SECURITIES AND EXCHANGE COMMISSION

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OTC Derivatives Dealers

AGENCY: Securities and Exchange Commission.
ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting rules and rule amendments under the Securities Exchange Act of 1934 that tailor capital, margin, and other broker-dealer regulatory requirements to a class of registered dealers, called OTC derivatives dealers, that are active in over-the-counter derivatives markets. Registration as an OTC derivatives dealer under these rules is optional and is an alternative to registration as a broker-dealer under the traditional broker-dealer regulatory structure. It is available only to entities that engage in dealer activities in eligible over-the-counter derivative instruments and that meet certain financial responsibility and other requirements.
EFFECTIVE DATE: The rules and rule amendments shall become effective on January 4, 1999.
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SUPPLEMENTARY INFORMATION:

Table of Contents

I. Executive Summary
A. Introduction
B. The Proposing Release
C. Final Rules and Rule Amendments
1. General
2. Scope of Permissible Securities Activities
a. Eligible OTC Derivative Instruments
b. Cash Management Securities Activities
c. Ancillary Portfolio Management Securities Activities
3. Intermediation of Securities Transactions
4. Exemptions for OTC Derivatives Dealers
a. Exemption from SRO Membership
b. Exemption from Certain Margin Requirements
c. Exemption from SIPA
5. Section 11(a) of the Exchange Act
6. Net Capital Requirements
7. Rules 8c–1, 15c2–1, 15c3–2, and 15c3–3
8. Recordkeeping and Reporting
II. Discussion: New Rules and Amended Rules
A. Definitions
1. Rule 3b–12; Definition of OTC Derivatives Dealer
2. Rule 3b–13; Definition of Eligible OTC Derivative Instrument
3. Proposed Rule 3b–14; Definition of Permissible Derivatives Counterparty
4. Proposed Rule 3b–16; Definition of Hybrid Security
5. Rules 3b–14 and 3b–15; Definitions of Cash Management
Securities Activities and Ancillary Portfolio Management
Securities Activities
a. Rule 3b–14; Cash Management Securities Activities
i. Counterparty Collateral
ii. Cash Management
iii. Financing
b. Rule 3b–15; Ancillary Portfolio Management Securities Activities
i. Hedging
ii. Arbitrage
iii. Trading
iv. Documentation of Activities
B. Amendment to Rule 15b1–1; Registration with the Commission
C. Rule 15a–1; Securities Activities of OTC Derivatives Dealers
1. Scope of Permissible Securities Activities
2. Commission Orders Regarding OTC Derivatives Dealers' Activities
3. Intermediation of Securities Transactions
4. Communications Regarding Securities Transactions
5. Confirmation of Securities Transactions
6. Position Limits
D. Exemptions for OTC Derivatives Dealers
1. Rule 15b9–2; Exemption from SRO Membership
2. Rule 36a1–1; Exemption from Certain Margin Requirements
3. Rule 36a1–2; Exemption from SIPA
E. Rule 11a1–6; Transactions for Certain Accounts of OTC Derivatives Dealers
F. Net Capital Requirements for OTC Derivatives Dealers
1. Overview of Amendments to Rule 15c3–1
2. Reasons for Allowing OTC Derivatives Dealers to Use Value-at-Risk Models
3. Discussion of Net Capital Requirements
a. Rule 15c3–1(a)(5)
b. Appendix F
i. Application Requirement
ii. Market Risk
iii. Credit Risk
iv. Qualitative Requirements for Value-at-Risk Models
v. Quantitative Requirements for Value-at-Risk Models
G. Rules 8c–1, 15c2–1, 15c3–2, and 15c3–3
H. Recordkeeping and Reporting
1. Amendments to Rules 17a–3 and 17a–4; Books and Records to be Maintained by OTC Derivatives Dealers
2. Amendments to Rule 17a–11; Notification Requirements
3. Rule 15c3–4; Internal Risk Management Control Systems for OTC Derivatives Dealers
4. Rule 17a–12; Reports to be Made by OTC Derivatives Dealers
5. Amendments to Form X–17A–5
III. Costs and Benefits of the Rules and Rule Amendments
A. Comments and Survey
B. Benefits
1. Regulatory Capital Effects
2. Operational Cost Savings
3. Decreased Margin Requirements
C. Costs
1. Costs of Combining Activities into One Operation
2. Registration as an OTC Derivatives Dealer
3. Risk Management Adjustments
4. Books and Records Requirements
5. Regulatory Reporting
6. Regulation U Margin Requirements
D. Conclusion
IV. Efficiency, Competition, and Capital Formation
V. Summary of Final Regulatory Flexibility Analysis
A. Need for the Rules and Rule Amendments
B. Small Entities Subject to the Rules
C. Projected Reporting, Recordkeeping, and Other Compliance Requirements
D. Alternatives to Minimize Effect on Small Entities
VI. Paperwork Reduction Act
VII. Statutory Authority
Text of Rules and Rule Amendments

I. Executive Summary

A. Introduction

Over-the-counter (''OTC'') derivative instruments are important financial management tools employed by many corporations, financial institutions, governmental entities, and other end-users. Participants in the OTC derivatives markets engage in transactions involving a wide range of instruments in order to effectively manage risks associated with their business activities or their financial assets.

Whether OTC derivatives transactions are structured as interest rate swaps, cross currency swaps, equity swaps, basis swaps, total return swaps, asset swaps, credit swaps, or options, they share certain characteristics.[1] For

[1] Swaps are contracts that typically allow the parties to the contract to exchange cash flows

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 energy products, or spreads between the values of different assets. More importantly, each of these instruments can provide users with a carefully tailored method for managing a variety of risks.[2]

OTC derivative instruments, for example, can be used by corporations and local governments to lower funding costs, or by multinational corporations to manage risk associated with fluctuating exchange rates. They can also be used by portfolio managers to manage volatility in investment portfolios or to obtain exposure to different assets without taking a position in the cash markets. Because of the benefits these instruments offer, the derivatives markets have grown significantly over the past two decades.[3]

The traditional broker-dealer regulatory structure under the Securities Exchange Act of 1934 (''Exchange Act),[4] however, has not permitted a firm to operate a competitive OTC derivatives business in the United States that involves the broad range of OTC derivative instruments currently available to participants in these markets. While some of these OTC derivative instruments are securities, others are not. OTC options on equity securities or on U.S. government securities, for example, are securities within the meaning of section 3(a)(10) of the Exchange Act.[5] Firms that effect transactions in these or other OTC derivative instruments that are securities in the United States are required to register as broker-dealers under section 15(b) of the Exchange Act[6] and fulfill all requirements applicable to other securities broker-dealers, including Exchange Act rules governing margin and capital.

