department of the Treasury, Office of the Comptroller of the Currency Docket No. 96–18, Federal Reserve System, Docket No. R–0884, Federal Deposit Insurance Corporation, RIN 3064–AB64 (Sept. 6, 1996), 61 FR 47358.

[48] Exchange Act Rel. No. 39456 (Dec. 17, 1997).

[49] To some degree, the multiplication factor applied to a firm's VAR is designed to provide capital for risks other than credit or market risk. See *infra* Section II.E.3.b.iii. for a discussion of how an OTC derivatives dealer would determine its appropriate multiplication factor.

[50] In general, market risk is the risk of adverse price movements resulting from a change in market prices, interest rates, volatilities, correlations, or other market factors.

[51] See *infra* Section II.E.3.b.iii. for a discussion of how an OTC derivatives dealer would determine the appropriate multiplication factor.

incorporated into the model.[52] The firm's application would also include a description of the risk management controls adopted by the firm pursuant to proposed Rule 15c3–4.[53]

Second, an OTC derivatives dealer could use an alternative method of computing the market risk capital charge for equity instruments and OTC options and use VAR for its other proprietary positions. This alternative method would also be used by a firm that does not receive Commission authorization to use a VAR model for equity instruments. Under the alternative method, an OTC derivatives dealer would deduct from its net worth an amount equal to the largest theoretical loss calculated in accordance with the theoretical pricing model set forth in Appendix A of Rule 15c3–1.[54] The OTC derivatives dealer would be permitted to use its own theoretical pricing model as long as it contains the minimum pricing factors set forth in Appendix A.[55]

ii. Credit Risk. OTC derivatives dealers electing to apply Appendix F would deduct from their net worth a capital charge for credit risk.[56] This charge would have two parts and would be computed on a counterparty by counterparty basis. First, for each counterparty, OTC derivatives dealers would take a capital charge equal to the net replacement value in the account of the counterparty (''net replacement value'')[57] multiplied by 8%, and further multiplied by a counterparty factor. The counterparty factor would be based on the counterparty's rating by at least two nationally recognized statistical rating organizations (''NRSROs'' or ''rating organizations''). The counterparty factors would range from 20% for counterparties that are highly rated to 100% for counterparties with ratings among the lowest rating categories. By using the ratings of the rating organizations as a basis, the counterparty factors would link the size of the credit risk capital charge to the perceived risk that the counterparty may default. A charge of 100% of the net replacement value would be assessed for counterparties that are in bankruptcy or whose bonds are in default. The Commission requests comment on alternatives to relying on the ratings of NRSROs for approximating the risk that a counterparty may default.

The second part of the credit risk charge would consist of a concentration charge that would apply when the net replacement value in the account of any one counterparty exceeds 25% of the OTC derivatives dealer's tentative net capital. In these situations, the amount of the concentration charge would also be based on the counterparty's rating by at least two rating organizations. For counterparties that are highly rated, the concentration charge would equal 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital. The concentration charge would increase in relation to the OTC derivatives dealer's exposure to lower rated counterparties. For example, the concentration charge for counterparties with ratings among the lowest rating categories would equal 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital. Further, if the aggregate net replacement values of all counterparties exceeds 300% of the OTC derivatives dealer's tentative net capital, the OTC derivatives dealer would deduct 100% of the excess from its net worth. The Commission requests comment on whether the 300% threshold for determining an overall concentration charge would result in excessive concentration risk charges.

If a counterparty is not rated by a rating organization, an OTC derivatives dealer would be permitted to use its own ratings of the counterparty to calculate its credit risk charge. In these situations, however, the OTC derivatives dealer would have to demonstrate that its ratings criteria and due diligence procedures, including procedures for the initial analysis and ongoing review of the counterparty, are equivalent to those used by NRSROs.

iii. Qualitative Requirements for Value-at-Risk Models. OTC derivatives dealers that elect to apply Appendix F would be required to have VAR models that meet certain minimum qualitative requirements. The Commission proposes to establish these minimum requirements to ensure that the VAR models used for computing market risk capital charges are the same as those used to perform internal risk management functions.

The qualitative requirements would address four aspects of an OTC derivatives dealer's risk management system. First, an OTC derivatives dealer's VAR model would have to be integrated into the OTC derivatives dealer's daily risk management process. Second, an OTC derivatives dealer's policies and procedures would have to identify and provide for appropriate stress tests.[58] The OTC derivatives dealer's policies and procedures would have to identify the procedures to follow in response to the results of the stress tests and backtests, and the OTC derivatives dealer would be required to follow these procedures. Third, an OTC derivatives dealer's VAR model and risk management systems would be required to undergo both periodic independent reviews that would be performed by internal audit staff, and annual reviews that would be conducted by an independent public accountant. Fourth, OTC derivatives dealers would be required to conduct backtesting.

Backtesting would be intended to gauge the accuracy of a dealer's model by comparing the dealer's projections against actual trading results. The OTC derivatives dealer would be required to conduct backtesting by comparing each of its most recent 250 business days' actual net trading profit or loss with the corresponding daily VAR measures. In addition, once each quarter, the OTC derivatives dealer would have to identify the number of exceptions, that is, the number of business days for which the actual daily net trading loss, if any, exceeds the corresponding daily VAR measure. The number of exceptions would determine the multiplication factor the OTC

[52] See *infra* Sections II.E.3.b.iii. through iv. for a description of the qualitative and quantitative requirements.

[53] See *infra* Section II.H.3. for a description of the risk management controls that would be required by proposed Rule 15c3–4.

[54] 17 CFR 240.15c3–1a. The Commission recently amended Appendix A to include theoretical pricing models. Exchange Act Rel. No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

[55] 17 CFR 240.15c3–1a(b)(1)(B). The minimum pricing factors in Appendix A require that a pricing model consider:

(1) The current spot price of the underlying asset;

(2) The exercise price of the option;

(3) The remaining time until the option's expiration;

(4) The volatility of the underlying asset;

(5) Any cash flows associated with ownership of the underlying asset that can reasonably be expected to occur during the remaining life of the option; and

(6)The current term structure of interest rates.

[56] In general, credit risk is the risk that a counterparty will fail to perform its obligations to an OTC derivatives dealer.

[57] For purposes of calculating credit risk charges, net replacement value in the account of a counterparty would mean the aggregate value of all receivables due from that counterparty (which would be computed by marking the value of such receivables to market daily), including the effect of legally enforceable netting agreements and the application of liquid collateral.

[58] Stress tests are used to evaluate changes in the value of a firm's portfolio under extreme market conditions. The Commission expects stress tests to include the core risk factors of: (1) Parallel yield curve shifts; (2) changes in the steepness of yield curves; (3) parallel yield curve shifts combined with changes in the steepness of yield curves; (4) changes in yield volatilities; (5) changes in the value of equity indices; (6) changes in equity index volatilities; (7) changes in the value of key currencies (relative to the U.S. dollar); (8) changes in foreign exchange rate volatilities; and (9) changes in swap spreads in at least the G–7 countries plus Switzerland. Stress tests should also be designed to reflect the composition of the firm's portfolio.

derivatives dealer would be required to use for the following quarter, and which would continue to apply until the next quarter's backtesting results are obtained or unless the Commission determines that a different adjustment or other action is appropriate. Depending on the number of exceptions, the multiplication factors would range from three to four. Increasing the multiplication factor in response to the number of backtesting exceptions increases an OTC derivatives dealer's market risk charge, thus penalizing an OTC derivatives dealer that uses a less accurate model. Although the multiplication factor would increase an OTC derivative's dealer's market risk charge and corresponding capital requirement, the Commission intends that firms work to improve the accuracy of their models rather than set aside additional capital for an inaccurate model.

The multiplication factor is intended to cover the additional risks that would be present in an OTC derivatives dealer's portfolio, other than market and credit risk. For example, an OTC derivatives dealer would be subject to legal, liquidity, and operational risk. Operational risk is generally the risk of human error or deficiencies in the firm's operating systems, including VAR model. It is difficult to quantify and develop capital charges specifically for these risks. The Commission, however, believes that the multiplication factor would be an appropriate way to account for these other risks facing OTC derivatives dealers.

iv. Quantitative Requirements for Value-at-Risk Models. Appendix F would also contain minimum quantitative requirements to address regulatory concerns. Because broker-dealers generally use VAR models to measure portfolio volatility on a day-to-day basis, the Commission would impose certain requirements on VAR models to address regulatory capital-related concerns where a longer time horizon is appropriate. For example, OTC derivatives dealers would be required to calculate VAR measures using a confidence level with a price change equivalent to a ten-business day movement in rates and prices, rather than a one-day price movement that is used in many VAR models currently used by firms for internal risk management purposes.

F. Use of Counterparty Collateral

1. Proposed Amendments to Exchange Act Rules 8c–1 and 15c2–1; Hypothecation Rules

The Commission proposes to amend Exchange Act Rules 8c–1[59] and 15c2–1,[60] which address the hypothecation of customer securities. The hypothecation rules generally prohibit a broker-dealer from using its customers' securities as collateral to finance its own trading, speculating, or underwriting transactions. More specifically, the rules state three main principles: first, that a broker or dealer is prohibited from commingling the securities of different customers as collateral for a loan without the consent of each customer; second, that a broker or dealer cannot commingle its customers' securities with its own under the same pledge; and third, that a broker or dealer can only pledge its customers' securities up to the value of monies owed to the broker-dealer by its customers.

In privately negotiated OTC derivatives transactions, counterparties generally agree that assets pledged as collateral may be used in the business of the OTC derivatives dealer without being segregated. For this reason, it is not necessary to treat counterparties as customers of OTC derivatives dealers for purposes of Exchange Act Rules 8c–1 and 15c2–1, or to apply these rules to counterparty assets held as collateral by an OTC derivatives dealer. Accordingly, Rules 8c–1 and 15c2–1 would be amended so that an OTC derivatives dealer would not be deemed to hold collateral for the account of any customer when that collateral is received as a result of the OTC derivatives dealer acting as counterparty in transactions in eligible OTC derivative instruments and the permissible derivatives counterparty has consented to the unrestricted use of its collateral after receiving appropriate disclosure.

2. Proposed Amendments to Exchange Act Rule 15c3–3; Customer Protection Rule

The Commission also proposes to amend Exchange Act Rule 15c3–3,[61] the Commission's customer protection rule. The customer protection rule generally prohibits a broker or dealer from using customers' funds and securities to finance its business. As a result, this rule helps to ensure that customers can promptly obtain their funds or securities from a broker-dealer.

As amended, Rule 15c3–3 would clarify that the term ''customer,'' as used in the rule, is not intended to include a permissible derivatives counterparty that has consented to the unrestricted use of its collateral by an OTC derivatives dealer after receiving appropriate disclosure. As noted previously, counterparties in privately negotiated OTC derivative transactions generally agree that assets pledged as collateral may be used in the business of the OTC derivatives dealer without being segregated.

G. Proposed Rule 36a1–2; Exemption From SIPA

Under proposed Rule 36a1–2, OTC derivatives dealers would be exempted from the provisions of the Securities Investor Protection Act of 1970 (''SIPA''),[62] including membership in the Securities Investor Protection Corporation (''SIPC'').[63] Under SIPA, broker-dealers registered under Section 15(b) become SIPC members. The Commission is concerned that the application of SIPA's liquidation provisions to an OTC derivatives dealer in bankruptcy could undermine certain provisions of the bankruptcy code applicable to the dealer's business.[64] The potential application of SIPA to OTC derivatives dealers would create legal uncertainty about the rights of counterparties in transactions with registered OTC derivatives dealers in the event of dealer insolvency.[65] This

[59] 17 CFR 240.8c–1.

[60] 17 CFR 240.15c2–1.

[61] 17 CFR 240.15c3–3.

[62] 15 U.S.C. 78aaa *et seq.*

[63] Section 2 of SIPA [15 U.S.C. 78bbb] generally incorporates SIPA into the Exchange Act.

[64] The bankruptcy code contains certain exceptions to its automatic stay provisions that enable a counterparty in a derivatives transaction to exercise its rights to liquidate a position (*i.e.,* it preserves a counterparty's contractual termination, setoff, and collateral foreclosure rights) in the event of the other counterparty's insolvency. See, e.g., 11 U.S.C. Section 362(b)(6), (7), (17); *id.* at Sections 555, 556, 559, and 560. Several of these provisions, however, may be subject to a stay order under SIPA. See 11 U.S.C. Section 555 (contractual right to liquidate a securities contract); *id.* at Section 559 (contractual right to liquidate a repurchase agreement).

[65] The Commission believes that the counterparty collateral that would be held by OTC derivatives dealers should not be considered customer assets for purposes of SIPA. Congress enacted SIPA in 1970 primarily to protect the retail customers of a broker-dealer in the event of its financial difficulty. Congress was concerned that prior to the enactment of SIPA, public customers sometimes had encountered difficulty in obtaining their cash balances or securities from insolvent broker-dealers. Congress analogized the need for SIPA to the need which prompted establishment of the Federal Deposit Insurance Corporation. H.R. Rep. No. 91–1613, 91st Cong., 2d Sess. 2 (1970). The Commission believes that the type of privately negotiated transactions and counterparty assets

Continued

uncertainty could impair the ability of securities firms electing to register OTC derivatives dealers to compete effectively with banks and foreign dealers, which are not subject to similar legal uncertainty.

Accordingly, the Commission believes that the purposes of SIPA would not be promoted by its application to OTC derivatives dealers, and may in fact result in legal uncertainty for OTC derivatives dealer counterparties. The Commission therefore believes that exempting OTC derivatives dealers from SIPA would be necessary or appropriate in the public interest and consistent with the protection of investors. The Commission requests comments on the need, appropriateness, and form of the proposed exemption.

H. Books and Records

1. Proposed Amendments to Exchange Act Rules 17a–3 and 17a–4; Books and Records to be Maintained by OTC Derivatives Dealers

OTC derivatives dealers, like other broker-dealers that are registered with the Commission, would be required to comply with the books and records requirements of Exchange Act Rules 17a–3 [66] and 17a–4.[67] Section 17(a)(1) of the Exchange Act [68] requires registered broker-dealers to make, keep, furnish, and disseminate records and reports that are prescribed by the Commission as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. Consistent with the requirements of Section 17(a)(1), Rules 17a–3 and 17a–4 require all broker-dealers to make and keep certain records relating to their business activities. These rules would also apply to OTC derivatives dealers.[69]

Currently, Rule 17a–3 does not specifically provide for maintaining records relating to the full range of activities that would be conducted by OTC derivatives dealers. For this reason, Rule 17a–3 would be amended to reflect the activities of OTC derivatives dealers and to require that OTC derivatives dealers compile a register of all transactions in eligible OTC derivative instruments. The Commission also proposes to make technical amendments to Rule 17a–4 to require OTC derivatives dealers to retain the records required to be made pursuant to proposed Rules 15c3–4 and 17a–12. As discussed in more detail below, the records required under Rule 17a–12 would be similar to those currently required under Rule 17a–5. In part, these records would include the OTC derivatives dealer's risk management control guidelines and information supporting data contained in the dealer's annual audited financial statements. These records would have to be retained for three years.

2. Proposed Amendments to Exchange Act Rule 17a–11; Notification Requirements

OTC derivatives dealers would be subject to the provisions of Exchange Act Rule 17a–11, which requires a broker-dealer to report capital and other operational problems to the Commission and the broker-dealer's examining authority within specified time periods.[70] Because Rule 17a–11 provides the Commission with valuable tools in overseeing the financial and operational health of broker-dealers, it is appropriate that Rule 17a–11 also apply to OTC derivatives dealers.

Rule 17a–11 would be amended to take into consideration the new tentative net capital requirements that would apply to OTC derivatives dealers. As a result, if an OTC derivatives dealer's tentative net capital were to drop below 120 percent of its required minimum, the dealer would be required to provide notice both to the Commission and the examining authority responsible for reviewing its activities pursuant to proposed Rule 15b9–2. Notice would also be required in the event the OTC derivatives dealer's tentative net capital were to drop below its required minimum. This notice requirement would provide the Commission and the examining authority with early warning of an OTC derivatives dealer's financial or operational problems and allow the Commission and the examining authority to increase their supervision of the dealer's operations. It would also give the Commission and the examining authority time to obtain additional information about the OTC derivatives dealer's financial condition and to take corrective action, as necessary.

3. Proposed Rule 15c3–4; Internal Risk Management Control Systems for OTC Derivatives Dealers

Section 15(c)(3) of the Exchange Act [71] enables the Commission to adopt rules and regulations regarding the financial responsibility of broker-dealers that the Commission deems necessary or appropriate in the public interest or for the protection of investors. Pursuant to this authority, the Commission is proposing Rule 15c3–4 to require OTC derivatives dealers to establish a system of internal controls for monitoring and managing the risks associated with their business activities.

Participants in OTC derivatives markets are exposed to various risks, including (1) operational risk; [72] (2) market risk; [73] (3) credit risk; [74] (4) liquidity risk; [75] and (5) legal risk.[76] These risks are due, in part, to the characteristics of OTC derivative products and the way OTC derivative markets have evolved in comparison to the markets for equity securities and listed options. For example,

(collateral) involved in the OTC derivatives business are quite different from the ordinary brokerage business and customer assets contemplated by SIPA.

[66] 17 CFR 240.17a–3.

[67] 17 CFR 240.17a–4.

[68] 15 U.S.C. 78q(a)(1).