Traditional U.S. broker-dealer regulation seems particularly restrictive when contrasted with OTC derivatives activities that are conducted outside of the broker-dealer regulatory regime. Firms located off-shore can often structure their securities activities in a manner that will avoid or lessen the regulatory burdens imposed on broker-dealers under U.S. law. For example, off-shore firms can often avoid registering as broker-dealers in the United States if they engage in securities transactions only with non-U.S. persons, or if they comply with the requirements of Rule 15a–6 under the Exchange Act.[7]

Similarly, because U.S. banks are excluded from the Exchange Act definitions of ''broker'' and ''dealer,''[8] they are not subject to U.S. broker-dealer regulation. They, therefore, may engage in a broad range of OTC derivatives activities in accordance with guidance issued by their appropriate banking regulators.[9] In addition, firms that effect transactions only in OTC derivative instruments that are not securities are not subject to U.S. broker-dealer regulation.

The potential costs of broker-dealer regulation, as applied to dealers in OTC derivative instruments, have affected the way U.S. securities firms conduct business in the OTC derivatives markets. In many instances, U.S. securities firms have decided to separate their securities activities from their non-securities activities. These firms often place their non-securities OTC derivatives activities in separate, unregistered affiliates located in the United States, and conduct some or all of their securities OTC derivatives activities from abroad. However, fragmenting a firm's OTC derivatives business in this manner may hinder its ability to manage risk and compete for business.

For example, U.S. securities firms have voiced concerns regarding their ability to manage counterparty credit risk effectively under the traditional broker-dealer regulatory regime. Typically, in order to reduce credit exposure to a single counterparty, dealers in OTC derivative instruments enter into master agreements with their counterparties that provide for netting of the outstanding financial obligations existing between the dealers and their counterparties. As these firms have pointed out, it would be more efficient and effective to conduct both securities and non-securities OTC derivatives transactions with a counterparty through a single legal entity, subject to appropriately tailored regulatory requirements, rather than through multiple legal entities. The firms have also indicated that certain counterparties prefer to deal with a firm through a single entity that is capable of transacting business across a broad range of OTC derivative instruments.

B. The Proposing Release

In response to the concerns raised by firms seeking to conduct an OTC derivatives business in the United States, the Commission proposed to establish a form of limited broker-dealer regulation that would give the firms an opportunity to conduct business in a vehicle subject to modified regulation appropriate to the OTC derivatives markets.[10] This form of limited broker-dealer regulation was intended to allow securities firms to establish dealer

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related to the value or performance of certain assets, rates, or indices 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. Credit derivatives function like contingent options to the extent payments under the contract are triggered by the occurrence of a credit event, such as a decline in an issuer's credit rating or default in performance under a debt obligation.

[2] *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).

[3] 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 over $29 trillion. *See* ''ISDA Market Survey,'' ISDA Internet web site (http://www.isda.org).

[4] 15 U.S.C. 78a *et seq.*

[5] 15 U.S.C. 78c(a)(10)

[6] 15 U.S.C. 78o(b).

[7] 17 CFR 240.15a–6.

[8] *See* Section 3(a)(4) of the Exchange Act (15 U.S.C. 78c(a)(4)) (defining broker) and Section 3(a)(5) of the Exchange Act (15 U.S.C. 78c(a)(5)) (defining dealer). The exclusion for banks from the definitions of ''broker'' and ''dealer'' under the Exchange Act 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)).

[9] Banking regulators have issued guidance to banks engaging in derivatives activities. *See e.g., Federal Financial Institutions Examination Council, Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*, 63 FR 20191 (Apr. 23, 1998); *Federal Reserve Board, Trading and Capital-Markets Activities Manual* (1998) (including discussions of various derivative instruments, such as credit derivatives); *Federal Reserve SR Letter 97–21, Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities* (July 11, 1997); *Federal Reserve SR Letter 97–18, Application of Market Risk Capital Requirements to Credit Derivatives* (June 13, 1997); *FDIC FIL 62–96, Supervisory Guidance for Credit Derivatives* (Aug. 19, 1996); *Federal Reserve SR Letter 96–17, Supervisory Guidance for Credit Derivatives* (Aug. 12, 1996); *OCC Bulletin 96–43, Credit Derivatives* (Aug. 12 1996); *OCC Bulletin 96–25, Fiduciary Risk Management of Derivatives and Mortgage-Backed Securities* (Apr. 30, 1996); *OCC Bulletin 94–31, Questions and Answers for BC–277* (May 10, 1994); and *Risk Management of Financial Derivatives, OCC Banking Circular No. 277* (Oct. 1993).

[10] Exchange Act Release No. 39454 (Dec. 17, 1997), 62 FR 67940 (Dec. 30, 1997) (''Proposing Release'').

affiliates, referred to as ''OTC derivatives dealers,'' that would be able to compete more effectively with banks and foreign dealers in global OTC derivatives markets, while also maintaining standards necessary to ensure investor protection.

In the Proposing Release, the Commission specifically solicited comment on the extent to which persons eligible to become registered as OTC derivatives dealers believed that the proposal would address competitive inequalities that discouraged securities firms from conducting an OTC derivatives business in the United States. Commenters were also asked to express their views on the application of the Commission's broker-dealer rules to OTC derivatives dealers and whether additional amendments or exemptions were needed for this class of dealers.