[69] In general, Exchange Act Rule 17a–3 requires broker-dealers to make records concerning the purchases and sales of securities, receipts and deliveries of securities, and receipts and disbursements of cash. In addition, the rule requires broker-dealers to make and keep ledgers reflecting securities borrowed and securities received, repurchase and reverse repurchase agreements, and a record of net capital computations.

Exchange Act Rule 17a–4 specifies how long broker-dealers must keep the records required to be made under Rule 17a–3 and how long they must keep other records made in the normal course of business. Specifically, Rule 17a–4(b) requires broker-dealers to keep trial balances, internal audit workpapers, and net capital computations and related workpapers for three years. Rule 17a–4(b) also requires broker-dealers to keep all written agreements relating to the broker-dealer's business for three years.

[70] 17 CFR 240.17a–11. Under Rule 17a–11, if a broker-dealer's net capital falls below the required minimum level, the broker-dealer must provide both the Commission and the broker-dealer's designated examining authority with notice of such deficiency. A broker-dealer is also required to give same-day notice if it fails to make and keep current its books and records pursuant to Rules 17a–3 and 17a–4, and to submit a report within 48 hours detailing the steps it is taking to correct the problem. In addition, Rule 17a–11 requires a broker-dealer to give notice when it discovers any material inadequacy in its system of internal controls, or is notified of this inadequacy by its independent public accountant. In these instances, the broker-dealer is required to submit a report detailing steps being taken to correct the inadequacy.

[71] 15 U.S.C. 78o(c)(3).

[72] Operational risk encompasses the risk of loss due to the breakdown of controls within the firm including, but not limited to, unidentified limit excesses, unauthorized trading, fraud in trading or in back office functions, inexperienced personnel, and unstable and easily accessed computer systems.

[73] Market risk involves the risk that prices or rates will adversely change due to economic forces. Such risks include adverse effects of movements in equity and interest rate markets, currency exchange rates, and commodity prices. Market risk can also include the risks associated with the cost of borrowing securities, dividend risk, and correlation risk.

[74] Credit risk comprises risk of loss resulting from counterparty default on loans, swaps, options, and during settlement.

[75] Liquidity risk includes the risk that a firm will not be able to unwind or hedge a position.

[76] Legal risk arises from possible risk of loss due to an unenforceable contract or an ultra vires act of a counterparty.

individually negotiated OTC derivative products generally are not very liquid. Also, the absence at this time of a clearing system for OTC derivative products means that market participants face risks associated with the financial and legal ability of counterparties to perform under the terms of specific transactions. The additional exposure to credit risk, liquidity risk, and other risks makes it necessary for OTC derivatives market participants to implement a risk management control system.

During the past few years, the importance of operational risk management controls has been highlighted by the multi-billion dollar losses experienced by several large financial firms. These losses were caused by unauthorized and undisclosed employee trading. In each case, these losses went virtually undetected by management because of the lack of basic internal controls, including the separation of responsibility for recording the trades on the firms' books from the personnel responsible for trading.

Risk management controls within financial institutions promote the stability of these firms and, consequently, the stability of the entire financial system. They do this by reducing the risk of significant losses by a firm, which also reduces the risk that spreading losses would cause multiple defaults and undermine markets as a whole. Specifically, internal risk management controls promote stability by providing two important functions: (1) Protecting against firm specific risk such as operational, market, credit, legal, and liquidity risks; and (2) protecting the financial industry from systemic risk.[77]

The specific elements of a risk management system will vary depending on the size and complexity of a firm's business operations. As a result, the design and implementation of a system of internal controls for a particular firm should reflect the circumstances of the firm. Any well-developed risk management system, however, should include a risk management strategy, policies and procedures to accomplish that strategy, risk measurement methodologies, compliance monitoring and reporting, and on-going assessment of the effectiveness of the strategies, policies, and procedures.

The Commission recognizes that an individual firm must have the flexibility to implement specific policies and procedures unique to its circumstances. As a result, proposed Rule 15c3–4 would establish only basic elements for the design, implementation, and review of an OTC derivatives dealer's risk management control system. These elements are designed to ensure the integrity of the risk management process, to clarify that the appropriate level of management is authorizing the types of activity that can be conducted and the level of risk that can be assumed, and to ensure that the OTC derivatives dealer reviews its activities for consistency with risk management guidelines.

The proposed rule would require an OTC derivatives dealer to assess a number of aspects about its business environment when creating its risk management control system. This assessment is designed to ensure that the system implemented is appropriate for the individual firm. For example, an OTC derivatives dealer would need to consider the sophistication and experience of relevant trading, risk management, and internal audit personnel, as well as the management philosophy and culture of the firm.

Despite the need for firms to develop controls appropriate to their specific circumstances, the proposed rule would also require certain elements to be included in OTC derivatives dealers' internal control systems. These elements ensure that internal control systems protect against risks that are universal to the business of OTC derivatives dealers. For example, the unit at the firm responsible for monitoring risk must be separate from and senior to the trading units whose activity create the risks. This is to ensure the independence of the risk management process. In addition, personnel responsible for recording transactions in the books of the OTC derivatives dealer cannot be the same as those responsible for executing transactions. This is to ensure that trading losses cannot be hidden.

Finally, the OTC derivatives dealer's management must periodically review the firm's business activities for consistency with established risk management guidelines. This will ensure that personnel are operating within the scope of permissible activity and that the risk management system will continue to be adequate.

4. Proposed Rule 17a–12; Reports To Be Made by OTC Derivatives Dealers

Exchange Act Rule 17a–5[78] requires all broker-dealers to file various reports with the Commission. These reports include periodic Financial Operational Combined Uniform Single Reports (FOCUS),[79] annual audited financial statements, and designations of accountant. Under proposed Rule 17a–12, similar periodic requirements would be put into place for OTC derivatives dealers.

Proposed Rule 17a–12 would require OTC derivatives dealers to file quarterly FOCUS reports, and to include in these filings the enhanced reporting information and the evaluation of risk in relation to capital provisions of the Framework for Voluntary Oversight of the Derivatives Policy Group (''DPG'').[80] The DPG credit and market risk information (Schedules I–V and VI of the proposed FOCUS report) are intended to enable the Commission to ascertain the nature and scope of a firm's OTC derivatives activity and to monitor the firm's risk exposure.

Proposed Rule 17a–12 would also require the OTC derivatives dealer to file annually its audited financial statements along with a corresponding audit report. Among other things, the annual audit report would include a statement of financial condition, a statement of income, a statement of cash flows, a statement of changes in owners' equity, and a statement of changes in subordinated liabilities. The proposed rule establishes guidelines for the content and form of the annual report, accountant qualifications, the process for designating an accountant, and audit objectives.

Each of the reports required under proposed Rule 17a–12 would assist the Commission to monitor the operations

[77] Systemic risk encompasses the risk that the failure of one firm or within one market segment would trigger failures in other market segments or throughout the financial markets as a whole.

[78] 17 CFR 240.17a–5. Rule 17a–5 was adopted by the Commission pursuant to authority under Section 17 of the Exchange Act [15 U.S.C. 78q], and particularly Section 17(e) [15 U.S.C. 78q(e)], which requires every broker or dealer to file annually with the Commission a certified balance sheet and income statement, and such other information concerning its financial condition as the Commission may prescribe.

[79] Form X–17A–5 [17 CFR 249.617].

[80] See Framework for Voluntary Oversight, Derivatives Policy Group (Mar. 1995). The firms comprising the DPG consist of the six U.S. broker-dealers with the largest OTC derivatives affiliates. This group was organized to respond to the public policy interests of Congress, federal agencies, and others in the OTC derivatives activities of unregulated affiliates of SEC-registered broker-dealers and CFTC-registered futures commission merchants. The Framework for Voluntary Oversight specifies certain information that the members of the DPG have voluntarily agreed to submit regarding their OTC derivatives activities and establishes certain internal control principles that group members should follow.

of OTC derivatives dealers and to enforce their compliance with the Commission's rules. These reports would also enable the Commission to review the business activities of OTC derivatives dealers and to anticipate, where possible, how these dealers may be affected by significant economic events.

5. Proposed Amendments to Form X–17A–5

Proposed Rule 17a–12 would require that certain conforming changes be made to Rule 249.617 to require OTC derivatives dealers to file the appropriate parts of Form X–17A–5, commonly known as the FOCUS report. These changes would provide for appropriate disclosure of the business activities of OTC derivatives dealers and the risks associated with those activities.

Under the proposed amendments to Form X–17A–5, the net capital computation worksheet would be revised to reflect the proposed net capital requirements for OTC derivatives dealers. Other changes would include revising the statement of financial condition and the statement of income, and eliminating the customer reserve computation and commission income line items. OTC derivatives dealers would also be required to include certain information in the quarterly FOCUS filing. This information would include credit concentration information, together with a geographic breakdown and a counterparty breakdown as described in the DPG Framework for Voluntary Oversight. OTC derivatives dealers would also be required to provide, where applicable, a detailed summary of all long and short securities and commodities positions, including all OTC derivatives contracts.

By incorporating the DPG credit and market risk information into the FOCUS filing requirement for OTC derivatives dealers, the Commission would be able to ascertain the nature and scope of a firm's OTC derivatives activity and to monitor the firm's risk exposure. This information has been valuable to the Commission in understanding the OTC derivatives business of those firms already participating in the DPG Framework for Voluntary Oversight program.

III. General Requests for Comment

The Commission solicits comment on its proposal to establish a limited, optional regulatory system for OTC derivatives dealers. In particular, the Commission solicits comments on the extent to which persons eligible to become registered as OTC derivatives dealers believe this proposed system would address any competitive inequalities that discourage securities firms from conducting an OTC derivatives business in the United States. The Commission also solicits comments on this proposal from derivatives counterparties and other interested participants in global financial markets. In addition, commenters are requested to express their views on the application of the Commission's broker-dealer rules to OTC derivatives dealers and whether additional amendments or exemptions would be needed for this class of dealers. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission is also requesting information regarding the potential impact of the proposed rules on the national economy on an annual basis. Commenters should provide empirical data to support their views.

IV. Costs and Benefits of the Proposed Rules and Rule Amendments

To assist the Commission in its evaluation of the costs and benefits that may result from the proposed limited regulatory system for OTC derivatives dealers, commenters are requested to provide analysis and data relating to the costs and benefits associated with the proposals. In particular, the Commission requests comments on the potential costs for any necessary modifications to accounting, information management, and recordkeeping systems required to implement the proposed rules and rule amendments and the potential benefits arising from participation in the regulatory scheme.

The Commission has identified certain costs and benefits that would be associated with the proposed regulatory system for OTC derivatives dealers. This proposed system would be optional and is designed to allow U.S. securities firms to establish separate OTC derivatives dealer affiliates capable of acting as counterparties with respect to both securities and non-securities OTC derivative products. Capital, margin, and other broker-dealer regulatory requirements would be tailored to the activities of these entities. Registration as an OTC derivatives dealer would be an alternative to registration as a fully regulated broker-dealer under Section 15(b) of the Exchange Act for firms combining a business in securities and non-securities OTC derivative products, and would be available only to entities acting primarily as counterparties in privately negotiated OTC derivatives transactions.

It is expected that firms electing to become registered as OTC derivatives dealers would be able to conduct business more efficiently and at lower cost than under current Commission rules. This would allow OTC derivatives dealers to compete more effectively against banks and foreign dealers in OTC derivatives markets. The Commission expects that the benefits to OTC derivatives dealers of being able to compete more effectively in global derivatives markets at a lower cost would outweigh the potential cost of this limited regulation.

Cost savings would result in several areas. First, firms that currently conduct securities OTC derivatives activities from registered broker-dealers and non-securities OTC derivatives activities from separate, unregistered entities, would be able to combine these activities in one OTC derivatives dealer. This combination of operations in one entity would result in a decrease in operational costs. There would also be a decrease in regulatory costs. OTC derivatives dealers that register with the Commission would become subject to tailored capital and other requirements that are intended to impose lesser regulatory burdens than are imposed on fully regulated broker-dealers. In addition, OTC derivatives dealers would be exempted from the margin requirements of Section 7 and Regulation T, provided these dealers comply with the margin requirements of Regulation U. Applying Regulation U to extensions of credit by OTC derivatives dealers would allow them to extend credit on the broader range of securities OTC derivatives products that make up their business.

The Commission preliminary believes that the proposed rules and rule amendments would promote both efficiency and capital formation. The proposed rules and rule amendments should provide broker-dealers the opportunity to increase operational efficiency by reducing the need to fractionalize their OTC derivatives business. The Commission, however, solicits comment on whether the proposal would promote both efficiency and capital formation.

The proposed limited regulatory system for OTC derivatives dealers would also result in benefits to regulators and to financial markets. First, OTC derivatives dealers that register with the Commission would be subject to the proposed net capital requirements and other financial responsibility requirements for OTC derivatives dealers. These are intended

to ensure against excessive leverage and the risks associated with conducting an OTC derivatives business, and to provide a cushion of capital against market declines and other risks. Second, Commission oversight authority, including proposed reporting and notice requirements, would enable the Commission to monitor the financial condition and securities activities of OTC derivatives dealers. Third, proposed internal risk management control systems are intended to promote the financial responsibility of OTC derivatives dealers to the extent they have elected to do business through this type of broker-dealer. By reducing the risk of significant losses by a single firm, internal risk management control systems would also reduce the risk that the problems of one firm would spread, causing defaults by other firms and undermining securities markets as a whole.

Firms electing to register as OTC derivatives dealers would incur various costs. As a preliminary matter, there may be costs associated with combining activities currently conducted in a registered broker-dealer with activities conducted in other unregistered entities. These firms would incur the one-time and on-going costs of registration as an OTC derivatives dealer. These firms would also have the one-time and on-going costs of making adjustments to risk management practices to conform with proposed Rule 15c3–4, and of maintaining capital required by proposed Appendix F to the net capital rule. In addition, these firms would have the one-time and on-going costs of complying with the books and records requirements under proposed amendments to Rules 17a–3 and 17a–4. OTC derivatives dealers would incur costs associated with preparing and submitting FOCUS reports and annual audited financial statements. This would include the cost of contracting with a certified public accountant to conduct an annual audit. Moreover, while OTC derivatives dealers would be exempted from the more restrictive margin requirements of Regulation T, the dealers would have the one-time and on-going costs associated with complying with the margin requirements of Regulation U, including the costs of developing systems for compliance and the costs associated with subjecting currently unregulated offshore activities to Regulation U.

V. The Effects on Competition of the Proposed Rules and Rule Amendments

Section 23(a)(2) of the Exchange Act [81] requires the Commission, in adopting rules under the Exchange Act, to consider the impact any rule would have on competition and to not adopt any rule that would impose a burden on competition not necessary or appropriate in the public interest. The Commission's preliminary view is that the proposed rules for OTC derivatives dealers would not have any anticompetitive effects. These rules are intended to remove substantial regulatory and economic barriers that impede the ability of U.S. securities firms to compete effectively in global securities markets. In particular, by providing OTC derivatives dealers with relief from certain provisions of the federal securities laws, these rules would put U.S. securities firms on a level footing with their bank and foreign dealer competitors.

As discussed above, the limited regulatory system for OTC derivatives dealers would be optional, and would be an alternative to regulation as a fully regulated broker-dealer. OTC derivatives dealers that elect to register with the Commission in order to conduct both securities and non-securities OTC derivatives transactions in a single entity would be subject to modified capital, margin, and other regulatory requirements. Because of the substantial minimum capital requirements that would be imposed on OTC derivatives dealers, regulation as an OTC derivatives dealer would be available only to large, well-capitalized firms.

In general, major dealers in OTC derivatives markets include the largest, highest capitalized banks and securities firms. It is possible, however, that there may be smaller firms participating in these markets that could not satisfy the minimum capital requirements for OTC derivatives dealers and, as a result, not be able to take advantage of the competitive benefits available under the proposed rules. Nevertheless, these minimum capital requirements for OTC derivatives dealers are necessary to ensure against excessive leverage and the risks associated with conducting an OTC derivatives business, and to provide a cushion of capital against severe market disturbances. The Commission requests comment on the competitive benefits to OTC derivatives dealers that may result under the proposed rules. The Commission also requests comment on any anticompetitive effects that may result under the proposed rules.

VI. Summary of Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 U.S.C. 603 regarding proposed rules and rule amendments under the Exchange Act that would tailor capital, margin, and other broker-dealer regulatory requirements to the activities of OTC derivatives dealers. The following summarizes the IRFA.

The proposed rules and rule amendments are intended to improve the efficiency and competitiveness of U.S. securities firms participating in global OTC derivatives markets. These improvements would be realized through a limited regulatory structure that is intended to be deregulatory and to impose fewer costs on firms conducting an OTC derivatives business than would be imposed under the Commission's current rules. In particular, the application of revised capital requirements and an exemption from the margin provisions of Section 7 of the Exchange Act [82] are expected to make it feasible for firms to conduct a business involving both securities and non-securities OTC derivative products within the United States.

A broker-dealer (including any person that would be an OTC derivatives dealer) generally would be considered a small entity if (i) it has total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a–5(d) or, if not required to file such statements, a broker-dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (ii) it is not affiliated with any person (other than a natural person) that is not a small business or small organization.[83]

Under the proposed amendments to Rule 15c3–1, OTC derivatives dealers would be required to maintain at least $100 million in tentative net capital and at least $20 million in regulatory net capital. Based on these minimum capital requirements, the IRFA notes that no OTC derivatives dealer would be considered a small entity. Major dealers in OTC derivatives markets tend to be the largest, highest-capitalized banks and securities firms. The proposed capital requirements have been tailored

[81] 15 U.S.C. 78w(a)(2).