The Commission received twenty-one comment letters in response to the proposed rules and rule amendments, including comments from, among others, industry representatives, self-regulatory organizations, and other regulators.[11] The majority of the commenters endorsed the Commission's initiative to develop an alternative regulatory framework for OTC derivatives dealers. These commenters supported the Commission's intent to provide a regulatory framework for OTC derivatives dealers that would enable these dealers to compete more effectively with both banks and foreign dealers in OTC derivatives markets. They often noted in particular their support of the Commission's efforts to address the regulatory costs imposed by existing capital requirements on securities firms seeking to operate an OTC derivatives business in the United States.[12]

The commenters, however, also suggested that the Commission modify the proposed rules and rule amendments in various ways to more accurately reflect the manner in which firms conduct an OTC derivatives business. Many commenters stressed the need for the alternative regulatory regime to establish a practical commercial framework for the conduct of this business and to provide U.S. securities firms with flexibility in structuring their derivatives activities.

C. Final Rules and Rule Amendments

1. General

After considering the comment letters, the Commission is adopting rules and rule amendments that will allow U.S. securities firms to establish separately capitalized entities that may engage in dealer activities in eligible OTC derivative instruments, which include both securities and non-securities OTC derivative instruments. OTC derivatives dealers are also permitted to engage in certain additional securities activities related to conducting an OTC derivatives business. A firm engaging in the permitted activities has the option of registering with the Commission under Section 15(b) of the Exchange Act[13] as an OTC derivatives dealer, subject to specially tailored capital, margin, and various other requirements.

These tailored requirements are intended, in part, to improve the efficiency and competitiveness of U.S. securities firms active in global OTC derivatives markets. By permitting U.S. securities firms to conduct both securities and non-securities OTC derivatives activities through a single legal entity, the new structure will enable the firms to enter into more comprehensive netting arrangements with counterparties and thus more effectively manage credit risk. End-users should also benefit as a result of a reduction in the legal risks that arise when securities firms structure their derivatives activities in a manner that avoids U.S. broker-dealer registration.[14] As noted by one commenter, all participants in the OTC derivatives markets have a vital interest in ensuring that OTC derivatives transactions are available in a framework where the legal rights and obligations of the parties to an agreement are certain and enforceable.[15] The new regulatory regime for OTC derivatives dealers is intended to help provide that legal certainty to these markets.

As a ''dealer'' under the Exchange Act,[16] an OTC derivatives dealer remains subject to all other rules applicable to ''fully regulated broker-dealers,''[17] unless otherwise provided by the new rules and rule amendments. In addition, the Commission wishes to emphasize that purchasers and sellers of OTC derivative instruments that are securities will continue to be protected by the general anti-manipulation and anti-fraud provisions, including Section 17(a) of the Securities Act of 1933,[18] and Section 9(a)[19] and 10(b)[20] of the Exchange Act, and Rule 10b–5 thereunder.[21]

An OTC derivatives dealer also remains subject to all applicable statutes, rules, and regulations of other U.S. financial regulators. In particular, to the extent that the Commodity Exchange Act (''CEA'')[22] and the rules and regulations adopted under the CEA apply to the activities of an OTC derivatives dealer, the new regulatory structure in no way alters the application of these laws to the activities of an OTC derivatives dealer.

2. Scope of Permissible Securities Activities

In order to take advantage of the new regulatory regime for conducting an OTC derivatives dealer business in the United States, an OTC derivatives dealer must, among other things, limit its securities activities to those specified in Rules 3b–12 and 15a–1. In general, these rules provide that an OTC derivatives dealer's securities activities must be limited to (1) engaging in dealer activities in eligible OTC derivative instruments (as defined in Rule 3b–13) that are securities; (2) issuing and reacquiring securities that are issued by the dealer, including warrants on securities, hybrid securities, and structured notes; (3) engaging in cash management securities activities (as defined in Rule 3b–14); (4) engaging in ancillary portfolio management securities activities (as defined in Rule 3b–15); and (5) engaging in such other securities activities that the Commission designates by order.[23] An OTC

[11] The staff of the Division of Market Regulation has prepared a summary of the comment letters received on the proposed rules and rule amendments entitled ''Comment Summary for Proposing Release on OTC Derivatives Dealers'' (hereinafter referred to as ''Comment Summary''). Copies of the comment letters and the Comment Summary have been placed in Public Reference File No. S7–30–97 and are available for inspection in the Commission's Public Reference Room.

[12] *See* Letters cited in Section II., n.1 of the Comment Summary.

[13] 15 U.S.C. 78o(b).

[14] *See, e.g.,* Comment Letter from the End-Users of Derivatives Association, Inc. (''EUDA Letter''). p. 1.

[15] *See* Comment Letter from the International Swaps and Derivatives Association, Inc. (''ISDA Letter''), pp. 1–2.

[16] *See* Section 3(a)(5) of the Exchange Act (15 U.S.C. 78c(a)(5)).

[17] For purposes of this release, the term ''fully regulated broker-dealer'' means a broker or dealer that is registered with the Commission under section 15(b) of the Exchange Act (15 U.S.C. 78o(b)), but that is not an OTC derivatives dealer, and therefore is subject to all statutes, rules, and regulations imposed on broker-dealers under the transitional broker-dealer regulatory regime, including membership in a securities self-regulatory organization.

[18] 15 U.S.C. 78q(a).

[19] 15 U.S.C. 78i(a).

[20] 15 U.S.C. 78j(a).

[21] 17 CFR 240.10b–5. *See, e.g., In the Matter of BT Securities Corporation*, Exchange Act Release No. 35136 (Dec. 22, 1994).

[22] 7 U.S.C. 1 *et seq.*

[23] The alternative regulatory framework generally does not limit the non-securities activities of an OTC derivatives dealer, provided that the dealer complies with financial responsibility and internal risk management controls requirements. An OTC derivatives dealer's non-securities activities are also

derivatives dealer must also be affiliated with a fully regulated broker-dealer.[24]

The Commission has defined the terms ''cash management securities activities'' and ''ancillary portfolio management securities activities.''[25] These two terms replace the term ''permissible risk management, arbitrage, and trading transactions,'' which was included in the Proposing Release. The new terms serve substantially the same purpose as the proposed term in that they describe the additional securities activities in which an OTC derivatives dealer may engage in connection with its OTC derivatives dealer business. As a practical matter, a firm seeking to register as an OTC derivatives dealer will need to be able to conduct these additional securities activities, such as engaging in certain financing and hedging transactions, in order to compete effectively with other market participants.