[82] 15 U.S.C. 78g.

[83] Exchange Act Rule 0–10 [17 CFR 240.0–10].

to this market and are necessary to ensure against excessive leverage and the risks associated with conducting an OTC derivatives business, as well as to provide for a cushion of capital against severe market disturbances. The Commission is not aware of any small entities that are active as dealers in OTC derivatives markets. In the IRFA, the Commission requests comment on whether there are small entities that act as dealers in OTC derivatives markets, and what effect, if any, the proposed rules and rule amendments would have on their activities.

The Commission also requests comment from persons acting as counterparties in transactions with persons eligible to become registered as OTC derivatives dealers. Under proposed Rule 3b–14, the term ''permissible derivatives counterparty'' would include a range of financial institutions, corporations, and other institutional entities with whom OTC derivatives dealers would be permitted to enter into OTC derivatives transactions. Like OTC derivatives dealers, these institutional counterparties are frequently large, well-capitalized entities. The proposed definition may include potential counterparties that would be considered small entities for purposes of the Regulatory Flexibility Act (''RFA'').[84]

The proposed definition would include various classes of persons, such as banks, trust companies, saving associations, credit unions, insurance companies, investment companies, broker-dealers, commodity pools, futures commission merchants, and governmental entities, without regard to any minimum financial requirements. The Commission requests comment regarding the participation of these classes of persons in OTC derivatives markets, whether any of them would be considered small entities, and what effect, if any, the proposed rules and rule amendments would have on their activities.

The proposed definition would also include classes of persons, such as corporations, partnerships, trusts, and employee benefit plans, that would have minimum financial requirements for being considered a permissible derivatives counterparty. In the case of corporations, partnerships, trusts, and certain other entities described in the proposed definition, any such entity would be required to have total assets exceeding $10 million, have obligations under the terms of an OTC derivatives transaction that are guaranteed by certain classes of persons described in the rule, or a net worth of $1 million if it enters into OTC derivatives transactions in connection with the conduct of its business. Employee benefit plans would be required to have total assets exceeding $5 million. Alternatively, employee benefit plans would satisfy the definition if its investment decisions are made by a bank, trust company, insurance company, investment adviser, or commodity trading advisor subject to regulation by the Commodity Futures Trading Commission.

Some of these entities, despite minimum financial requirements, may be considered small entities for purposes of the RFA. The Commission requests comment regarding the participation of these classes of persons in OTC derivatives markets. Commenters should address whether any of these potential participants in OTC derivatives markets are likely to be small entities, and what effect, if any, the proposed rules and rule amendments would have on their activities. The Commission also requests comment from small entities that would not be able to satisfy the definition of permissible derivatives counterparty and, therefore, would not be eligible to engage in transactions with OTC derivatives dealers. Commenters should indicate what effect, if any, the proposed rules and rule amendments would have on their activities.

As explained in the IRFA, none of the recordkeeping, reporting, or other compliance requirements under the proposed rules and rule amendments are expected to be unduly burdensome. Under the proposed amendments to Rule 15c3–1, the Commission would allow OTC derivatives dealers to use VAR models to calculate their net capital requirements. Although many dealers active in OTC derivatives markets already use VAR models, OTC derivatives dealers would be required to bring their use of models into compliance with the requirements of proposed Rule 15c3–1.

OTC derivatives dealers would also be exempted under proposed Rule 36a1–1 from the provisions of Section 7 of the Exchange Act, provided they comply with other federal margin requirements applicable to non-broker-dealer lenders. This exemption is intended to be deregulatory and to allow OTC derivatives dealers greater flexibility by allowing them to extend credit on securities other than ''margin stock,'' including securities OTC derivative instruments. These OTC derivative dealers, however, would be required to implement systems for complying with the margin requirements applicable to their business.

Under the proposed amendments to Rules 17a–3, 17a–4, 17a–11, proposed Rule 17a–12, and proposed revisions to Form X–17A–5 (FOCUS report), OTC derivatives dealers would be required to maintain certain records regarding their OTC derivatives transactions, and to provide certain information to the Commission regarding their financial condition and operations. Any new requirements under these proposed rules and rule amendments would supplement current requirements that apply to fully regulated broker-dealers. Compliance with these requirements would require modification of the existing recordkeeping systems of dealers that become registered as OTC derivatives dealers.

Under proposed Rule 15c3–4, OTC derivatives dealers would be required to maintain internal risk management controls. In general, dealers in OTC derivatives markets already maintain and follow internal risk management controls. Under proposed Rule 15c3–4, OTC derivatives dealers would be required to modify their existing controls systems to the requirements under the rule. It is also expected that OTC derivatives dealers that elect to register with the Commission under the proposed amendments to Rule 15b1–1 would maintain general policies and procedures designed to promote compliance with the Commission rules, including compliance with the restrictions on the activities of OTC derivatives dealers described in proposed Rule 15a–1.

As noted in the IRFA, the Commission requests comment on the costs of coming into compliance with the recordkeeping, reporting, and other requirements under the proposed rules and rule amendments, and whether there would be any on-going costs associated with complying with the rules and rule amendments. Commenters should provide detailed estimates of these costs. The IRFA also notes that none of the recordkeeping, reporting, or other compliance requirements under the proposed rules and rule amendments are expected to apply to counterparties that enter into transactions with OTC derivatives dealers. The Commission, however, requests comment regarding the participation of small entities as counterparties in OTC derivatives markets, and what counterparty costs, if any, may be associated with the obligations of OTC derivatives dealers to comply with the proposed rules and rule amendments.

[84] 5 U.S.C. 601 *et seq.*

As discussed further in the IRFA, the Commission has considered alternatives to the proposed rules and rule amendments that would accomplish the stated objectives of improving the efficiency and competitiveness of U.S. securities firms participating in global OTC derivatives markets, and making it feasible for these firms to conduct a business involving securities and non-securities OTC derivative products within the United States. The proposed rules and rule amendments accomplish these objectives by tailoring capital, margin, and other regulatory requirements to the activities of OTC derivatives dealers. The proposed capital requirements, in particular, provide OTC derivatives dealers with significant alternatives for computing risk charges. These requirements do this, while also being intended to ensure against excessive leverage and risk, and to provide a cushion of capital against severe market disturbances. Improved competition and efficiency should benefit participants in OTC derivatives markets.

As noted in the IRFA, the Commission is encouraging the submission of written comments with respect to any aspect of the IRFA. Comment specifically is requested whether any small entities would be affected by the proposed rules and rule amendments, the costs of compliance with the proposed rules and rule amendments, and suggested alternatives that would accomplish the objectives of the proposed rules and rule amendments. After receipt of any comments from interested persons and preliminary evaluation of the possible compliance costs and effects upon competition, it may be appropriate to conclude, and for the Chairman of the Commission to certify, that the proposal does not have a significant economic impact on a substantial number of small entities. Comments received will also be considered in the preparation, if required, of a Final Regulatory Flexibility Analysis if the proposed rules and rule amendments are adopted. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission is also requesting information regarding the potential impact of the proposed rules and rule amendments on the economy on an annual basis. Commenters should provide empirical data to support their views. A copy of the IRFA may be obtained by contacting Glenn J. Jessee, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 7–11, Washington, D.C. 20549.

VII. Paperwork Reduction Act

Certain provisions of the proposed rules and rule amendments contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. § 3501 *et seq.*). The Commission has submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for the collections of information are: (1) Appendix F to Rule 15c3–1, Optional Market and Credit Risk Requirements for OTC Derivatives Dealers; (2) Rule 15c3–4 Internal Risk Management Control Systems for OTC Derivatives Dealers (New Rule); (3) Rule 17a–3 Records to be Made by Certain Exchange Members, Brokers and Dealers (OMB Control Number 3235–0033); and (4) Rule 17a–12 Reports to be Made by OTC Derivatives Dealers (New Rule).

The Commission proposes to implement a limited regulatory system under the Exchange Act for OTC derivatives dealers. Under the proposed regulatory structure, OTC derivatives dealers would be permitted to act primarily as counterparties with respect to certain types of securities and non-securities OTC derivative instruments, and to issue and reacquire issued securities, without being required to comply with the full range of capital, margin, and other regulatory requirements applicable to other registered broker-dealers.

The collection of information obligations imposed by the proposed rules and rule amendments would be mandatory. However, it is important to note that registration as an OTC derivatives dealer would be voluntary. The information collected, retained, and/or filed pursuant to the proposed rules and rule amendments would be kept confidential to the extent permitted by the Freedom of Information Act [5 U.S.C. 552 *et seq.*]. An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid OMB control number.

A. Appendix F to Rule 15c3–1, Optional Market and Credit Risk Requirements for OTC Derivatives Dealers

Rule 15c3–1 requires broker-dealers to maintain minimum levels of net capital computed in accordance with the rule's provisions. The net capital reserves are intended to ensure that broker-dealers have sufficient capital to protect the assets of customers and to meet their responsibilities to other broker-dealers. The Commission is proposing to add Appendix F to the rule to provide an alternative net capital requirement and method for determining net capital for OTC derivatives dealers.

Under proposed Appendix F's alternative method for determining net capital requirements, an OTC derivatives dealer would be permitted to use a VAR model to calculate its net capital requirements. The OTC derivatives dealer would be required to send notice to the Commission describing its VAR model, including whether the firm has developed its own model and how the qualitative and quantitative aspects of Appendix F of the rule are incorporated into the model. In addition to developing and submitting a notice describing its model, an OTC derivatives dealer would be required to maintain its model according to certain prescribed standards. Maintenance of the model would require an OTC derivatives dealer to create and maintain certain information and periodically adjust the model. For example, the OTC derivatives dealer would be required to conduct backtesting by comparing each of its most recent 250 business days' actual net trading profit or loss with the corresponding daily VAR measures. Finally, the OTC derivatives dealer would be required to submit a description of its risk management control system implemented pursuant to proposed Rule 15c3–4.

Proposed Appendix F would help to ensure that OTC derivatives dealers would be able to meet their financial obligations and would facilitate the monitoring of the financial condition of OTC derivatives dealers by the Commission. Failure to require the current and proposed collections of information would undermine the safety and soundness of OTC derivatives dealers and the securities markets.

It is anticipated that Appendix F would affect approximately six OTC derivatives dealers. However, it is possible that more than ten OTC derivatives dealers would be affected. It is anticipated that the six affected OTC derivatives dealers would each spend an average of approximately 1,000 hours developing and submitting their VAR model and the description of their risk management control system to the Commission. In addition, these OTC derivatives dealers would spend annually, an average of approximately 1,000 hours each maintaining the model. Consequently, the total initial burden is estimated to be 6,000 hours and the total annual burden is estimated to be 6,000 hours. The estimates of the initial and annual burdens are based on discussions with potential respondents. The retention period for any

recordkeeping requirement under the rule would be three years.

B. Proposed Rule 15c3–4

Proposed Rule 15c3–4 would establish basic elements governing the creation, execution, and review of a firm's risk management control system. These elements are designed to ensure the integrity of the risk measurement, monitoring, and management process, and to clarify accountability, at the appropriate organizational level, for defining the permitted scope of activity and level of risk.

The proposed rule would require an OTC derivatives dealer to consider a number of issues affecting its business environment when creating its risk management control system. For example, an OTC derivatives dealer would need to consider, among other things, the sophistication and experience of relevant trading, risk management, and internal audit personnel, as well as the separation of duties among these personnel, when designing and implementing its internal control system's guidelines, policies, and procedures. This would help to ensure that the control system that is implemented would adequately address the risks posed by the firm's business and the environment in which it is being conducted. In addition, this would enable an OTC derivatives dealer to implement specific policies and procedures unique to its circumstances.

In implementing its policies and procedures, an OTC derivatives dealer would be required to document and record its system of internal risk management controls. In particular, an OTC derivatives dealer would be required to document its consideration of certain issues affecting its business when designing its internal controls. An OTC derivatives dealer would also be required to prepare and maintain written guidelines that discuss its internal control system, including procedures for determining the scope of authorized activities.

The proposed rule would be an integral part of the Commission's financial responsibility program for OTC derivatives dealers. The information to be collected under proposed Rule 15c3–4 would be essential to the regulation and oversight of OTC derivatives dealers and their compliance with the Commission's proposed financial responsibility requirements. More specifically, requiring an OTC derivatives dealer to document the planning, implementation, and periodic review of its risk management controls would ensure that all pertinent issues are considered, that the risk management controls are implemented properly, and that they continue to adequately address the risks faced by OTC derivatives dealers.

It is anticipated that the proposed rule would affect approximately six OTC derivatives dealers. However, it is possible that more than ten OTC derivatives dealers would be affected. It is estimated that the average amount of time a firm would spend implementing its risk management control system would be 2,000 hours. On average, it is expected that an OTC derivatives dealer would spend approximately 200 hours each year reviewing and updating its risk management control system. The total initial burden for all OTC derivatives dealers would be 12,000 hours and the annual burden would be 1,200 hours. The estimates of the initial and annual burdens are based on discussions with potential respondents. The retention period for the recordkeeping requirement under the rule would be three years.

C. Proposed Amendments to Rule 17a–3.

OTC derivatives dealers, like other broker-dealers that are registered with the Commission, would be required to comply with the books and records requirements of Exchange Act Rule 17a–3.[85] In general, Rule 17a–3 requires broker-dealers to make records concerning the purchases and sales of securities, receipts and deliveries of securities, and receipts and disbursements of cash. As part of the limited regulatory system for OTC derivatives dealers, the Commission proposes to amend Rule 17a–3 to reflect the business conducted by OTC derivatives dealers.[86] In particular, Rule 17a–3(a)(10) would be amended to require OTC derivatives dealers to compile a register of all transactions in eligible OTC derivative instruments. Currently, Rule 17a–3(a)(10) requires broker-dealers to make a record of all securities puts, calls, spreads, straddles, and other options in which a member, broker, or dealer has any direct or indirect interest, but does not address other types of OTC transactions.

Rule 17a–3 is an important part of the Commission's financial responsibility program for broker-dealers. The information required to be preserved under the proposed amendment of the rule would be used by representatives of the Commission and the examining authority responsible for reviewing the activities of the OTC derivatives dealer pursuant to proposed Rule 15b9–2 to ensure that OTC derivatives dealers would be in compliance with applicable Commission rules.

It is anticipated that the proposed rule amendment would affect approximately six OTC derivatives dealers. However, it is possible that more than ten OTC derivatives dealers would be affected. The current estimate of the time required to comply with the existing provisions of Rule 17a–3 is one hour per broker-dealer per working day. It is expected that any additional burden under the proposed rule amendment would be minimal because the information that would be called for under the proposed amendment to the rule is information a prudent OTC derivatives dealer would already maintain during the ordinary course of its business. The proposed amendment to Rule 17a–3 would require each of the six affected OTC derivatives dealers to spend approximately 52 hours per year collecting the required information. Thus, the Commission estimates that complying with the proposed amendment to Rule 17a–3 would require an additional 312 hours per year (52 hours per year multiplied by six affected OTC derivatives dealers). The estimates of the initial and annual burdens are based on discussions with potential respondents. The retention period for the recordkeeping requirements under the rule would be three years.

D. Proposed Rule 17a–12

Proposed Rule 17a–12 would establish the basic periodic reporting structure for OTC derivatives dealers. The proposed rule would require OTC derivatives dealers to file quarterly Financial and Operational Combined Uniform Single Reports (FOCUS).[87] OTC derivatives dealers would be required to include in these quarterly filings the enhanced reporting information and the evaluation of risk in relation to capital provisions of the DPG's Framework for Voluntary Oversight.[88] Finally, proposed Rule 17a–12 would require an OTC derivatives dealer to file annually its audited financial statements along with a corresponding audit report.

The proposed rule would be integral part of the Commission's financial responsibility program for OTC derivatives dealers. The information to

[85] 17 CFR 240.17a–3.

[86] The Commission is authorized by Sections 17(a) [15 U.S.C. 78q(a)] and 23(a) [15 U.S.C. 78w(a)] of the Exchange Act to promulgate rules and regulations regarding the maintenance and preservation of books and records of brokers-dealers.

[87] Form X–17A–5 [17 CFR 249.617].

[88] See Framework for Voluntary Oversight, Derivatives Policy Group (Mar. 1995).

be collected under proposed Rule 17a–12 would be essential to the regulation and oversight of OTC derivatives dealers and would assist the Commission and the examining authorities responsible for reviewing the activities of OTC derivatives dealers pursuant to proposed Rule 15b9–2 to monitor and enforce compliance with applicable Commission rules, including rules pertaining to financial responsibility. These FOCUS and annual reports would also be intended to be used to evaluate the activities conducted by OTC derivatives dealers and to anticipate, where possible, how these dealers could be affected by significant economic events.

It is anticipated that the proposed rule would affect approximately six OTC derivatives dealers. However, it is possible that more than ten OTC derivatives dealers would be affected. It is estimated that the average amount of time necessary to prepare and file the information required by the proposed rule would be 180 hours annually per OTC derivatives dealer. This is based upon an estimated average of four responses per year and an average of 20 hours spent preparing each response with an additional 100 hours spent on preparing the annual audit. This estimate of the annual burden is based on discussions with potential respondents. The retention period for the recordkeeping requirements under the rule would be three years.