The final rules and rule amendments also contain restrictions to prevent U.S. securities firms from moving their general securities dealing activities into the new OTC derivatives dealer entity, or from using these entities for substantial proprietary trading activities. For example, the definitions of both ''cash management securities activities'' and ''ancillary portfolio management securities activities'' include limitations to prevent an OTC derivatives dealer from engaging in dealing activities in cash market instruments or from establishing a proprietary trading desk.

In addition, an OTC derivatives dealer's securities activities must consist primarily of dealer activities in eligible OTC derivative instruments that are securities, issuing and reacquiring its issued securities, and cash management securities activities. Thus, if the securities activities of an OTC derivatives dealer were to consist only or primarily of ancillary portfolio management securities activities, the dealer would be in violation of the rules.

a. *Eligible OTC Derivative Instruments.* As noted above, an OTC derivatives dealer is permitted to engage in dealer activities in ''eligible OTC derivative instruments,'' as that term is defined in Rule 3b–13. The term is defined broadly to encompass the wide range of securities and non-securities OTC derivative instruments currently existing in the derivatives markets, as well as to allow for the inclusion of reasonably similar instruments that market participants may develop in the future. The types of instruments that generally satisfy the criteria set forth in Rule 3b–13 include interest rate swaps, currency swaps, securities swaps, commodity swaps, OTC options on similar asset classes, long-dated forwards on securities, and forwards relating to assets other than securities. Other types of instruments also satisfy the criteria in the rule.

Short-dated securities forwards, however, are excluded from the definition of eligible OTC derivative instrument, as are securities derivative instruments that are listed or traded on a national securities exchange or on Nasdaq. Except as otherwise determined by the Commission by order, a securities derivative instrument that is one of a class of fungible instruments that are standardized as to their material economic terms is also excluded from the definition.

The new regulatory framework also allows an OTC derivatives dealer to issue and reacquire its issued securities, including hybrid securities. For purposes of Rules 3b–12 and 15a–1, which describe the permissible securities activities of an OTC derivatives dealer, the term ''hybrid security'' is defined as a security that incorporates payment features economically similar to the OTC derivative instruments that are enumerated in the definition.[26] The term ''hybrid security'' is used only in the context of an OTC derivatives dealer's permissible securities activities under the rules, and is not intended to have a broader application.

b. *Cash Management Securities Activities.* An OTC derivatives dealer may engage in ''cash management securities activities,'' as defined in Rule 3b–14. Under the rule, an OTC derivatives dealer may engage in cash management securities activities in connection with its permissible securities activities or its non-securities activities (that involve eligible OTC derivative instruments or other financial instruments). Cash management securities activities include (1) any acquisition or disposition of collateral provided by a counterparty, or any acquisition or disposition of collateral to be provided to a counterparty; (2) cash management; and (3) financing of certain positions of the dealer. Any securities trading activities associated with cash management by an OTC derivatives dealer must be at a level commensurate with the dealer's *bona fide* operational needs, taking into consideration the Commission's capital requirements for the dealer and the amount of capital needed by the dealer to satisfy counterparties' credit requirements.

c. *Ancillary Portfolio Management Securities Activities.* An OTC derivatives dealer may also engage in ''ancillary portfolio management securities activities,'' as defined in Rule 3b–15. These securities activities must be limited to transactions in connection with the OTC derivatives dealer's dealer activities in eligible OTC derivative instruments, the issuance of securities by the dealer, or such other securities activities that the Commission designates by order. They must also (1) be conducted for the purpose of reducing the dealer's market or credit risk or consist of incidental trading activities for portfolio management purposes; and (2) be limited to risk exposures within the market, credit, leverage, or liquidity risk parameters set forth in the trading authorizations granted to the associated person (or to the associated person's supervisor) who executes the transaction for the dealer, and in the written guidelines approved by the dealer's governing body and included in the dealer's internal risk management control system (as required under new Rule 15c3–4). Rule 3b–15 also requires that ancillary portfolio management securities activities be conducted only by associated persons of the dealer who perform substantial duties for the dealer in connection with its dealer activities in eligible OTC derivative instruments.

Again, the limitations on an OTC derivatives dealer's ancillary portfolio management securities activities under Rule 3b–15 are aimed at preventing a fully regulated broker-dealer from moving its securities book into its OTC derivatives dealer affiliate or otherwise permitting the OTC derivatives dealer to engage in substantial proprietary securities trading activities. An OTC derivatives dealer's ability to engage in incidental securities trading activities for portfolio management purposes under Rule 3b–15, however, recognizes

restricted under this framework by the practical limitations imposed by the definitions of ''cash management securities activities'' and ''ancillary portfolio management securities activities.''

[24] As proposed, the alternative regulatory framework defined the term ''permissible derivatives counterparty,'' and required that an OTC derivatives dealer's counterparties be limited to such persons. In response to commenters' concerns, and in light of the protections afforded through other provisions of the alternative regulatory framework, the final rules do not restrict the persons that may act as counterparties in OTC derivatives transactions. The final rules, however, do not exempt OTC derivatives dealers or their fully regulated broker-dealer affiliates from counterparty limitations imposed under any other applicable regulatory or self-regulatory requirements.

[25] *See* Rules 3b–14 (17 CFR 240.3b–14) and 3b–15 (17 CFR 240.3b–15).

[26] *See* Rules 3b–12(d) (17 CFR 240.3b–12(d)) and 15a–1(e) (17 CFR 240.15a–1(e).

that the dealer may to a limited extent engage in securities trading activity that may not be for the specific purpose of reducing its market or credit risk.