E. Request for Comments

Written comments are invited on: (a) Whether the proposed collections of information would be necessary for the proper performance of the functions of the agency, including whether the information would have practical utility; (b) the accuracy of the agency's estimates of the burdens of the proposed collections of information; (c) ways to enhance the quality, utility, and clarity of the information to be collected; and (d) ways to minimize the burden of the collections of information on respondents, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the following persons: (i) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Room 3208, New Executive Office Building, Washington, D.C. 20503; and (ii) Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549 with reference to File No. S7–30–97. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VIII. Statutory Authority

The Commission is amending Title 17, Chapter II of the Code of Federal Regulations pursuant to the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) (particularly sections 3(b), 15(a), 15(b), 15(c), 17(a), 23, and 36 thereof (15 U.S.C. 78c(b), 78o(a), 78o(b), 78o(c), 78q(a), 78w, and 78mm)).

Text of Proposed Rule Amendments

List of Subjects

17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies).

17 CFR Parts 240 and 249

Broker-dealers, Reporting and recordkeeping requirements, Securities.

PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

1. The authority citation for Part 200 continues to read in part as follows:

Authority: 15 U.S.C. 77s, 78d–1, 78d–2, 78w, 78ll(d), 79t, 77sss, 80a–37, 80b–11, unless otherwise noted.

* * * * *

2. Section 200.30–3 is amended by adding paragraph (a)(63) to read as follows:

§ 200.30–3(a)(63) Delegation of authority to Director of Division of Market Regulation.

* * * * *

(a) * * *

(63) Pursuant to § 240.15a–1(a)(1)(iii) of this chapter, to designate by order other securities transactions in which an OTC derivatives dealer may engage.

* * * * *

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*(d), 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

4. By adding §§ 240.3b–12 through 240.3b–16 to read as follows:

§ 240.3b–12 Definition of OTC derivatives dealer.

The term *OTC derivatives dealer* means any dealer that:

(a) Limits its securities activities to:

(1) Engaging as a counterparty in transactions in eligible OTC derivative instruments with permissible derivatives counterparties;

(2) Issuing and reacquiring issued securities, including warrants on securities, hybrid securities, and structured notes, through a registered broker or dealer (other than an OTC derivatives dealer); or

(3) Engaging in other securities transactions which the Commission designates by order pursuant to § 240.15a–1(a)(1)(iii); and

(b) In connection with the activities described in paragraph (a) of this section, engages in permissible risk management, arbitrage, and trading transactions.

§ 240.3b–13 Definition of eligible OTC derivative instrument.

The term *eligible OTC derivative instrument* means any agreement, contract, or transaction (or class thereof):

(a) That is not part of a fungible class of agreements, contracts, or transactions that are standardized as to their material economic terms;

(b) That is based, in whole or in part, on the value of, any interest in, any quantitative measure of, or the occurrence of any event relating to, one or more securities, commodities, currencies, interest or other rates, indices, or other assets, or that involves the purchase and sale of a security on a firm basis at least one year following the transaction date; and

(c) That is not entered into and traded on or through an exchange, an electronic marketplace, or similar facility supervised or regulated by the Commission, or any other multilateral transaction execution facility.

§ 240.3b–14 Definition of permissible derivatives counterparty.

The term *permissible derivatives counterparty* means, and shall be limited to, the following persons or classes of persons:

(a) A bank or trust company (acting on its own behalf or on behalf of another permissible derivatives counterparty);

(b) A savings association or credit union;

(c) An insurance company;

(d) An investment company or a foreign person performing a similar role or function subject as such to foreign regulation, *provided* that such investment company or foreign person

is not formed solely for the specific purpose of constituting a permissible derivatives counterparty;

(e) A commodity pool formed and operated by a person subject to regulation under the Commodity Exchange Act (7 U.S.C. 1 *et seq.*) or a foreign person performing a similar role or function subject as such to foreign regulation, *provided* that such commodity pool or foreign person is not formed solely for the specific purpose of constituting a permissible derivatives counterparty and has total assets exceeding $5 million;

(f) A corporation, partnership, proprietorship, organization, trust, or other entity not formed solely for the specific purpose of constituting a permissible derivatives counterparty:

(1) Which has total assets exceeding $10 million;

(2) The obligations of which under the terms of a transaction in eligible OTC derivative instruments are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by any such entity referenced in paragraph (f)(1) of this section or by an entity referred to in paragraphs (a), (b), (c), (d), (e), (f) or (h) of this section; or

(3) Which has a net worth of $1 million and enters into transactions in eligible OTC derivative instruments in connection with the conduct of its business, or which has a net worth of $1 million and enters into transactions in eligible OTC derivative instruments to manage the risk of an asset or liability owned or incurred in the conduct of its business or reasonably likely to be owned or incurred in the conduct of its business;

(g) An employee benefit plan subject to the Employee Retirement Income Security Act of 1974 or a foreign person performing a similar role or function subject as such to foreign regulation with total assets exceeding $5 million, or whose investment decisions are made by a bank, trust company, insurance company, investment adviser, or a commodity trading adviser subject to regulation under the Commodity Exchange Act;

(h) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any such entity;

(i) A broker, dealer, or a foreign person performing a similar role or function subject as such to foreign regulation, acting on its own behalf or on behalf of another permissible derivatives counterparty; *provided, however,* that if such broker or dealer (or foreign person) is a natural person or proprietorship, the broker or dealer (or foreign person) must also meet the requirements of either paragraph (f) or (k) of this section;

(j) A futures commission merchant, floor broker, or floor trader subject to regulation under the Commodity Exchange Act or a foreign person performing a similar role or function subject as such to foreign regulation, acting on its own behalf or on behalf of another permissible derivatives counterparty; *provided, however,* that if such futures commission merchant, floor broker, or floor trader (or foreign person) is a natural person or proprietorship, the futures commission merchant, floor broker, or floor trader (or foreign person) must also meet the requirements of paragraph (f) or (k) of this section; or

(k) Any natural person with total assets exceeding at least $10 million.

§ 240.3b–15 Definition of permissible risk management, arbitrage, and trading transaction.

The term *permissible risk management, arbitrage, and trading transaction* means, when used in connection with any transaction engaged in by, or effected on behalf of, an OTC derivatives dealer, a transaction involving:

(a) The taking possession of or selling of counterparty collateral;

(b) Cash management;

(c) Hedging an element of market or credit risk associated with one or more existing or anticipated transactions in eligible OTC derivative instruments or the issuance of securities, including warrants on securities, hybrid securities, or structured notes;

(d) Financing, through repurchase and reverse repurchase transactions, buy/sell transactions, and securities lending and borrowing transactions, a securities position that is acquired in connection with a transaction listed in paragraphs (a) through (c) of this section, or that is designated by the Commission pursuant to § 240.15a–1(a)(1)(iii);

(e) Arbitrage, provided that arbitrage involving securities shall be limited to arbitrage of a securities position that is acquired in connection with a transaction listed in paragraphs (a) through (c) of this section, or that is designated by the Commission pursuant to § 240.15a–1(a)(1)(iii); or

(f) Securities trading relating to a securities position that is acquired in connection with a transaction listed in paragraphs (a) through (c) of this section, *provided* that the number of any such transactions does not exceed 150 transactions in any calendar year, and provided further that the OTC derivatives dealer engaging in any such transaction maintains and enforces written policies and procedures reasonably designed to achieve compliance with the other provisions of this section.

§ 240.3b–16 Definition of hybrid security.

The term *hybrid security* shall mean a security that incorporates payment features economically similar to options, forwards, futures, swap agreements, or collars involving currencies, interest rates, commodities, securities, or indices (or any combination, permutation, or derivative of such contract or underlying interest).

5. Section 240.8c–1 is amended by revising paragraph (b)(1) to read as follows:

§ 240.8c1 Hypothecation of customers' securities.

* * * * *

(b) * * *

(1) The term *customer* shall not be deemed to include any general or special partner or any director or officer of such member, broker or dealer, or any participant, as such, in any joint, group or syndicate account with such member, broker or dealer or with any partner, officer or director thereof, or a permissible derivatives counterparty as defined in § 240.3b–14 who has delivered collateral pursuant to a transaction in an eligible OTC derivative instrument and who has consented to the unrestricted use of its collateral by an OTC derivatives dealer after receiving disclosure of the unrestricted use of the collateral;

* * * * *

6. By adding § 240.15a–1 under the undesignated center heading ''Exemption of Certain Securities From Section 15(a)'' to read as follows:

§ 240.15a–1 Transactions by OTC derivatives dealers.

(a) An OTC derivatives dealer shall not engage in any securities transaction other than:

(1)(i) Engaging as a counterparty in transactions in eligible OTC derivative instruments with permissible derivatives counterparties;

(ii) Issuing and reacquiring issued securities, including warrants on securities, hybrid securities, and structured notes, through a registered broker or dealer (other than an OTC derivatives dealer); or

(iii) Engaging in other securities transactions which the Commission designates by order; and

(2) In connection with the transactions described in paragraph

(a)(1) of this section, engaging in permissible risk management, arbitrage, and trading transactions.

(b) To the extent an OTC derivatives dealer engages in any securities transaction listed in paragraph (a) of this section, such transaction shall be effected through a registered broker or dealer other than an OTC derivatives dealer.

7. Section 240.15b1–1 is amended to revise paragraph (a) to read as follows:

§ 240.15b1–1 Application for registration of brokers or dealers.

(a) An application for registration of a broker or dealer that is filed pursuant to Section 15(b) of the Act (15 U.S.C. 78o(b)) shall be filed on Form BD (§ 249.501 of this chapter) in accordance with the instructions to the form. A broker or dealer that is an OTC derivatives dealer shall indicate where appropriate on Form BD that the type of business in which it is engaged is solely that of acting as an OTC derivatives dealer.

* * * * *

8. By adding § 240.15b9–2 under the underquoted center heading ''registration of brokers and dealers'' to read as follows:

§ 240.15b9–2 Exemption from SRO membership for OTC derivatives dealers.

Any broker or dealer required by Section 15(b)(8) of the Act (15 U.S.C. 78o(b)(8)) to become a member of a registered national securities association shall be exempt from such requirement, provided that:

(a) Such broker or dealer is an OTC derivatives dealer; and

(b) Such OTC derivatives dealer enters into an agreement with the examining authority designated pursuant to Section 17(d) of the Act (15 U.S.C. 78(q)(d)) for one or more of its affiliates that is a registered broker or dealer by which such examining authority agrees to conduct a review of such OTC derivatives dealer, report to the Commission any potential violation of applicable Commission rules, and evaluate the OTC derivatives dealer's procedures and controls designed to prevent violations of the Commission's rules.

9. Section 240.15c2–1 is amended to revise paragraph (b)(1) to read as follows:

§ 240.15c2–1 Hypothecation of customers' securities.

* * * * *

(b) * * *

(1) The term *customer* shall not be deemed to include any general or special partner or any director or officer of such broker or dealer, or any participant, as such, in any joint, group or syndicate account with such broker or dealer or with any partner, officer or director thereof, or a permissible derivatives counterparty as defined in § 240.3b–14 who has delivered collateral pursuant to a transaction in an eligible OTC derivative instrument and who has consented to the unrestricted use of its collateral by a OTC derivatives dealer after receiving disclosure of the unrestricted use of the collateral;

* * * * *

10. Section 240.15c3–1 is amended to add a sentence following the first sentence in the introductory text of paragraph (a); add paragraph (a)(5); redesignate paragraph (c)(12) as paragraph (c)(12)(i) and add paragraph (c)(12)(ii) and (c)(15) to read as follows:

§ 240.15c3–1 Net capital requirements for brokers or dealers.

(a) * * * In lieu of applying paragraphs (a)(1) and (a)(2) of this section, every dealer meeting the definition of an OTC derivatives dealer pursuant to § 240.3b–12 under the Securities Exchange Act of 1934 shall maintain net capital pursuant to paragraph (a)(5) of this section. * * *

* * * * *

(5) A dealer meeting the definition of an OTC derivatives dealer pursuant to § 240.3b–12 may elect not to apply the provisions of paragraph (c)(2)(vi) of this section to its securities, money market instruments, options, or eligible OTC derivative instruments and in lieu thereof apply the provisions in appendix F of this chapter (§ 240.15c3–1f). An OTC derivatives dealer shall at all times maintain tentative net capital of not less than $100 million and net capital of not less than $20 million.

* * * * *

(c) * * *

(12)(i) * * *

(ii) The term *examining authority* of an OTC derivatives dealer shall mean for the purposes of §§ 240.15c3–1 and 240.15c3–1a through d the examining authority responsible for conducting reviews of the OTC derivatives dealer pursuant to 240.15b9–2.

* * * * *

(15) The term *tentative net capital* shall mean the net capital of a broker or dealer before deducting the securities haircuts computed pursuant to paragraph (c)(2)(vi) of this section and the charges on inventory computed pursuant to appendix B of this chapter (§ 240.15c3–1b). However, for an OTC derivatives dealer electing to use appendix F of this chapter (§ 240.15c3–1f), the term ''tentative net capital'' shall mean the OTC derivatives dealer's net capital before deducting the charges for market and credit risk as computed pursuant to appendix F and increased by unrealized trading gains and unsecured receivables resulting from transactions in eligible OTC derivative instruments with permissible derivatives counterparties.

* * * * *

11. By adding Section 240.15c3–1f to read as follows:

§ 240.15c3–1f Optional Market and Credit Risk Requirements for OTC Derivatives Dealers (appendix F to 17 CFR 240.15c3–1).

(a) A dealer meeting the definition of an OTC derivatives dealer pursuant to § 240.3b–12 may elect to compute capital charges for market and credit risk pursuant to this appendix in place of computing securities haircuts pursuant to § 240.15c3–1(c)(2)(vi). A dealer may make this election by filing an application with the Commission stating whether the firm has developed its own model and describing the qualitative and quantitative aspects of its internal value-at-risk (''VAR'') model, which at a minimum must adhere to the criteria set forth in paragraph (d) of this appendix. The dealer's application shall also include a description of the risk management controls adopted pursuant to § 240.15c3–4.

Market Risk

(b) An OTC derivatives dealer electing to apply this appendix F shall compute a capital requirement for market risk using the Full Value-at-Risk Method or the Alternative Method as follows:

(1) *Full value-at-risk method*. An OTC derivatives dealer shall deduct from net worth an amount for market risk exposure for eligible OTC derivatives instruments and other positions in its proprietary or other accounts equal to the VAR of these positions obtained from its proprietary model, multiplied by the appropriate multiplication factor in paragraph (d)(1)(iv)(C) of this appendix. The model may not be used by the dealer for this purpose until the use of the model by the dealer has been authorized by the Commission.

(2) *Alternative method for equities*. An OTC derivatives dealer may choose to use the alternative method to calculate market risk for equity instruments, including OTC options, or if the Commission does not approve an OTC derivatives dealer's use of a VAR model for equity instruments, the OTC derivatives dealer using this appendix must use the alternative method. Under the alternative method, the deduction for market risk must be an amount equal to the largest theoretical loss calculated

in accordance with the theoretical pricing model set forth in appendix A of this section (§ 240.15c3–1a). The OTC derivatives dealer may use its own theoretical pricing model as long as it contains the minimum pricing factors set forth in appendix A.

Credit Risk

(c) The capital requirement for credit risk arising from its transactions in eligible OTC derivatives instruments shall be:

(1) The net replacement value in the account of the counterparty (including the effect of legally enforceable netting agreements and the application of liquid collateral) multiplied by 8% multiplied by the counterparty factor. The counterparty factors are:

(i) 20% for entities with ratings for senior unsecured long-term debt or commercial paper in the two highest rating categories by at least two nationally recognized statistical rating organizations (''NRSROs'');

(ii) 50% for entities with ratings for senior unsecured long-term debt in the third and fourth highest ratings categories by at least two NRSROs; and

(iii) 100% for entities with ratings for senior unsecured long-term debt below the four highest rating categories.

(2) The net replacement value in the account of the counterparty (including the effect of legally enforceable netting agreements and the application of liquid collateral) with senior unsecured long-term debt in default.

(3) A concentration charge calculated as follows:

(i) Where the net replacement value in the account of any one counterparty exceeds 25% of the OTC derivatives dealer's tentative net capital, it must deduct from net worth:

(A) For counterparties with ratings for senior unsecured long-term debt or commercial paper in the two highest rating categories by at least two NRSROs, 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital;

(B) For counterparties with ratings for senior unsecured long-term debt in the third and fourth highest rating categories by at least two NRSROs, 20% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital; and

(C) For counterparties with ratings for senior unsecured long-term debt below the four highest rating categories, 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital; and

(ii) Where the aggregate of the net replacement values of all counterparties exceeds 300% of an OTC derivatives dealer's tentative net capital, it must deduct from net worth 100% of the amount of such excess.

(4) Counterparties that are not rated by an NRSRO may be rated by the OTC derivatives dealer upon demonstrating to the Commission that the OTC derivatives dealer uses ratings criteria equivalent to those used by NRSROs and that such ratings are current.

VAR Models

(d) An OTC derivatives dealer's VAR model must meet the following qualitative and quantitative requirements:

(1) *Qualitative requirements.* An OTC derivatives dealer electing to apply this appendix F must have a VAR model that meets the following minimum qualitative requirements:

(i) The OTC derivatives dealer's VAR model must be integrated into the firm's daily risk management process;

(ii) The OTC derivatives dealer must conduct appropriate stress tests of the VAR model, and develop procedures to follow in response to the results of such tests;

(iii) The OTC derivatives dealer must conduct periodic reviews (which may be performed by internal audit staff) of its VAR model. The OTC derivatives dealer's VAR model also must be subject to annual reviews conducted by independent public accountants;

(iv) The OTC derivatives dealer must conduct backtesting of the VAR model pursuant to the following procedures:

(A) Beginning one year after an OTC derivatives dealer starts to comply with this appendix, an OTC derivatives dealer must conduct backtesting by comparing each of its most recent 250 business days' actual net trading profit or loss with the corresponding daily VAR measures generated for determining market risk capital charges and calibrated to a one-day holding period and a 99 percent, one-tailed confidence level;

(B) Once each quarter, the OTC derivatives dealer must identify the number of exceptions, that is, the number of business days for which the actual daily net trading loss, if any, exceeded the corresponding daily VAR measure; and

(C) An OTC derivatives dealer must use the multiplication factor indicated in Table 1 of this appendix in determining its capital charge for market risk until it obtains the next quarter's backtesting results, unless the Commission determines that a different adjustment or other action is appropriate.

TABLE 1.—MULTIPLICATION FACTOR BASED ON RESULTS OF BACKTESTING

Number of exceptions	Multiplication factor
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9	3.85
10 or more	4.00

(2) *Quantitative requirements.* An OTC derivatives dealer electing to apply this Appendix F must have a VAR model that meets the following quantitative requirements:

(i) The VAR measures must be calculated on a daily basis using a 99 percent, one-tailed confidence level with a price change equivalent to a ten-business day movement in rates and prices;

(ii) The effective historical observation period for VAR measures must be at least one year, and the weighted average time lag of the individual observations cannot be less than six months. Historical data sets must be updated at least every three months and reassessed whenever market prices or volatilities are subject to large changes;

(iii) The VAR measures must include the risks arising from the non-linear price characteristics of options positions and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates or prices. An OTC derivatives dealer must measure the volatility of options positions by different maturities;

(iv) The VAR measures may incorporate empirical correlations within and across risk categories, provided that the OTC derivatives dealer's process for measuring correlations is sound. In the event that the VAR measures do not incorporate empirical correlations across risk categories, then the OTC derivatives dealer must add the separate VAR measures for the four major risk categories in paragraph (d)(2)(v) of this appendix to determine its aggregate VAR measure; and

(v) The OTC derivatives dealer's VAR model must use risk factors sufficient to measure the market risk inherent in all covered positions. The risk factors must address interest rate risk, equity price risk, foreign exchange rate risk, and commodity price risk. For material exposures in the major currencies and

markets, modelling techniques must capture spread risk and must incorporate enough segments of the yield curve to capture differences in volatility and less than perfect correlation of rates along the yield curve. An OTC derivatives dealer must provide the Commission with evidence that the OTC derivatives dealer's VAR model takes account of specific risk in positions.

12. Section 240.15c3–3 is amended to revise paragraph (a)(1), and in paragraph (h) to revise the phrase ''§ 240.17a–5,'' to read ''§ 240.17a–5 or § 240.17a–12,''.

§ 240.15c3–3 Customer protection—reserves and custody of securities.

(a) * * *

(1) The term *customer* shall mean any person from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of that person. The term shall not include a broker or dealer, a municipal securities dealer, or a government securities broker or government securities dealer. The term shall not include general partners or directors or principal officers of the broker or dealer or any other person to the extent that person has a claim for property or funds which by contract, agreement or understanding, or by operation of law, is part of the capital of the broker or dealer or is subordinated to the claims of creditors of the broker or dealer. The term shall not include a permissible derivatives counterparty as defined in § 240.3b–14 who has delivered collateral pursuant to a transaction in an eligible OTC derivative instrument and who has consented to the unrestricted use of its collateral by an OTC derivatives dealer after receiving disclosure of the unrestricted use of the collateral. The term customer shall, however, include another broker or dealer to the extent that broker or dealer maintains an omnibus account for the account of customers with the broker or dealer in compliance with Regulation T (12 CFR part 220).

* * * * *

13. By adding § 240.15c3–4 to read as follows:

§ 240.15c3–4 Internal risk management control systems for OTC derivatives dealers.

(a) An OTC derivatives dealer shall establish and document a system of internal risk management controls to assist it to manage the risks associated with its business activities.

(b) An OTC derivatives dealer shall consider the following when adopting its internal control system guidelines, policies, and procedures:

(1) The ownership and governance structure of the OTC derivatives dealer;

(2) The composition of the governing body of the OTC derivatives dealer;

(3) The management philosophy and culture of the OTC derivatives dealer;

(4) The scope and nature of established risk management guidelines;

(5) The scope and nature of the permissible OTC derivatives activities;

(6) The sophistication and experience of relevant trading, risk management, and internal audit personnel;

(7) The sophistication and functionality of information and reporting systems; and

(8) The scope and frequency of monitoring, reporting, and auditing activities.

(c) An OTC derivatives dealer's internal risk management control system shall include the following elements:

(1) A risk control unit that reports directly to senior management and is independent from business trading units;

(2) Separation of duties between personnel responsible for entering into a transaction and those responsible for recording the transaction in the books and records of the OTC derivatives dealer;

(3) Periodic reviews (which may be performed by internal audit staff) and annual reviews (which must be conducted by independent public accountants) of the OTC derivatives dealer's risk management systems;

(4) Definitions of risk, risk monitoring, and risk management; and

(5) Written guidelines, approved by the OTC derivatives dealer's governing body, that include and discuss the following:

(i) The OTC derivatives dealer's consideration of the elements in paragraph (b) of this section;

(ii) The scope, and the procedures for determining the scope of authorized activities or any nonquantitative limitation on the scope of authorized activities;

(iii) Any quantitative guidelines for managing the OTC derivatives dealer's overall risk exposure;

(iv) The type, scope, and frequency of reporting by management on risk exposures;

(v) The procedures for and the timing of the governing body's periodic review of the risk monitoring and risk management written guidelines, systems, and processes;

(vi) The process for monitoring risk independent of the business or trading units whose activities create the risks being monitored;

(vii) The performance of risk management function by persons independent from or senior to the business or trading units whose activities create the risks;

(viii) The authority and resources of the groups or persons performing the risk monitoring and risk management functions;

(ix) The procedures governing the action management should take when internal risk management guidelines have been exceeded;

(x) The procedures to monitor and address the risk that an OTC derivative transaction contract will be unenforceable;

(xi) The procedures requiring the documentation of the principal terms of OTC derivatives transactions and other relevant information regarding such transactions; and

(xii) The procedures authorizing specified employees to commit the OTC derivatives dealer to particular types of transactions.

(d) Management must periodically review, in accordance with written procedures, the OTC derivatives dealer's business activities for consistency with risk management guidelines. Management must review the following:

(1) Whether risks arising from the OTC derivatives dealer's OTC derivatives activities are consistent with prescribed guidelines;

(2) Whether risk exposure guidelines for each business unit are appropriate for the business unit;

(3) Whether the data necessary to conduct the risk monitoring and risk management function as well as the valuation process over the OTC derivatives dealer's portfolio of products is accessible on a timely basis and information systems are available to capture, monitor, analyze, and report relevant data;

(4) Whether procedures are in place to enable management to take action when internal risk management guidelines have been exceeded;

(5) Whether procedures are in place to monitor and address the risk that an OTC derivative transaction contract will be unenforceable;

(6) Whether procedures are in place to identify and address any deficiencies in the operating systems and to contain the extent of losses arising from unidentified deficiencies;

(7) Whether procedures are in place to authorize specified employees to commit the OTC derivatives dealer to particular types of transactions, to specify any quantitative limits on such authority, and to provide for the oversight of their exercise of such authority;

(8) Whether procedures are in place to provide for adequate documentation of the principal terms of OTC derivatives transactions and other relevant information regarding such transactions;

(9) Whether personnel resources with appropriate expertise are committed to implementing the risk monitoring and risk management systems and processes; and

(10) Whether a mechanism is in place for periodic internal and external review of the risk monitoring and risk management functions.

14. Amend § 240.17a–3, in paragraph (a)(4)(vi) by revising the phrase ''Rule 17a–13 and Rule 17a–5 hereunder'' to read ''§§ 240.17a–13, 240.17a–5, and 240.17a–12'', and by adding a sentence to the end of paragraph (a)(10) to read as follows:

§ 240.17a–3 Records to be made by certain exchange members, brokers and dealers.

(a) * * *

(10) * * * An OTC derivatives dealer shall also keep a record of all eligible OTC derivative instruments as defined in § 240.3b–13 in which such OTC derivatives dealer has any direct or indirect interest or which such dealer has written or guaranteed, containing, at least, an identification of the security or other instrument and the number of units involved.

* * * * *

15. Amend § 240.17a–4 as follows:

a. In paragraph (b)(8) introductory text by revising the phrase ''Part IIA'' to read ''Part IIA or Part IIB'' and by revising the phrase ''§ 240.17a–5(i)(xv)'' to read ''§§ 240.17a–5(d) and 240.17a–12(b)'';

b. In paragraph (b)(8)(xv) by revising the phrase ''§ 240.17a–5'' to read ''§§ 240.17a–5 and 240.17a–12'';

c. By adding paragraph (b)(10) to read as follows:

d. In paragraph (f)(2)(i) by adding the phrase ''or its examining authority pursuant to § 240.15b9–2'' after the phrase ''(15 U.S.C. 78q(d))'' and by adding the phrase ''or its examining authority pursuant to § 240.15b9–2'' after the phrase ''designated examining authority'';

e. In paragraph (f)(2)(ii)(D) by adding the phrase '', the examining authority pursuant to § 240.15b9–2'' after the phrase ''by the Commission'';

f. In paragraphs (f)(3)(i), (f)(3)(iv)(A), (f)(3)(v)(A), and (f)(3)(vi) by adding the phrase '', its examining authority pursuant to § 240.15b9–2,'' after the phrase ''of the Commission''; and

g. In paragraph (f)(3)(vii) by adding the phrase ''its examining authority pursuant to § 240.15b9–2 or'' after the phrase ''shall file with''.

§ 240.17a–4 Records to be preserved by certain exchange members, brokers and dealers.

* * * * *

(b) * * *

(10) The records required to be made pursuant to § 240.15c3–4 and the results of the periodic reviews conducted pursuant to § 240.15c3–4(d).

* * * * *

16. Amend § 240.17a–11 by revising paragraph (b) and paragraph (c)(3) to read as follows; in paragraph (e) introductory text by adding the phrase ''or § 240.17a–12(f)(2)'' after the phrase ''240.17a–5(h)(2)'' and by adding the phrase ''or § 240.17a–12(e)(2)'' after the phrase ''240.17a–5(g)''; by revising paragraph (f) to read as follows; in paragraph (g) by adding the phrase ''the examining authority responsible for conducting reviews of an OTC derivatives dealer pursuant to § 240.15b9–2,'' after the phrase ''the designated examining authority of which such broker or dealer is a member,''; and in paragraph (h) by revising the phrase ''§ 240.15c3–3(i) and § 240.17a5–5(h)(2)'' to read ''§ 240.15c3–3(i), § 240.17a–5(h)(2), and § 240.17a–12(f)(2)''.

§ 240.17a–11 Notification provisions for brokers and dealers.

* * * * *

(b)(1) Every broker or dealer whose net capital declines below the minimum amount required pursuant to § 240.15c3–1 shall give notice of such deficiency that same day in accordance with paragraph (g) of this section. The notice shall specify the broker's or dealer's net capital requirement and its current amount of net capital. If a broker or dealer is informed by its designated examining authority, its examining authority pursuant to § 240.15b9–2, or the Commission that it is, or has been, in violation of § 240.15c3–1 and the broker or dealer has not given notice of the capital deficiency under this § 240.17a–11, the broker or dealer, even if it does not agree that it is, or has been, in violation of § 240.15c3–1, shall give notice of the claimed deficiency, which notice may specify the broker's or dealer's reasons for its disagreement.

(2) In addition to the requirements of paragraph (b)(1) of this section, an OTC derivatives dealer shall also provide notice if its tentative net capital falls below the minimum amount required pursuant to § 240.15c3–1. The notice shall specify the OTC derivatives dealer's net capital requirement, tentative net capital requirement, its current amount of net capital, and tentative net capital.

(c) * * *

(3) If a computation made by a broker or dealer pursuant to § 240.15c3–1 shows that its total net capital is less than 120 percent of the broker's or dealer's required minimum net capital. If a computation made by an OTC derivatives dealer pursuant to § 240.15c3–1 shows that its total tentative net capital is less than 120 percent of the dealer's required minimum tentative net capital.

* * * * *

(f) Every national securities exchange, national securities association, or examining authority responsible for conducting reviews of an OTC derivatives dealer pursuant to § 240.15b9–2 that learns that a member broker or dealer or an OTC derivatives dealer has failed to send notice or transmit a report required by paragraphs (b), (c), (d), or (e) of this section, even after being advised by the securities exchange, national securities association, or examining authority responsible for conducting reviews of an OTC derivatives dealer pursuant to § 240.15b9–2 to send notice or transmit a report, shall immediately give notice of such failure in accordance with paragraph (g) of this section.

* * * * *

17. By adding § 240.17a–12 to read as follows:

§ 240.17a–12 Reports to be made by certain OTC derivatives dealers.

(a) *Filing of quarterly reports.* (1) This paragraph (a) shall apply to every OTC derivatives dealer registered pursuant to Section 15 of the Act (15 U.S.C. 78o).

(i) Every OTC derivatives dealer shall file Part IIB of Form X–17A–5 (§ 249.617 of this chapter) within 17 business days after the end of each calendar quarter and within 17 business days after the date selected for the annual audit of financial statements where said date is other than the end of the calendar quarter.

(ii) Upon receiving from the Commission or the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2 written notice that additional reporting is required, an OTC derivatives dealer shall file monthly, or at such times as shall be specified, Part IIB of Form X–17A–5 (§ 249.617 of this chapter) and such other financial or operational information as shall be required by the Commission or the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2.

(2) The reports provided for in this paragraph (a) shall be considered filed when received at the Commission's

principal office in Washington, D.C., and at the principal office of the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2. All reports filed pursuant to this paragraph (a) shall be deemed to be confidential.

(3) Upon written application by an OTC derivatives dealer to the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2, the examining authority may extend the time for filing the information required by this paragraph (a). The examining authority for the OTC derivatives dealer shall maintain, in the manner prescribed in § 240.17a–1, a record of each extension granted.

(b) *Annual filing of audited financial statements.* (1)(i) Every OTC derivatives dealer registered pursuant to Section 15 of the Act (15 U.S.C. 78o) shall file annually, on a calendar or fiscal year basis, a report which shall be audited by an independent public accountant. Reports pursuant to this paragraph (b) shall be as of the same fixed or determinable date each year, unless a change is approved in writing by the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2. A copy of such written approval shall be sent to the Commission's principal office in Washington, D.C.

(ii) An OTC derivatives dealer succeeding to and continuing the business of another OTC derivatives dealer need not file a report under this paragraph (b) as of a date in the fiscal or calendar year in which the succession occurs if the predecessor OTC derivatives dealer has filed a report in compliance with this paragraph (b) as of a date in such fiscal or calendar year.

(2) The annual audited report shall contain a Statement of Financial Condition (in a format and on a basis which is consistent with the total reported on the Statement of Financial Condition contained in Form X–17A–5 (§ 249.617 of this chapter), Part IIB, a Statement of Income, a Statement of Cash Flows, a Statement of Changes in Stockholders' or Partners' or Sole Proprietor's Equity, and Statement of Changes in Liabilities Subordinated to Claims of General Creditors. Such statements shall be in a format which is consistent with such statements as contained in Form X–17A–5 (§ 249.617 of this chapter), Part IIB. If the Statement of Financial Condition filed in accordance with instructions to Form X–17A–5 (§ 249.617 of this chapter), Part IIB, is not consolidated, a summary of financial data for subsidiaries not consolidated in the Part IIB Statement of Financial Condition as filed by the OTC derivatives dealer shall be included in the notes to the consolidated statement of financial condition reported on by the independent public accountant. The summary financial data shall include the assets, liabilities, and net worth or stockholders' equity of the unconsolidated subsidiaries.

(3) Supporting schedules shall include, from Part IIB of Form X–17A–5 (§ 249.617 of this chapter), a Computation of Net Capital under § 240.15c3–1.

(4) A reconciliation, including appropriate explanations, of the Computation of Net Capital under § 240.15c3–1 contained in the audit report with the broker's or dealer's corresponding unaudited most recent Part IIB filing shall be filed with the report when material differences exist. If no material differences exist, a statement so indicating shall be filed.

(5) The annual audit report shall be filed not more than sixty (60) days after the date of the financial statements.

(6) Two copies of the annual audit report shall be filed at the Commission's principal office in Washington, D.C., and the principal office of the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2.

(c) *Nature and form of reports.* The financial statements filed pursuant to paragraph (b) of this section shall be prepared and filed in accordance with the following requirements:

(1) An audit shall be conducted by a public accountant who shall be in fact independent as defined in paragraph (f) of this section, and it shall give an opinion covering the statements filed pursuant to paragraph (b) of this section.

(2) Attached to the report shall be an oath or affirmation that, to the best knowledge and belief of the person making such oath or affirmation the financial statements and schedules are true and correct and neither the OTC derivatives dealer, nor any partner, officer, or director, as the case may be, has any significant interest in any counterparty or in any account classified solely as that of a counterparty. The oath or affirmation shall be made before a person duly authorized to administer such oaths or affirmations. If the OTC derivatives dealer is a sole proprietorship, the oath or affirmation shall be made by the proprietor; if a partnership, by a general partner; or if a corporation, by a duly authorized officer.