The new regulatory structure for OTC derivatives dealers incorporates the concept of managing risk on a portfolio-wide basis and does not expressly limit the range of permissible ancillary portfolio management securities activities. Instead, these activities are limited by the requirement that they not give rise to risk exposures that, on an aggregate portfolio basis, exceed the risk limits adopted for the dealer's business under the rules. They are also limited by other requirements that serve to ensure that the OTC derivatives dealer does not engage in dealer activities in securities that are not eligible OTC derivative instruments. The final rules are intended to be flexible and to accommodate current business practices of OTC derivatives dealers. Because the rules define a broad scope of permissible securities activities, however, the restrictions on proprietary trading and dealing in cash market instruments may prove inadequate. Rule 15a–1 therefore preserves the Commission's ability to clarify, by order, whether certain securities activities are within the scope of ancillary portfolio management securities activities.[27]

3. Intermediation of Securities Transactions

Rule 15a–1 generally requires that all securities transactions of an OTC derivatives dealer, including securities OTC derivatives transactions, be effected through its fully regulated broker-dealer affiliate.[28] The intermediation requirement is designed, in part, to ensure that all securities transactions remain subject to existing sales practice standards and to reduce the risk that counterparties will mistakenly view an OTC derivatives dealer as a fully regulated broker-dealer. Certain professional counterparties, however, are less likely to need or expect the protections offered by the fully regulated broker-dealer under this framework. Therefore, the rules provide two limited exceptions to the broker-dealer intermediation requirement for securities transactions.

First, an OTC derivatives dealer is not required to use its fully regulated broker-dealer affiliate to effect securities transactions with a registered broker or dealer, a bank acting in a dealer capacity, a foreign broker or dealer, or an affiliate of the OTC derivatives dealer, provided that the counterparty is acting as principal. Second, if an OTC derivatives dealer engages in an ancillary portfolio management securities activity involving a foreign security, it is not required to effect that securities transaction through its fully regulated broker-dealer affiliate if a registered broker or dealer, a bank, or a foreign broker or dealer is acting as agent for the OTC derivatives dealer.

In addition, any person that solicits a potential counterparty to engage in a securities transaction with an OTC derivatives dealer, or otherwise has any contact with the counterparty regarding the transaction, generally must be a registered representative of the fully regulated broker-dealer affiliate.[29] These persons may be dual employees of both the OTC derivatives dealer and the fully regulated broker-dealer. However, if the counterparty is a registered broker or dealer, a bank acting in a dealer capacity, a foreign broker or dealer, or an affiliate of the OTC derivatives dealer, employees of the OTC derivatives dealer may solicit or have other forms of contact with the counterparty, even if they are not also registered representatives of the fully regulated broker-dealer. This is consistent with the exception for these same counterparties from the general requirement that an OTC derivatives dealer's securities transactions be effected through its fully regulated broker-dealer affiliate.

In addition, the rule does not require registered representatives of the fully regulated broker-dealer affiliate to be involved in contacts with foreign counterparties, in certain situations. Contacts with a foreign counterparty may generally be conducted by an associated person of a foreign broker or dealer who is not resident in the United States, if the foreign broker or dealer is affiliated with the OTC derivatives dealer and is registered under applicable local law. This approach recognizes the global nature of the OTC derivatives markets, and the practical limitations imposed by requiring registered representatives of the fully regulated broker-dealer affiliate to participate in all such contacts. Any resulting securities transaction, however, must generally be effected through the OTC derivatives dealer's fully regulated broker-dealer affiliate.

4. Exemptions for OTC Derivatives Dealers

The final rules and rule amendments provide exemptions from certain provisions of the Exchange Act to OTC derivatives dealers due to, among other things, the unique nature of this business. Specifically, OTC derivatives dealers are exempted from (a) membership in a securities self-regulatory organization (''SRO''); (b) certain margin requirements under the Exchange Act; and (c) the provisions of the Securities Investor Protection Act of 1970[30] (''SIPA''), including membership in the Securities Investor Protection Corporation (''SIPC'').[31]

a. *Exemption from SRO Membership.* Under Rule 15b9–2, OTC derivatives dealers are exempt from membership in an SRO. SRO membership for OTC derivatives dealers, and the additional regulation it entails, is not warranted at this time. As a practical matter, certain SRO rules are not consistent with the OTC derivatives dealer regulatory structure, and accordingly, should not apply directly to the OTC derivatives dealer. In addition, with limited exceptions, all securities transactions of an OTC derivatives dealer must be effected through its fully regulated broker-dealer affiliate, which will be an SRO member. As a result, SRO rules, including sales practice requirements, will generally apply to these securities transactions.

While the Commission had proposed that the designated examining authority (''DEA'') of the OTC derivatives dealer's fully regulated broker-dealer affiliate would review the OTC derivatives dealer's activities for violations of Commission rules, the New York Stock Exchange (''NYSE'') and the National Association of Securities Dealers, Inc. (''NASD'') expressed serious concerns with overseeing OTC derivatives dealers on a contractual basis (without the dealers being SRO members). The Commission staff, therefore, will examine OTC derivatives dealers to ensure compliance with Commission rules.

b. *Exemption from Certain Margin Requirements.* Federal regulations that govern the collateral, or margin, that must be collected by dealers in connection with securities transactions have created certain competitive inequalities between registered broker-

[27] *See* Rule 15a–1(b)(4) (17 CFR 240.15a–1(b)(4)).

[28] *See* Rule 15a–1(c) (17 CFR 240.15a–1(c)). An OTC derivatives dealer may issue and reacquire its issued securities through an unaffiliated fully regulated broker-dealer. *Id.*

[29] *See* Rule 15a–1(d) (17 CFR 240.15a–1(d)). The rule provides an exception for clerical and ministerial activities that are conducted by associated persons of the OTC derivatives dealer.

[30] 15 U.S.C. 78aaa *et seq.*

[31] In 1996, Congress added section 36 to the Exchange Act (15 U.S.C. 78mm), which gives the Commission broad authority to exempt any person from any of the provisions of the Exchange Act. The exemptions from certain margin requirements under the Exchange Act and from SIPA were adopted using this new exemptive authority.

dealers and other entities, including banks, that conduct an OTC derivatives business. Registered broker-dealers that extend credit for the purpose of purchasing or carrying securities are required to comply with the provisions of Regulation T.[32] The margin requirements for banks are contained in Regulation U.[33]

After the Commission issued the Proposing Release, several amendments to Regulation T were adopted that reduced the regulatory distinctions between broker-dealers and other lenders.[34] In general, Regulation T and Regulation U permit lenders to extend good faith credit against all non-equity securities and set specific limits on the amount of credit lenders can extend on equity securities.[35] However, several differences between Regulation T and Regulation U still remain, such as margin requirements for short OTC options. U.S. securities firms have indicated that because of these differences, applying Regulation T to their OTC derivatives business would continue to unnecessarily inhibit their ability to compete in the derivatives markets with banks and other lenders subject to Regulation U.