(3) All of the statements filed pursuant to paragraph (b) of this section shall be confidential except that they shall be available for use by any official or employee of the United States or by any other person to whom the Commission authorizes disclosure of such information as being in the public interest.

(d) *Qualification of accountants.* The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of his place of residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of his place of residence or principal office.

(e) *Designation of accountant.* (1) Every OTC derivatives dealer shall file no later than December 10 of each year a statement with the Commission's principal office in Washington, D.C., and the principal office of the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2. Such statement shall indicate the existence of an agreement dated no later than December 1, with an independent public accountant covering a contractual commitment to conduct the OTC derivatives dealer's annual audit during the following calendar year.

(2) The agreement may be of a continuing nature, providing for successive yearly audits, in which case no further filing is required. If the agreement is for a single audit, or if the continuing agreement previously filed has been terminated or amended, a new statement must be filed by the required date.

(3) The statement shall be headed ''Notice pursuant to § 240.17a–12(e)'' and shall contain the following information:

(i) Name, address, telephone number and registration number of the OTC derivatives dealer;

(ii) Name, address and telephone number of the accounting firm; and

(iii) The audit date of the OTC derivatives dealer for the year covered by the agreement.

(4) Notwithstanding the date of filing specified in paragraph (e)(1) of this section, every OTC derivatives dealer shall file the notice provided for in paragraph (e) of this section within 30 days following the effective date of registration as an OTC derivatives dealer.

(f) *Independence of accountant.* An accountant shall be independent in

accordance with the provisions of § 210.2–01(b) and (c) of this chapter.

(g) *Replacement of accountant.* (1) An OTC derivatives dealer shall file a notice that must be received by the Commission's principal office in Washington, D.C., and the principal office of the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2 not more than 15 business days after:

(i) The OTC derivatives dealer has notified the accountant whose opinion covered the most recent financial statements filed under paragraph (b) of this section that the accountant's services will not be utilized in future engagements; or

(ii) The OTC derivatives dealer has notified an accountant who was engaged to give an opinion covering the financial statements to be filed under paragraph (b) of this section that the engagement has been terminated; or

(iii) An accountant has notified the OTC derivatives dealer that it would not continue under an engagement or give an opinion covering the financial statements to be filed under paragraph (b) of this section; or

(iv) A new accountant has been engaged to give an opinion covering the financial statements to be filed under paragraph (b) of this section without any notice of termination having been given to or by the previously engaged accountant.

(2) Such notice shall state the date of notification of the termination of the engagement or engagement of the new accountant as applicable and the details of any problems existing during the 24 months (or the period of the engagement, if less) preceding such termination or new engagement relating to any matter of accounting principles or practices, financial statement disclosure, auditing scope or procedure, or compliance with applicable rules of the Commission, which problems, if not resolved to the satisfaction of the former accountant, would have caused the former accountant to make reference to them in connection with the report on the subject matter of the problems. The problems required to be reported in response to the preceding sentence include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. Problems contemplated by this section are those which occur at the decision making level—*i.e.*, between principal financial officers of the OTC derivatives dealer and personnel of the accounting firm responsible for rendering its report. The notice shall also state whether the accountant's report on the financial statements for any of the past two years contained an adverse opinion or a disclaimer of opinion or was qualified as to uncertainties, audit scope, or accounting principles, and describe the nature of each such adverse opinion, disclaimer of opinion, or qualification. The OTC derivatives dealer shall also request the former accountant to furnish the OTC derivatives dealer with a letter addressed to the Commission stating whether the former accountant agrees with the statements contained in the notice of the OTC derivatives dealer and, if not, stating the respects in which the former accountant does not agree. The OTC derivatives dealer shall file three copies of the notice and the accountant's letter, one copy of which shall be manually signed by the sole proprietor, or a general partner or a duly authorized corporate officer, as appropriate, and by the accountant, respectively.

(h) *Audit objectives.* (1) The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control, internal management controls, and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. The audit shall include all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on the statement of financial condition, results of operations, cash flows, and the Computation of Net Capital under § 240.15c3–1. The scope of the audit and review of the accounting system, the internal accounting controls, internal management controls, and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in the following are detected:

(i) The accounting system;

(ii) The internal accounting controls; and

(iii) Procedures for safeguarding securities.

(2) A material inadequacy in the accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures referred to in paragraph (h) of this section which is expected to be reported under these audit objectives includes any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to:

(i) Inhibit an OTC derivatives dealer from promptly completing securities transactions or promptly discharging its responsibilities to counterparties, other brokers and dealers or creditors;

(ii) Result in material financial loss;

(iii) Result in material misstatements of the OTC derivatives dealer's financial statements;

(iv) Result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in paragraphs (h)(2)(i), (ii), or (iii) of this section; or

(v) Result in any matter that would be deemed a reportable condition under U.S. Generally Accepted Auditing Standards.

(i) *Extent and timing of audit procedures.* (1) The extent and timing of audit procedures are matters for the independent public accountant to determine on the basis of its review and evaluation of existing internal controls and other audit procedures performed in accordance with generally accepted auditing standards and the audit objectives set forth in paragraph (h) of this section. In determining the extent of testing, consideration shall be given to the materiality of an area and the possible effect on the financial statements and schedules of a material misstatement in a related account. The performance of auditing procedures involves the proper synchronization of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as, for example, securities counts, transfer verification, and customer and broker confirmation in connection with verification of securities positions.

(2) If, during the course of the audit or interim work, the independent public accountant determines that any material inadequacies exist in the accounting system, internal accounting control, procedures for safeguarding securities, or as otherwise defined in paragraph (h)(2) of this section, then the independent public accountant shall call it to the attention of the chief financial officer of the OTC derivatives dealer, who shall have a responsibility to inform the Commission and the examining authority responsible for performing reviews of the dealer pursuant to § 240.15b9–2 by telegraphic or facsimile notice within 24 hours thereafter as set forth in § 240.17a–11(e) and (g). The OTC derivatives dealer shall also furnish the accountant with a copy of said notice to the Commission by telegram or facsimile within said 24 hour period. If the accountant fails to

receive such notice from the OTC derivatives dealer within said 24 hour period, or if the accountant disagrees with the statements contained in the notice of the OTC derivatives dealer, the accountant shall have a responsibility to inform the Commission and the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2 by report of material inadequacy within 24 hours thereafter as set forth in § 240.17a–11(g). Such report from the accountant shall, if the OTC derivatives dealer failed to file a notice, describe any material inadequacies found to exist. If the OTC derivatives dealer filed a notice, the accountant shall file a report detailing the aspects, if any, of the OTC derivatives dealer's notice with which the accountant does not agree.

(j) *Accountant's reports, general provisions.*—(1) *Technical requirements.* The accountant's report shall be dated; be signed manually; indicate the city and state where issued; and identify without detailed enumeration the financial statements and schedules covered by the report.

(2) *Representations as to the audit.* The accountant's report shall state whether the audit was made in accordance with generally accepted auditing standards; state whether the accountant reviewed the procedures followed for safeguarding securities; and designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case which have been omitted, and the reason for their omission. Nothing in this section shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required under this section.

(3) *Opinion to be expressed.* The accountant's report shall state clearly the opinion of the accountant:

(i) In respect of the financial statements and schedules covered by the report and the accounting principles and practices reflected therein; and

(ii) As to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

(4) *Exceptions.* Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

(5) *Definitions.* For the purpose of this section, the terms *audit* (or *examination), accountant's report, and certified* shall have the meanings given in § 210.1–02 of this chapter.

(k) *Accountant's report on material inadequacies.* The OTC derivatives dealer shall file concurrently with the annual audit report a supplemental report by the accountant describing any material inadequacies found to exist or found to have existed since the date of the previous audit. The supplemental report shall indicate any corrective action taken or proposed by the OTC derivatives dealer in regard thereto. If the audit did not disclose any material inadequacies, the supplemental report shall so state.

(l) *Accountant's report on management controls.* The OTC derivatives dealer shall file concurrently with the annual audit report a supplemental report by the accountant indicating the independent public accountant's opinion on the OTC derivatives dealer's compliance with its internal risk management control objectives. The procedures are to be performed and the report is to be prepared in accordance with U.S. Generally Accepted Auditing Standards.

(m) *Accountant's report on inventory pricing and modeling.* (1) The OTC derivatives dealer shall file concurrently with the annual audit report a supplemental report by the accountant indicating the results of the accountant's review of the broker's or dealer's inventory pricing and modelling procedures. This review shall be conducted in accordance with procedures agreed to by the OTC derivatives dealer and by the independent public accountant conducting the review.

(2) The agreed-upon procedures are to be performed and the report is to be prepared in accordance with the U.S. Generally Accepted Auditing Standards.

(3) Every OTC derivatives dealer shall file prior to the commencement of the initial review, the procedures to be performed pursuant to paragraph (m)(1) of this section with the Commission's principal office in Washington, D.C., and the principal office of the examining authority responsible for reviewing the OTC derivatives dealer pursuant to § 240.15b9–2. Prior to the commencement of each subsequent review, every OTC derivatives dealer shall file with the Commission's principal office in Washington, D.C., and with the examining authority responsible for reviewing the OTC derivatives dealer pursuant to § 240.15b9–2 notice of changes in the agreed-upon procedures.

(n) *Extensions and exemptions.* (1) An examining authority responsible for performing reviews of an OTC derivatives dealer pursuant to § 240.15b9–2 may extend the period under paragraph (b) of this section for filing annual audit reports. The examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2 shall maintain, in the manner prescribed in § 240.17a–1, a record of each extension granted.

(2) On written request of the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2, on written request of the OTC derivatives dealer, or on its own motion, the Commission may grant an extension of time or an exemption from any of the requirements of this section either unconditionally or on specified terms and conditions.

(o) *Notification of change of fiscal year.* (1) In the event any OTC derivatives dealer finds it necessary to change its fiscal year, it must file, with the Commission's principal office in Washington, D.C., and the principal office of the examining authority responsible for performing reviews of the OTC derivatives dealer pursuant to § 240.15b9–2, a notice of such change.

(2) Such notice shall contain a detailed explanation of the reasons for the change. Any change in the filing period for the audit report must be approved by the examining authority responsible for reviewing the OTC derivatives dealer pursuant to § 240.15b9–2.

(p) *Filing requirements.* For purposes of filing requirements as described in § 240.17a–12, such filing shall be deemed to have been accomplished upon receipt at the Commission's principal office in Washington, D.C., with duplicate originals simultaneously filed at the locations prescribed in the particular paragraph of § 240.17a–12 which is applicable.

18. By adding §§ 240.36a1–1 and 240.36a1–2 to read as follows:

§ 240.36a1–1 Exemption from Section 7 for OTC derivative dealers.

(a) Except as provided in paragraph (b) of this section, transactions by an OTC derivatives dealer shall be exempt from the provisions of Section 7 of the Act (15 U.S.C. 78g), provided that the OTC derivatives dealer complies with other federal margin requirements applicable to non-broker-dealer lenders.

(b) The exemption provided under paragraph (a) of this section shall not apply to extensions of credit made directly by a registered broker or dealer

(other than an OTC derivatives dealer) in connection with transactions in eligible OTC derivative instruments for which an OTC derivatives dealer acts as counterparty.

§ 240.36a1–2 Exemption from SIPA for OTC derivatives dealers.

OTC derivatives dealers, as defined in § 240.3b–12, shall be exempted from the provisions of the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa *et seq.*).

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

19. The authority citation for Part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a, *et seq.*, unless otherwise noted;

* * * * *

20. Section 249.617 is amended by adding the phrase ''§ 240.17a–12,'' after the phrase ''240.17a–5(a), (b), and (d),''.

21. Form X–17A–5 (referenced in § 249.617) is amended by adding section IIB to read as follows:

Note: Form X–17A–5 does not, and the amendments will not, appear in the Code of Federal Regulations. Part IIB of Form X–17A–5 is attached as Appendix A to this document.

Dated: December 17, 1997.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

Appendix A

[Note: the text of Appendix A does not appear in the Code of Federal Regulations.]

General Instructions

The FOCUS Report (Form X–17A–5IIB) constitutes the basic financial and operational report required of OTC derivatives dealers. Much of the information required by the FOCUS report is the same or similar to the information required to be reported by broker-dealers required to file Form X–17A–5 Part II. Consequently, for those items that appear on both forms, the instructions for X–17A–5 Part II are to be followed when completing form X–17A–5 Part IIB. The following instructions apply to new information requests and to items appearing on both forms that have been altered to better reflect an OTC derivatives dealer's unique business.

Computation of Net Capital and Required Net Capital

(Under 15c3–1 Appendix F)

Tentative Net Capital

For purposes of paragraph (a)(5), the term ''tentative net capital'' means the net capital of an OTC derivatives dealer before the application of either the securities haircuts in paragraph (c)(2)(vi) of Rule 15c3–1 or the charges for market and credit risk as computed pursuant to proposed Appendix F and increased by unsecured receivables (unrealized gains) resulting from eligible OTC derivative instruments.

Market Risk Exposure

The capital requirement for an OTC derivatives dealer electing to apply Appendix F of Rule 240.15c3–1 is computed as follows:

(1) Full Value-at-Risk Method. An OTC derivatives dealer shall deduct from net worth an amount for market risk exposure for eligible OTC derivatives transactions and other positions in its proprietary or other accounts equal to the value at risk (''VAR'') of these positions obtained from its proprietary model, multiplied by the appropriate multiplication factor. See paragraph (d)(1)(v)(C) of Appendix F for more information on the multiplication factor. The proprietary model used to calculate the capital requirement for market risk must be approved by the Commission prior to its use.

(2) Alternative Method for Equities. An OTC derivatives dealer may choose to use the alternative method to calculate market risk for equity instruments, including OTC options, or if the Commission does not approve an OTC derivatives dealer's use of VAR models for equity instruments, the OTC derivatives dealer must use the alternative method. Under the alternative method, the deduction for market risk will be an amount equal to the largest theoretical loss calculated in accordance with the theoretical pricing model set forth in Appendix A of Rule 240.15c3–1. The OTC derivatives dealer may use its own theoretical pricing model as long as it contains the minimum pricing factors set forth in Appendix A.

Credit Risk Exposure

The capital requirement for credit risk arising from an OTC derivatives dealer's eligible OTC derivatives transactions consists of a counterparty charge and a concentration charge. The counterparty charge is computed as follows:

(1) the net replacement value for each counterparty (less the value of any liquid collateral) multiplied by 8% multiplied by the counterparty factor. The counterparty factors are 20% for entities with ratings for senior unsecured long term debt or commercial paper in the two highest rating categories by at least two nationally recognized statistical rating organization (''NRSROs''); 50% for entities with ratings for senior unsecured long term debt in the third and fourth highest ratings categories by at least two NRSROs; and 100% for entities with ratings for senior unsecured long term debt below the four highest rating categories.

(2) The net replacement value for each counterparty with senior unsecured long term debt in default (less any liquid collateral).

The concentration charge is computed as follows: where the net replacement value in the account of any one counterparty exceeds 25% of the OTC derivatives dealer's tentative net capital, deduct the following amounts. For counterparties with ratings for senior unsecured long term debt or commercial paper in the two highest rating categories by at least two NRSROs, 5% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital. For counterparties with ratings for senior unsecured long term debt in the third and fourth highest rating categories by at least two NRSROs, 20% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital. For counterparties with ratings for senior unsecured long term debt below the four highest rating categories, 50% of the amount of the net replacement value in excess of 25% of the OTC derivatives dealer's tentative net capital. Finally, where the aggregate of the net replacement value of all counterparties exceeds 300% of an OTC derivative dealer's tentative net capital, it would deduct from net worth 100% of the amount of such excess.

Computation of Net Capital and Required Net Capital (alternative)

Tentative Net Capital

For purposes of paragraph (a)(5), the term ''tentative net capital'' means the net capital of an OTC derivatives dealer before the application of either the securities haircuts in paragraph (c)(2)(vi) of Rule 15c3–1 or the charges for market and credit risk as computed pursuant to proposed Appendix F and increased by unsecured receivables (unrealized gains) resulting from eligible OTC derivative instruments.

Credit Risk Exposure

The capital requirement for credit risk arising from an OTC derivatives dealer's eligible OTC derivatives transactions consists of a counterparty charge and a concentration charge. The counterparty charge is computed as follows:

(1) the net replacement value for each counterparty (less the value of any liquid collateral) multiplied by 8% multiplied by the counterparty factor. The counterparty factors are 20% for entities with ratings for senior unsecured long term debt or commercial paper in the two highest rating categories by at least two nationally recognized statistical rating organization (''NRSROs''); 50% for entities with ratings for senior unsecured long term debt in the third and fourth highest ratings categories by at least two NRSROs; and 100% for entities with ratings for senior unsecured long term debt below the four highest rating categories.

(2) The net replacement value for each counterparty with senior unsecured long term debt in default (less any liquid collateral).

The concentration charge is computed as follows: where the net deficit in the account of any one counterparty exceeds 50% of the OTC derivatives dealer's tentative net capital, deduct it from net worth. For counterparties with ratings for senior unsecured long term debt or commercial paper in the two highest rating categories by at least two NRSROs, 5% of the amount of the net deficit in excess of 25% of the OTC derivatives dealer's tentative net capital. For counterparties with ratings for senior unsecured long term debt in the third and fourth highest rating categories by at least two NRSROs, 20% of the amount of the net deficit in excess of 25% of the OTC derivatives dealer's tentative net capital. For counterparties with ratings for senior

unsecured long term debt below the four highest rating categories, 50% of the amount of the net deficit in excess of 25% of the OTC derivatives dealer's tentative net capital.

Finally, where the aggregate of the net deficits of all counterparties exceeds 300% of an OTC derivative dealer's tentative net capital, it would deduct from net worth 100% of the amount of such excess.

Aggregate Securities and OTC Derivatives Positions

Provide the following information for each affiliated broker-dealer as of the end of each quarter. Indicate the name of each affiliated broker-dealer in a separate column or complete a separate schedule for each affiliated broker-dealer. In the event a separate listing of a position, financial instrument or otherwise is required pursuant to any of the provisions of Section 240.17h-1T, the dealer should indicate as such in the appropriate section of this schedule. Where appropriate, indicate long and short positions separately.

BILLING CODE 8010–01–P

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM X-17A-5

FOCUS REPORT

(Financial and Operational Combined Uniform Single Report)

PART IIB [11]

(PLEASE READ INSTRUCTIONS BEFORE PREPARING FORM.)

THIS REPORT IS BEING FILED PURSUANT TO (Check Applicable Block(s)):

1) Rule 17a-12 [16] 2) Rule 17a-11 [18] 3) Special request by designated examining authority [19] 4) Other [26]

[13] (Name of Dealer)

[14] (SEC File No.)

[20] (Address of Principal Place of Business (DO NOT USE P. O. Box No.))

[15] (Firm I.D. No.)

[21] (City) [22] (State) [23] (Zip Code)

[24] (For Period Beginning (MM/DD/YY))

[25] (For Period Ending (MM/DD/YY))

NAME AND TELEPHONE NO. OF PERSON TO CONTACT IN REGARD TO THIS REPORT:

[30] (Name)

[31] ((Area Code) - Telephone No.)

NAME(s) OF SUBSIDIARIES OR AFFILIATES CONSOLIDATED IN THIS REPORT:

OFFICIAL USE

[32] [33]

[34] [35]

[36] [37]

[38] [39]

[Does respondent carry its own customer accounts?] Yes [40] No [41]

Check here if respondent is filing an audited report: [42]

EXECUTION:
The registrant/dealer submitting this Form and its attachments and the person(s) by whom it is executed represent hereby that all information contained therein is true, correct and complete. It is understood that all required items, statements, and schedules are considered integral parts of this Form and that the submission of any amendment represents that all unamended items, statements and schedules remain true, correct and complete as previously submitted.

Dated the _____ **day of** _____ **19** _____

MANUAL SIGNATURES OF:

1) _____
(Principal Executive Officer or Managing Partner)

2) _____
(Principal Financial Officer or Partner)

3) _____
(Principal Operations Officer or Partner)

ATTENTION -- Intentional misstatements or omissions of facts constitute Federal Criminal Violations. (See 18 U.S.C. 1001 and 15 U.S.C. 78:f(a))

FOR SEC USE ONLY

TO BE COMPLETED WITH THE ANNUAL AUDIT REPORT ONLY:

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this report:

70
((Name) IF INDIVIDUAL, give last, first, middle name)

71
((Address) DO NOT USE P. O. Box No.)

72 (City) 73 (State) 74 (Zip Code)

Check One:

Certified Public Accountant 75

Public Accountant 76

Accountant not resident in United States or any of its possessions 77

DO NOT WRITE UNDER THIS LINE

FOR SEC USE ONLY

WORK LOCATION 50	REPORT DATE (MM/DD/YY) 51	DOC. SEQ. NO. 52	CARD 53

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

N 2 [ ] [ ] [ ] [ ] [ ] [ ] [ ] [ ] [ ] 100

(Name of Dealer)

STATEMENT OF FINANCIAL CONDITION FOR OTC DERIVATIVES DEALERS

Consolidated [ ] 198

Unconsolidated [ ] 199

As of (MM/DD/YY) 99

(SEC File No.) 98

ASSETS

Assets	Allowable	Non - Allowable	Total
1. Cash	$ 200		$ 750
2. Cash segregated in compliance with federal and other regulations	210		760
3. Receivable from brokers/dealers and clearing organizations:			
A. Failed to deliver	220		770
B. Securities borrowed	240		780
C. Omnibus accounts	260		790
D. Clearing organization	280		800
E. Contracts:			
1. Interest Rate	300		810
2. Currency & Foreign Exchange	310		820
3. Equity	320		830
4. Commodity	330		840
5. Other	340		850
F. Other	350	$ 550	860
4. Receivable from customers:			
A. Securities accounts:			
1. Cash and fully secured accounts	360		
2. Partly secured accounts	370	560	
3. Unsecured accounts		570	
B. Commodity accounts	380	580	
C. Allowance for doubtful accounts	( ) 385	( ) 590	870

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer) As of (MM/DD/YY)

STATEMENT OF FINANCIAL CONDITION FOR OTC DERIVATIVES DEALERS

ASSETS (continued)

Assets		Allowable	Non - Allowable	Total
5. Receivables from non-customers:				
A. Cash and fully secured accounts		$ 390		
B. Partly secured and unsecured accounts		400	$ 600	$ 880
6. Securities purchased under agreements to resale		410	605	890
7. Securities and spot commodities owned at market value:				
A. Bankers acceptances, certificates of deposit and commercial paper		420		
B. U.S. and Canadian government obligations		430		
C. State and municipal government obligations		440		
D. Corporate obligations		450		
E. Stocks and warrants		460		
F. Options		470		
G. Arbitrage		472		
H. Other securities		474		
I. Spot commodities		480		900
8. Securities owned not readily marketable:				
A. At cost	$ 130	490	610	910
9. Other Investments not readily marketable:				
A. At cost	$ 140			
B. At estimated fair value		500	620	920
10. Securities borrowed under subordination agreements and partners' individual and capital securities accounts at market value:				
A. Exempted securities	$ 150			
B. Other	$ 160	510	630	930

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer) | As of (MM/DD/YY)

STATEMENT OF FINANCIAL CONDITION FOR OTC DERIVATIVES DEALERS

ASSETS (continued)

Assets		Allowable	Non - Allowable	Total
11. Secured demand notes - market value of collateral:				
A. Exempted securities	$ 170			
B. Other	$ 180	520	640	940
12. Investment in and receivables from affiliates, subsidiaries and associated partnerships		530	670	950
13. Property, furniture, equipment, leasehold improvements and rights under lease agreements:				
At cost (net of accumulated depreciation and amortization)		$ 540	$ 680	$ 960
14. Other Assets:				
A. Dividends and interest receivable		550	690	
B. Free shipments		560	700	
C. Loans and advances		570	710	
D. Miscellaneous		580	720	970
15. TOTAL ASSETS		$ 590	$ 740	$ 980

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer) As of (MM/DD/YY)

STATEMENT OF FINANCIAL CONDITION FOR OTC DERIVATIVES DEALERS

LIABILITIES AND OWNERSHIP EQUITY

Liabilities		Total
16. Bank loans payable:		
A. Includable in "Formula for Reserve Requirements"	$	1460
B. Other		1470
17. Securities sold under repurchase agreement		1480
18. Payable to brokers/dealers and clearing organizations:		
A. Failed to receive:		1490
B. Securities loaned:		1500
C. Omnibus accounts:		1510
D. Clearing organization:		1520
E. Other		1570
19. Payable to customers:		
A. Securities accounts-including free credit of $ 950		1580
B. Commodities accounts		1590
20. Payable to non - customers:		
A. Securities accounts		1600
B. Commodities accounts		1610
21. Securities sold not yet purchased at market value- including arbitrage of $ 960	$	1620
22. Accounts payable and accured liabilities and expenses:		
A. Drafts payable		1630
B. Accounts payable		1640
C. Income taxes payable		1650
D. Deferred income taxes		1660
E. Accured expenses and other liabilities		1670
F. Other		1680

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer) As of (MM/DD/YY)

STATEMENT OF FINANCIAL CONDITION FOR OTC DERIVATIVES DEALERS

LIABILITIES AND OWNERSHIP EQUITY (continued)

Liabilities		Total
23. Notes and mortgages payable:		
A. Unsecured		1690
B. Secured		1700
24. Liabilities subordinated to claims of general creditors:		
A. Cash borrowings:		1710
1. from outsiders	$ 970	
2. Includes equity subordination (15c3-1d) of	$ 980	
B. Securities borrowings, at market value		1720
1. from outsiders	$ 990	
C. Pursuant to secured demand note collateral agreements:		1730
1. from outsiders	$ 1000	
2. Includes equity subordination (15c3-1d) of	$ 1010	
D. Exchange memberships contributed for use of company, at market value		1740
E. Accounts and other borrowings not qualified for net capital purposes		1750
25. TOTAL LIABILITIES		$ 1760

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer)	As of (MM/DD/YY)

STATEMENT OF FINANCIAL CONDITION FOR OTC DERIVATIVES DEALERS

LIABILITIES AND OWNERSHIP EQUITY (continued)

Ownership Equity	Total	
26. Sole proprietorship	$	1770
27. Partnership-limited partners		1780
28. Corporation:		
A. Preferred stock		1791
B. Common Stock		1792
C. Additional paid-in capital		1793
D. Retained earnings		1794
E. Total		1795
F. Less capital stock in treasury	( )	1796
29. TOTAL OWNERSHIP EQUITY	$	1800
30. TOTAL LIABILITIES AND OWNERSHIP EQUITY	$	1810

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer)	As of (MM/DD/YY)

COMPUTATION OF NET CAPITAL AND NET CAPITAL REQUIRED
(Electing 15c3-1 Appendix E)

CAPITAL

Capital

1. Total Ownership Equity		$	750
2. Deduct: Ownership Equity not Allowable for Net Capital		( )	335
3. Total Ownership Equity Qualified for Net Capital			840
4. Add: Subordinated Liabilities Approved for Net Capital			840
5. Other Allowable Credits or Deductions			840
6. Total Capital and Approved Subordinations			840
7. Non-Allowable Assets	$ 550		
8. Secured demand note deficiency	550		
9. Other Deductions and Charges	300		
10. Total Non-Allowable Assets, Other Deductions, and Charges (add lines 7 - 9)		( )	335
11. Tentative Net Capital (Must equal or exceed $100,000,000)		$	580

Computation of Net Capital Requirements and Excess Net Capital

12. Market Risk Exposure:			
A. Total Value At Risk		$	340
Value At Risk Components:			
1. Fixed Income (VaR)	$ 310		
2. Currency (VaR)	320		
3. Commodities (VaR)	570		
4. Equities (VaR)	350		
NOTE: The sum of the value at risk components may not equal total value at risk.			
B. Multiplication Factor		X $	820
C. Subtotal (If Line 12A is positive, multiply Line 12A by 12B)			820
D. Alternative Method for Equities under Appendix A of Rule 15c3-1 (if applicable)			840
13. Subtotal Market Risk Exposure (add Lines 12C and 12D)		$	840
14. Credit Risk Exposure:			
A. Credit Risk Charge (Counterparty)			840
B. Concentration Charge			550

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer)	As of (MM/DD/YY)

COMPUTATION OF NET CAPITAL AND NET CAPITAL REQUIRED
(Electing 15c3-1 Appendix E)

CAPITAL (continued)

Capital

15. Subtotal Credit Risk Exposure (add Lines 14A and 14B)	$		840
16. Net Capital (Line 11 less Lines 13 and 15)			840
17. Minimum Capital Requirement		20,000,000	580
18. Excess Net Capital (Line 16 less Line 17)	$		840

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer)	As of (MM/DD/YY)

COMPUTATION OF NET CAPITAL AND NET CAPITAL REQUIRED
(Under (c)(3)(vi) of Rule 15c3-1)

Capital

1. Total Ownership Equity (from Statement of Financial Condition - Item 1800)	$	750
2. Deduct: Ownership Equity not allowable for Net Capital	( )	760
3. Total Ownership Equity Qualified for Net Capital		840
4. Add: Subordinated Liabilities Approved for Net Capital		840
5. Other Allowable Credits or Deductions		840
6. Total Capital and Approved Subordinations	$	840
7. Non-Allowable Assets	( )	335
8. Other Deductions and/or Charges:	( )	335
9. Secured demand note deficiency	( )	335
10. Commodity futures contracts and spot commodities proprietrary capital charges	( )	335
11. Other additions and/or allowable credits		840
12. Tentative Net Capital (must equal or exceed $100,000,000)	$	840

13. Haircuts On Securities (computed pursuant to 15c3-1(c)(2)(vi)):

A. Fixed Income	$	310
B. Currency		320
C. Commodities		570
D. Equities		350

14. Total deductions and/or charges	( )	335
15. Undue Concentration	( )	335
16. Other (List)	( )	335
17. Credit Risk	( )	335
18. Net Capital	$	840
19. Minimum Net Capital	$ 20,000,000	580
20. Excess Net Capital	$	840

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

For the Period (MM/DD/YY) from _____ 3932 to _____ 3933

_____ (Name of Dealer)

Number of months included in this statement [ ] 3931

STATEMENT OF INCOME (LOSS)

REVENUE

1. Contracts:			
A. Interest Rate/Fixed Income Products		$	3935
B. Over-the-counter currency and foreign exchange products for Net Capital			3937
C. Equity products			3938
D. Commodity Products			0
E. All other securities commissions			3939
F. Total securities commissions		$	3940
2. Gains or Losses on Firm Securities Trading Accounts:			
A. From market making in over-the-counter equity securities		$	3941
1. Includes gains or (losses) OTC market making in exchange listed equity securties	$ 3943		
B. From trading in debt securities			3944
C. From market making in options on a national securities exchange			3945
D. From all other trading			3949
E. Total gains or (losses)		$	3950
3. Gains or Losses on Firm Securities Investment Accounts:			
A. Includes realized gains (losses)	$ 4235		
B. Includes unrealized gains (losses)	4236		
C. Total realized and unrealised gains (losses)		$	3952
4. Interest			3960
5. Fees for account supervision, Investment advisory and administrative services			3975
6. Revenue from research services			3980
7. Commodities revenue			3990
8. Other revenue related to securities business			3985
9. Other revenue			3995
10. Total Revenue		$	4030

EXPENSES

11. Compensation	$	4110
12. Clerical and administrative employees' expenses		4040

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

For the Period (MM/DD/YY) from _____ 3932 to _____ 3933

_____ (Name of Dealer)

Number of months included in this statement _____ 3931

STATEMENT OF INCOME (LOSS)

EXPENSES (continued)

13. Salaries and other employment costs for general partners, and voting stockholder officers		$	4120
A. Includes interest credited to General and Limited Partners capital accounts	$ 4130		
14. Floor brokerage paid to certain brokers (see definition)			4055
15. Commissions and clearance paid to all other brokers (see definition)			4145
16. Clearance paid to non-brokers (see definition)			4135
17. Communications			4060
18. Occupancy and equipment costs			4080
19. Promotional costs			4150
20. Interest expense			4075
A. Includes interest on accounts subject to subordination agreements	4070		
21. Losses in error account and bad debts			4170
22. Data processing costs (including service bureau service charges)			4186
23. Non-recurring charges			4190
24. Regulatory fees and expenses			4195
25. Other expenses			4100
26. Total expenses		$	4200

NET INCOME

27. Income (loss) before Federal income taxes and items below (Item 10 less Item 26)		$	4210
28. Provision for Federal income taxes (for parent only)			4220
29. Equity in earnings (losses) of unconsolidated subsidiaries not included above			4222
A. After Federal income taxes of	4238		
30. Extraordinary gains (losses)			4224
A. After Federal income taxes of	4239		
31. Cumulative effect of changes in accounting principles			4225
32. Net income (loss) after Federal income taxes and extraordinary items			4230

MONTHLY INCOME

33. Income (current month only) before provision for Federal income taxes and extraordinary items		$	4211

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer) As of (MM/DD/YY)

Ownership Equity and Subordinated Liabilitites maturing or proposed to be withdrawn within the next six months and accruals, (as defined below), which have not been deducted in the computation of Net Capital.

Type of Proposed Withdrawal or Accrual (see below for code to enter)	Name of Lender or Contributor	Insider or Outsider? (In or Out)	Amount to be Withdrawn (cash amount and/or Net Capital Value of Securities)	Withdrawal or Maturity Date (MM/DD/YY)	Expect to Renew (Yes or No)
4600	4601	4602	$ 4603	4604	4605
4610	4611	4612	4613	4614	4615
4620	4620	4620	4620	4620	4620
4630	4630	4630	4630	4630	4630
4640	4640	4640	4640	4640	4640
4650	4650	4650	4650	4650	4650
4660	4660	4660	4660	4660	4660
4670	4670	4670	4670	4670	4670
4680	4680	4680	4680	4680	4680
4690	4690	4690	4690	4690	4690

Total $ 4699*

*** To agree with the total on Recap (Item No. 4880)**

OMIT PENNIES

WITHDRAWAL CODE:	DESCRIPTIONS
1	Equity Capital
2	Subordinated Liabilities
3	Accruals
4	15c3-1(c)(2)(iv) Liabilities

INSTRUCTIONS: Detail Listing must include the total of items maturing during the six month period following the report date, regardless of whether or not the capital contribution is expected to be renewed. The schedule must also include proposed capital withdrawals scheduled within the six month period following the report date including the proposed redemption of stock and payments of liabilities secured by fixed assets (which are considered allowable assets in the capital computation pursuant to Rule 15c-3-1(c)(2)(iv)), which could be required by the lender on demand or in less than six months.