Given the nature of the bilateral financial instruments and the relative sophistication of the counterparties in the OTC derivatives markets, and the safeguards against excessive leverage contained in Regulation U, the requirements of Regulation U are more appropriate for the lending that occurs in these markets. Accordingly, under Rule 36a1–1, transactions involving extensions of credit by an OTC derivatives dealer are exempt from the provisions of Section 7(c) of the Exchange Act[36] and Regulation T, provided that the OTC derivatives dealer complies with Section 7(d) of the Exchange Act[37] and Regulation U.[38]

c. *Exemption from SIPA.* Under Rule 36a1–2, OTC derivatives dealers are exempt from the provisions of SIPA, including membership in SIPC. 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. As a result, the application of SIPA to OTC derivatives dealers would create legal uncertainty about the rights of counterparties in transactions with OTC derivatives dealers in the event of dealer insolvency. This 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.

5. Section 11(a) of the Exchange Act

Rule 11a1–6 provides an exception under section 11(a) of the Exchange Act[39] for certain transactions effected by a fully regulated broker-dealer for the account of its OTC derivatives dealer affiliate. Section 11(a) makes it unlawful for a member of a national securities exchange to effect transactions on that exchange for certain accounts, including its own account or the account of an associated person.

This general prohibition, however, is subject to numerous exceptions. Among these is a general exception under section 11(a)(1)(G) for a member's proprietary transactions, where the member is primarily engaged in a public securities business, as indicated by certain calculations involving the member's gross revenues from the preceding fiscal year (the ''business mix'' test), and the transactions ''yield,'' in accordance with Commission rules, priority, parity, and precedence to transactions for accounts of persons who are not members, or associated with members, of the exchange.[40]

Rule 11a1–2 under the Exchange Act generally permits a member to effect a transaction for the account of an associated person if the member could have effected the transaction for its own account. The rule, however, requires that the associated person independently meet the ''business mix'' test in order for the member to rely on the exception provided under Section 11(a)(1)(G) for transactions effected for the account of that associated person.

Because an OTC derivatives dealer will be a newly created entity, it will not be able to demonstrate that it meets this test. Accordingly, new Rule 11a1–6, like existing Rule 11a1–2, allows a fully regulated broker-dealer member to effect a transaction on the exchange for the account of an affiliated OTC derivatives dealer if the member would have been permitted to effect the transaction for its own account. Rule 11a1–6 allows the fully regulated broker-dealer to rely on the exception under section 11(a)(1)(G) for transactions it effects for its OTC derivatives dealer affiliate even if that affiliate does not meet the ''business mix'' test. The fully regulated broker-dealer and the OTC derivatives dealer must comply with all other requirements of section 11(a).

6. Net Capital Requirements

The net capital rule has been amended to include an alternative net capital regime for OTC derivatives dealers. Under the amendments, an OTC derivatives dealer will be subject to higher minimum capital requirements than a fully regulated broker-dealer. The OTC derivatives dealer, however, may also be authorized by the Commission to use value-at-risk (''VAR'') models to calculate capital charges for market risk and to take alternative charges for credit risk than those currently prescribed. The minimum capital requirements for an OTC derivatives dealer are tentative net capital of at least $100 million and net capital of at least $20 million. Under the circumstances, these minimum amounts will provide a sufficient liquid capital cushion for entities that elect to register as an OTC derivatives dealer.

In order to use VAR models to calculate capital charges for market risk and to take alternative charges for credit risk, under new Appendix F to Rule 15c3–1, an OTC derivatives dealer must file an application with, and obtain authorization from, the Commission. The application, among other things, must describe the OTC derivatives dealer's VAR model or models, including the manner in which the model or models meet the requirements specified in Appendix F, and the dealer's internal risk management controls system (as required under Rule 15c3–4). The OTC derivatives dealer must also describe in the application any non-marketable securities that it wants to include in its VAR calculation.

An OTC derivatives dealer's VAR model must meet certain qualitative and quantitative requirements under Appendix F that parallel rules currently followed by U.S. banking agencies. To meet the qualitative requirements, among other things, an OTC derivatives dealer must integrate its VAR model into the firm's daily risk management process, and subject its VAR model to stress tests, internal and external audits, and backtesting. The quantitative requirements contain statistical

[32] 12 CFR 220.1.

[33] 12 CFR 221.1.

[34] *See* Securities Credit Transactions, Borrowing by Brokers and Dealers, Docket Nos. R–0905, R–0923, and R–0944, 63 FR 2806 (Jan 16, 1998).

[35] *See, e.g.,* 12 CFR 221.2(f).

[36] 15 U.S.C. 78g(c).

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

[38] Because Regulation U is promulgated pursuant to Section 7(d) of the Exchange Act, an OTC derivatives dealer remains subject to that provision. In addition, Rule 36a1–1 (17 CFR 240.36a1–1) applies only to extensions of credit *by* an OTC derivatives dealer. Section 7 of the Exchange Act continues to apply to persons extending credit *to* an OTC derivatives dealer. Credit extended to an OTC derivatives dealer, like credit extended to a fully regulated broker-dealer, however, is excepted from section 7 of the Exchange Act is it satisfies the conditions for such exceptions contained in section 7.

[39] 15 U.S.C. 78k(a).

[40] *See* 15 U.S.C. 78k(a)(1)(G).

parameters for VAR measures using a time horizon that is appropriate in the regulatory capital context, as well as risk factors that must be addressed in any model used. These parameters include the use of a ten-day holding period and a 99% confidence level.

An OTC derivatives dealer applying Appendix F must also compute a two-part credit risk capital charge, calculated on a counterparty-by-counterparty basis. The first part of the charge is calculated based on the net replacement value of all outstanding transactions with each counterparty after taking into account netting arrangements and possession of liquid collateral multiplied by a counterparty factor derived from the creditworthiness of that counterparty. The second part of the credit risk charge is a concentration charge that is also based on the creditworthiness of a particular counterparty, but that only applies when the net replacement value in the account of that counterparty exceeds 25% of the OTC derivatives dealer's tentative net capital.

Under Rule 15c3–4, an OTC derivatives dealer using Appendix F is also required to establish a comprehensive system of internal controls for monitoring and managing risks associated with its business activities. The establishment of a system of controls is an important element of the Commission's regulatory regime for OTC derivatives dealers. The risks that an OTC derivatives dealer's system of internal controls must specifically address include market, credit, leverage, liquidity, legal, and operational risks associated with conducting an OTC derivatives business.

The Commission will authorize an OTC derivatives dealer to use Appendix F if it determines that the dealer has met the requirements set forth in the rules relating to its VAR model and internal risk management control systems. In addition, an OTC derivatives dealer must file an application with the Commission before making any material changes to its VAR model or internal risk management control systems and receive authorization before implementing any such changes.

7. Rules 8c–1, 15c2–1, 15c3–2, and 15c3–3

Under the new regulatory structure, a counterparty to an OTC derivatives transaction generally will not be considered a ''customer'' for purposes of Rules 8c–1, 15c2–1, 15c3–2, and 15c3–3, the Commission's hypothecation and customer protection rules, and will not be protected by SIPA. In particular, except as otherwise agreed to in writing, if an OTC derivatives dealer notifies its counterparty that it will not segregate the collateral and may use the counterparty's collateral to further its own business operations, including commingling and pledging the counterparty's assets, the counterparty will not be considered a ''customer'' of the dealer for purposes of Rules 8c–1, 15c2–1, 15c3–2, and 15c3–3.

8. Recordkeeping and Reporting

The rules governing recordkeeping and reporting for an OTC derivatives dealer have also been modified. The rules will remain substantially the same as for fully regulated broker-dealers, but they have been tailored to the business of OTC derivatives dealers. Reporting will be required only on a quarterly basis. The reports will include, among other things, information from the dealer regarding its VAR computations, as well as various credit concentration information.

II. Discussion: New Rules and Amended Rules

After consideration of the issues raised in comment letters concerning the alternative regulatory structure for OTC derivatives dealers, the Commission is adopting new Rules 3b–12, 3b–13, 3b–14, 3b–15, 11a1–6, 15a–1, 15b9–2, 15c3–4, 17a–12, 36a1–1, and 36a1–2 [41] under the Exchange Act.[42] The Commission is also amending Rule 30–3 of the Commission's rules of practice [43] and Exchange Act Rules 8c–1, 15b1–1, 15c2–1, 15c2–5, 15c3–1, 15c3–2, 15c3–3, 17a–3, 17a–4, 17a–5, and 17a–11.[44] In addition, the Commission is revising Form X–17A–5 (FOCUS report).[45]

A. Definitions

The final rules set forth definitions of four new terms: (1) OTC derivatives dealer; (2) eligible OTC derivative instrument; (3) cash management securities activities; and (4) ancillary portfolio management securities activities. Although the Commission had also proposed to define the term ''permissible derivatives counterparty,'' the Commission has determined that it is unnecessary to use the term in the final rules and rule amendments. In addition, the Commission is not adopting a separate rule defining ''hybrid security,'' as proposed, but rather is including a definition of ''hybrid security'' only for purposes of the final rules that use the term. The definitions of the new terms, and the reasons for adopting them in their revised forms, are described below.

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

As proposed, Rule 3b–12 would have defined OTC derivatives dealer to mean any dealer that limited 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 through a fully regulated broker or dealer; or (3) engaging in other securities transactions that the Commission designated by order. The OTC derivatives dealer would also have been permitted to engage in ''permissible risk management, arbitrage, and trading transactions,'' in connection with any of these securities activities.

The proposed definition of OTC derivatives dealer was intended to identify a category of dealers that would primarily be engaged as counterparties in OTC derivatives transactions. The proposed definition also recognized that these dealers would need to engage in certain limited securities trading activities in connection with their OTC derivatives dealing activities in order to operate a competitive business. The Proposing Release, however, emphasized that an OTC derivatives dealer should not be able to take advantage of the modified regulatory requirements to engage in activities better suited to full broker-dealer regulation.[46]

Several commenters requested that the Commission clarify that the non-securities activities in which an OTC derivatives dealer would be permitted to engage would not be limited in either scope or volume (subject only to capital considerations).[47] The commenters were concerned that the language in the summary of the Proposing Release stating that registration as an OTC derivatives dealer was available only to entities acting *primarily* as counterparties in privately negotiated OTC derivatives transactions was

[41] 17 CFR 240.3b–12, 240.3b–13, 240.3b–14, 240.3b–15, 240.11a1–6, 240.15a–1, 240.15b9–2, 240.15c3–4, 240.17a–12, 240.36a1–1, and 240.36a1–2.

[42] 15 U.S.C. 78a *et seq.*

[43] 17 CFR 200.30–3.

[44] 17 CFR 240.8c–1, 240.15b1–1, 240.15c2–1, 240.15c2–5, 240.15c3–1, 240.15c3–2, 240.15c3–3, 240.17a–3, 240.17a–4, 240.17a–5, and 240.17a–11.

[45] 17 CFR 249.617.

[46] Proposing Release, Section II.A.1., n.17, 62 FR at 67942, n.17.