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

CAPITAL WITHDRAWALS

PART IIB

(Name of Dealer)	As of (MM/DD/YY)

Ownership Equity and Subordinated Liabilities maturing or proposed to be withdrawn within the next six months and accruals, which have not been deducted in the computation of net capital.

RECAP

1. Equity Capital
   - A. Partnership Capital:
     - 1. General Partners ..... $ _____ 4700
     - 2. Limited ..... _____ 4710
     - 3. Undistributed Profits ..... _____ 4720
     - 4. Other (describe below) ..... _____ 4730
     - 5. Sole Proprietorship ..... _____ 4735
   - B. Corporation Capital:
     - 1. Common Stock ..... $ _____ 4740
     - 2. Preferred Stock ..... _____ 4750
     - 3. Retained Earings (Dividends and Other) ..... _____ 4760
     - 4. Other (describe below) ..... _____ 4770
2. Subordinated Liabilities
   - A. Secured Demand Notes ..... $ _____ 4780
   - B. Cash Subordinates ..... _____ 4790
   - C. Debentures ..... _____ 4800
   - D. Other (describe below) ..... _____ 4810
3. Other Anticipated Withdrawals
   - A. Bonuses ..... $ _____ 4820
   - B. Voluntary Contributions to Pension or Profit Sharing Plans ..... _____ 4860
   - D. Other (describe below) ..... _____ 4870
4. Description of Other

_____

_____

_____

_____

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

CAPITAL WITHDRAWALS

PART IIB

(Name of Dealer)	As of (MM/DD/YY)

STATEMENT OF CHANGES IN OWNERSHIP EQUITY (SOLE PROPRIETORSHIP, PARTNERSHIP OR CORPORATION)

1. Balance, beginning of period		$	4240
A. Net Income (loss)			4250
B. Additions (includes non-conforming capital of	$ 4262		4260
C. Deductions	4272		4270
2. Balance, end of period (From item 1800)		$	4290

STATEMENT OF CHANGES IN LIABILITIES SUBORDINATED TO CLAIMS OF GENERAL CREDITORS

3. Balance, beginning of period	$	4300
A. Increases		4310
B. Decreases	( )	4320
4. Balance, end of period (From item 3520)	$	4330

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer) _____ As of (MM/DD/YY) _____

FINANCIAL AND OPERATIONAL DATA

	VALUATION	NUMBER
1. Month end total number of stock record breaks unresolved over three business days		
A. Breaks long	$ 4890	4900
B. Breaks short	$ 4890	4900

2. Is the firm in compliance with Rule 17a-13 regarding periodic count and verification of securities positions and locations at least once in each calendar quarter? (Check one) Yes 4930 No 4940

3. Personnel employed at end of reporting period:	
A. Income producing personnel	2045
B. Non-Income producing personnel (all other)	2055
C. Total	2055
4. Actual number of tickets executed during current month of reporting period	2055
5. Number of corrected customer confirmations mailed after settlement date	2055

	NO. OF ITEMS	DEBIT (Short Value)	NO. OF ITEMS	Credit (Long Value)
6. Money differences	2085	$ 2090	2080	$ 2055
7. Security suspense accounts	2085	$ 2090	2080	$ 2055
8. Security difference accounts	2085	$ 2090	2080	$ 2055
9. Commodity suspense accounts	2085	$ 2090	2080	$ 2055
10. Open transactions with correspondents, other brokers, clearing organizations, depositories and interoffice and inter-company accounts which could result in a charge -- unresolved amounts over 30 calendar days	2085	$ 2090	2080	$ 2055
11. Bank account reconciliations -- unresolved amounts over 30 calendar days	2085	$ 2090	2080	$ 2055
12. Open transfers over 40 calendar days, not confirmed	2085	$ 2090	2080	$ 2055
13. Transactions in reorganization accounts -- over 60 calendar days	2085	$ 2090	2080	$ 2055
14. Total	2085	$ 2090	2080	$ 2055

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer) As of (MM/DD/YY)

FINANCIAL AND OPERATIONAL DATA (continued)

	NO. OF ITEMS	Leger Amount	Market Value
15. Failed to deliver 11 business days or longer (21 business days or longer in the case of Municipal Securities)	2085	$ 2090	$ 2055
16. Failed to receive 11 business days or longer (21 business days or longer in the case of Municipal Securities)	2085	$ 2090	$ 2055
17. Security concentrations (See instructions in Part I):			
A. Proprietary positions			$ 2055
18. Total of personal capital borrowings due within six months			$ 2055
19. Maximum haircuts on underwriting commitments during the period			$ 2055
20. Planned capital expenditures for business expansion during next six months			$ 2055
21. Liabilities of other individuals or organizations guaranteed by respondent			$ 2055
22. Lease and rentals payable within one year			$ 2055
23. Aggregated lease and rental commitments payable for entire term of the lease			
A. Gross			$ 2055
B. Net			$ 2055

OMIT PENNIES

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIB

BROKER OR DEALER: as of _____

SCHEDULE I
CREDIT-CONCENTRATION REPORT ON OTC DERIVATIVES EXPOSURES (1)

Counterparty Identifier (2)	Country (3)	Industry Segment (4)	Rating (5)	Gross Replacement Value (6) Receivable (Gross Gain)	Gross Replacement Value (6) Payable (Gross Loss)	Net Replacement Value (7)	Current Net Exposure (8)	Total Credit Exposure (9)	Comments (10)
Totals									

(1) For purposes of this report, "OTC derivatives" means an eligible OTC derivatives instrument pursuant to section 240.3b-13.

(2) Identify counterparty by counterparty's corporate name.

(3) Identify country exposures by residence of main operating company.

(4) Report on a counterparty-by-counterparty basis by type of entity in accordance with ISDA guidelines (i.e., Primary ISDA Members, Non-Primary ISDA Members: Corporates, Financial Institutions, Government/Supranationals, or Other.

(5) Ratings are internal credit ratings as assigned by the firm. See Schedule IV for conversion of these ratings into a least two Nationally Recognized Statistical Rating (NRSRO) agency equivalent.

(6) Report gross replacement value (receivable and payable) (for each of the top 20 current net exposures), excluding the effect of legally enforceable netting agreements and excluding the application of collateral.

(7) Report net replacement value (for each of the top 20 current net exposures), including the effect of legally enforceable netting agreements but excluding the application of collateral.

(8) Report current net exposure (for each of the top 20 current net exposures), including the effect of legally enforceable netting agreements and the application of collateral.

(9) Report the sum of the current net exposure and the potential additional credit exposure.

(10) Provide additional relevant information (e.g., details on credit enhancements, type of contract, maturity, offsetting, significant additional exposures in affiliated entities, etc.).

BROKER OR DEALER: as of _____

SCHEDULE II
PORTFOLIO SUMMARY OF OTC DERIVATIVES EXPOSURES (1)

Credit Rating Category (2)	Industry Segment (3)	Current Net Exposure (4)	Net Replacement Value (5)	Gross Replacement Value (6) Receivable	Payable
XXX	Primary ISDA Member				
	Corporate				
	Financial Institutions				
	Government				
	Other				
	TOTAL				
XX	Primary ISDA Member				
	Corporate				
	Financial Institutions				
	Government				
	Other				
	TOTAL				
X	Primary ISDA Member				
	Corporate				
	Financial Institutions				
	Government				
	Other				
	TOTAL				
	GRAND TOTAL				

(1) See Note (1) on Schedule I.

(2) See Note (5) on Schedule I.

(3) See Note (4) on Schedule I.

(4) Net replacement value, after application of collateral.

(5) Include effect of legally enforceable netting agreements, before application of collateral.

(6) Exclude effect of netting agreements and exclude application of collateral.

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIB

BROKER OR DEALER: as of _____

SCHEDULE III
GEOGRAPHIC DISTRIBUTION (1) OF OTC DERIVATIVES EXPOSURES (2)

Country	Credit Rating Category (3)	Current Net Exposure (4)	Net Replacement Value (5)	Gross Replacement Value (6) Receivable	Gross Replacement Value (6) Payable
A	XXX				
	XX				
	X				
	YYY				
	YY				
	Y				
	Country A TOTAL				
B	XXX				
	XX				
	X				
	YYY				
	YY				
	Y				
	Country B TOTAL				
	GRAND TOTAL				

(1) Top 10 country exposures (by residence of main operating company).

(2) See Note (1) on Schedule I.

(3) See Note (5) on Schedule I.

(4) See Note (4) on Schedule II.

(5) See Note (5) on Schedule II.

(6) See Note (6) on Schedule II.

BROKER OR DEALER: as of _____

SCHEDULE IV
INTERNAL CREDIT RATING CONVERSION

Internal Credit Rating	Equivalent Ratings NRSRO 1	NRSRO 2
	Aaa	AAA
	Aa1	AA+
	Aa2	AA
	Aa3	AA-
	A1	A+
	A2	A
	A3	A-
	Baa1	BBB+
	Baa2	BBB
	Baa3	BBB-
	Ba1	BB+
	Ba2	BB
	Ba3	BB-
	B3	B+
	B2	B
	B1	B-
	CCC	CCC

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIB

BROKER OR DEALER:

as of _____

SCHEDULE V
NET REVENUES (1) FROM OTC DERIVATIVES (2) AND RELATED ACTIVITIES

Product Category (3)	Quarter Ended [DATE]	Month Ended [MONTH 3]	Month Ended [MONTH 2]	Month Ended [MONTH 1]
Fixed Income Products				
OTC Options				
Swaps				
Dollar				
Non-Dollar				
Currency & Foreign Exchange Products				
Equity Products				
Commodity Products				
Other Products (specify)				
Total All Products				

(1) Report net revenues from OTC derivatives activities in the specified product category after taking inro account related positions (including those that are not OTC derivatives), with net revenues defined as trading gains/losses plus interest and dividend income less dividend and interest expense (excluding all other expenses and allocable overhead).

(2) See Note (1) on Schedule I.

(3) Product types should be organized by one or more principle market categories.

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer)	As of (MM/DD/YY)

SCHEDULE VI
AGGREGATE SECURITIES AND OTC DERIVATIVE POSITIONS

I. AGGREGATE SECURITIES AND COMMODITIES POSITIONS

Aggregate Securities and Commodities Positions	LONG		SHORT	
1. U.S. Treasury securities	$	1000	$	1005
2. U.S. Government agency	$	1010	$	1015
3. Securities issued by states and political subdivisions in the U.S.	$	1020	$	1025
4. Foreign securities:				
A. Debt securities	$	1030	$	1035
B. Equity securities	$	1040	$	1045
5. Banker's acceptances	$	1050	$	1055
6. Certificates of deposit	$	1060	$	1065
7. Commercial paper	$	1070	$	1075
8. Corporate obligations	$	1080	$	1085
9. Stocks and warrants (other than arbitrage positions)	$	1090	$	1095
10. Arbitrage:				
A. Index arbitrage and program trading	$	1100	$	1105
B. Risk arbitrage	$	1110	$	1115
C. Other arbitrage	$	1120	$	1125
11. Options:				
A. Market value of put options:				
1. Listed	$	1130	$	1135
2. Unlisted	$	1140	$	1145
B. Market value of call options:				
1. Listed	$	1150	$	1155
2. Unlisted	$	1160	$	1165
12. Spot commodities	$	1170	$	1175
13. Investments with no ready market:				
A. Equity	$	1180	$	1185
B. Debt	$	1190	$	1195
C. Other (include limited partnership interests)	$	1200	$	1205
14. Other securites or commodities	$	1210	$	1215

15. Summary of delta or similar analysis (if available) (attach analysis)

000's OMITTED

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer) _____ As of (MM/DD/YY) _____

II. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND WITH CONCENTRATION OF CREDIT RISK

(Provide notional or contractual amounts where appropriate, or in the case of options, the values of the underlying instrument.)

A. Securities	LONG		SHORT	
1. When-issued securities:				
A. Gross commitments to purchase	$	2000	$	2005
B. Gross commitments to sell	$	2010	$	2015
2. Written stock option contracts:				
A. Market value, and the value of the underlying securities, of call contracts:				
1. Listed				
a. Market value	$	2020	$	2025
b. Value of underlying securities	$	2030	$	2035
2. Unlisted				
a. Market value	$	2040	$	2045
b. Value of underlying securities	$	2050	$	2055
B. Market value, and the value of the underlying securities, of put contracts:				
1. Listed				
a. Market value	$	2060	$	2065
b. Value of underlying securities	$	2070	$	2075
2. Unlisted				
a. Market value	$	2080	$	2085
b. Value of underlying securities	$	2090	$	2095
C. Market value, and the value of the underlying securities, of naked call contracts:				
1. Listed				
a. Market value	$	2100	$	2105
b. Value of underlying securities	$	2110	$	2115
2. Unlisted				
a. Market value	$	2120	$	2125
b. Value of underlying securities	$	2130	$	2035
D. Market value, and the value of the underlying securities, of naked put contracts:				
1. Listed				
a. Market value	$	2140	$	2145
b. Value of underlying securities	$	2150	$	2155
2. Unlisted				
a. Market value	$	2160	$	2165
b. Value of underlying securities	$	2170	$	2175

000's OMITTED

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer) _____ As of (MM/DD/YY) _____

II. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND WITH CONCENTRATION OF CREDIT RISK

(Provide notional or contractual amounts where appropriate, or in the case of options, the values of the underlying instrument.)

	LONG	SHORT
3. Futures:		
A. U.S. Treasury and mortgage-backed securities futures	$ 2020	$ 2025
B. Other futures (specify)	$ 2030	$ 2035
4. Forwards:		
A. U.S. Treasury and mortgage-backed securities	$ 2020	$ 2025
1. Aggregate current cost of replacing contracts by counter-party.	$ 2010	$ 2015
2. Per counterparty breakdown where credit risk exceeds the (attach schedule)		
B. Other forwards (specify)	$ 2020	$ 2025
1. Aggregate current cost of replacing contracts by counter-party.	$ 2010	$ 2015
2. Per counterparty breakdown where credit risk exceeds the (attach schedule)		
B. Interest Rate Swaps		
1. U.S. dollar denominated swaps:		
A. Total notional or contractual amount	$ 2000	$ 2005
B. Aggregate current cost of replacing contracts by counter-party.	$ 2010	$ 2015
C. Per counterparty breakdown. (attach schedule)		
2. Cross currency swaps:		
A. Total notional or contractual amount	$ 2000	$ 2005
B. Aggregate current cost of replacing contracts.	$ 2010	$ 2015
C. Per counterparty breakdown. (attach schedule)		
C. Foreign exchange		
1. Swaps:		
A. Total notional or contractual amount	$ 2000	$ 2005
B. Aggregate cost of replacing contracts by counterparty.	$ 2010	$ 2015
C. Per counterparty breakdown. (attach schedule)		
2. Notional or contractual amounts of commitments to purchase foreign currencies and U.S. dollar exchange:		
A. Futures	$ 2020	$ 2025

000's OMITTED

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer)	As of (MM/DD/YY)

II. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND WITH CONCENTRATION OF CREDIT RISK

(Provide notional or contractual amounts where appropriate, or in the case of options, the values of the underlying instrument.)

	LONG	SHORT
B. Forwards	$ 2020	$ 2025
1. Aggregate current cost of replacing contracts by counter-party.	$ 2010	$ 2015
2. Per counterparty breakdown. (attach schedule).		
3. Naked written option contracts:		
A. Contractual value	$ 2000	$ 2005
B. Value of the underlying instruments	$ 2000	$ 2005
D. All other swap agreements (specify type) (attach schedule if necessary)		
1. Total notional or contractual amount	$ 2000	$ 2005
2. Aggregate current cost of replacing contracts by counterparty.	$ 2010	$ 2015
3. Per counterparty breakdown. (attach schedule)		
E. Commodities		
1. Futures	$ 2020	$ 2025
2. Forwards	$ 2020	$ 2025
1. Aggregate current cost of replacing contracts by counter-party.	$ 2010	$ 2015
2. Per counterparty breakdown. (attach schedule).		
3. Sold option contracts (e.g., options on individual commodities and commodities indexes)		
A. Market value, and the value of the underlying instruments, of call contracts:		
1. Listed		
a. Market value	$ 2140	$ 2145
b. Value of underlying instruments	$ 2150	$ 2155
2. Unlisted		
a. Market value	$ 2160	$ 2165
b. Value of underlying instruments	$ 2170	$ 2175
B. Market value, and the value of the underlying instruments, of put contracts:		
1. Listed		
a. Market value	$ 2140	$ 2145
b. Value of underlying instruments	$ 2150	$ 2155

000's OMITTED

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT

PART IIB

(Name of Dealer)	As of (MM/DD/YY)

II. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND WITH CONCENTRATION OF CREDIT RISK

(Provide notional or contractual amounts where appropriate, or in the case of options, the values of the underlying instrument.)

	LONG	SHORT
2. Unlisted		
a. Market value	$ 2160	$ 2165
b. Value of underlying instruments	$ 2170	$ 2175
C. Market value, and the value of the underlying instruments, of naked call contracts:		
1. Listed		
a. Market value	$ 2140	$ 2145
b. Value of underlying instruments	$ 2150	$ 2155
2. Unlisted		
a. Market value	$ 2160	$ 2165
b. Value of underlying instruments	$ 2170	$ 2175
D. Market value, and the value of the underlying instruments, of naked put contracts:		
1. Listed		
a. Market value	$ 2140	$ 2145
b. Value of underlying instruments	$ 2150	$ 2155
2. Unlisted		
a. Market value	$ 2160	$ 2165
b. Value of underlying instruments	$ 2170	$ 2175

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