[47] *See* Comment Summary, Section IV.A.1.; Comment Letter from the Securities Industry Association's (''SIA'') OTC Derivative Products Committee, dated April 6, 1998 (''SIA Letter I''), p. 5; Comment Letter from Merrill Lynch & Co., Inc. (''Merrill Lynch Letter''), p. 4.

potentially inconsistent with the ability of these entities to engage in any non-securities activities.[48] In response to these comments, the Commission has revised the definition of OTC derivatives dealer to emphasize that the definition limits only the securities activities [49] of a dealer seeking to operate an OTC derivatives business under the new framework.[50]

Several commenters also questioned the proposed definition's limits on the scope of securities activities in which an OTC derivatives dealer could engage.[51] Merrill Lynch & Co., Inc. (''Merrill Lynch'') suggested that an OTC derivatives dealer should be permitted to engage in a full range of activities in *securities* derivative instruments (including acting as a dealer in such instruments).[52] Merrill Lynch also noted that there were numerous types of securities *principal* transactions in which an OTC derivatives dealer would need to engage to support its derivatives business. It expressed concern that any limitation on the nature or scope of such transactions could unnecessarily restrict, and in certain cases could increase the risk of, the dealer's derivatives business.[53] Other commenters believed that monitoring the limitations in the proposed rule could create unnecessary burdens for both the dealers and the Commission, and that the limitations were not always consistent with the manner in which an OTC derivatives business is currently conducted.[54]

Commenters also addressed the issue that the alternative regulatory structure for OTC derivatives dealers is not intended to permit U.S. securities firms to move their general securities dealing activities into an OTC derivatives dealer affiliate or to establish proprietary securities trading desks in the new entity.[55] In this regard, the Government Finance Officers Association (''GFOA'') questioned whether the proposal provided sufficient safeguards to ensure that a firm did not move its dealer activity in cash market instruments, such as stocks and bonds, to an OTC derivatives dealer.[56] Other commenters, however, believed that the proposal contained enough restrictions on securities dealing activities to avoid such behavior by an OTC derivatives dealer acting in good faith.[57]

Taking these comments into account, the final rule provides that an OTC derivatives dealer is a dealer that is affiliated with a registered broker or dealer (other than an OTC derivatives dealer) and whose securities activities are limited to (1) engaging in dealer [58] activities in eligible OTC derivative instruments that are securities; (2) issuing and reacquiring securities that are issued by the dealer, including warrants on securities, hybrid securities,[59] and structured notes;[60] (3) engaging in cash management securities activities (as defined in Rule 3b–14); (4) engaging in ancillary portfolio management securities activities (as defined in Rule 3b–15); and (5) engaging in such other securities activities that the Commission designates by order.

As detailed in Section II.A.5. below, the Commission has defined the terms ''cash management securities activities'' and ''ancillary portfolio management securities activities.'' These two terms replace the term ''permissible risk management, arbitrage, and trading transactions,'' which was included in the Proposing Release. The new terms serve substantially the same purpose as the proposed term in that they describe the additional securities activities in which an OTC derivatives dealer may engage in connection with its OTC derivatives business. As a practical matter, a firm seeking to register as an OTC derivatives dealer will need to be able to conduct these additional securities activities, such as engaging in certain financing and hedging transactions, in order to compete effectively with other market participants.

The focus of the alternative regulatory structure for OTC derivatives dealers, however, is on providing a regulatory vehicle that will allow a U.S. securities firm to establish a separately capitalized entity through which to book an OTC derivatives business. As a result, the final rules, including the definitions of ''cash management securities activities'' and ''ancillary portfolio management securities activities'' contain appropriate limitations to prevent an OTC derivatives dealer from engaging in dealing activities in cash market instruments or in substantial proprietary trading activities.

Rule 3b–12, as adopted, also requires that the securities activities of an OTC derivatives dealer consist primarily of engaging in dealer activities in eligible OTC derivative instruments that are securities, issuing and reacquiring its issued securities, and engaging in cash management securities activities. Thus, if the securities activities of an OTC derivatives dealer were to consist only or primarily of ancillary portfolio management securities activities, the OTC derivatives dealer would be in violation of the rule. For instance, an OTC derivatives dealer that trades in exchange-traded futures contracts may not engage in securities activities that consist only or primarily of managing the risks of those futures transactions.

[48] *See, e.g.,* SIA Letter I, p. 5.

[49] As a practical matter, the non-securities activities of an OTC derivatives dealer are limited by the capital requirements and by the limits imposed on cash management and ancillary portfolio management securities activities under this regulatory structure. This parallels the system for fully regulated broker-dealers, which does not prohibit non-securities activities by definition, but rather imposes practical limitations on those activities under the financial responsibility rules.

[50] In its comment letter, the Commodity Futures Trading Commission (''CFTC'') stated that the proposal for the alternative regulatory framework for OTC derivatives dealers extended beyond the Commission's authority to regulate securities. *See* Comment Letter from the CFTC (''CFTC Letter''), p. 1. While the proposal was appropriately restricted in scope to fall within the Commission's statutory jurisdiction, the revisions made to Rule 3b–12 (17 CFR 240.3b–12), as well as to the other rules and rule amendments, that strengthen the focus of the new regulatory framework on the securities activities of an OTC derivatives dealer serve to clarify the scope of the Commission's jurisdiction.

[51] *See* letters cited in Section IV.A.2. of the Comment Summary.

[52] Merrill Lynch Letter, p. 4.

[53] Merrill Lynch Letter, p. 5. Similarly, the SIA commented that, so long as an OTC derivatives dealer limited its securities dealing activities to transactions in eligible OTC derivative instruments with permissible derivatives counterparties, it was neither necessary nor desirable to limit the non-dealing securities activities of an OTC derivatives dealer. SIA Letter I, p. 6.

[54] *E.g.,* SIA Letter I, p. 6.

[55] *See, e.g,* Proposing Release, Section II.A.1., n.17, 62 FR 67942, n.17.

[56] Comment Letter from the Government Finance Officers Association (''GFOA Letter''), p. 3.

[57] *E.g.,* Comment Letter from Morgan Stanley Dean Witter (''MSDW Letter''), p. 10. In addition, one commenter suggested a simple prohibition on that business instead of a series of detailed and complex prophylactic limitations on the permissible activities of an OTC derivatives dealer. Comment Letter from Salomon Smith Barney (''Salomon Smith Barney Letter''), p. 2.

[58] When used in the context of eligible OTC derivative instruments (as defined in Rule 3b–13 (17 CFR 240.3b–13) or in the context of OTC derivative instruments in general, the term ''dealer'' activities includes buying, selling, and entering into OTC derivative instruments. *See* Section 3(a)(5) of the Exchange Act (15 U.S.C. 78c(a)(5)) (defining dealer).

[59] *See* Section II.A.4. below, discussing the definition of the term ''hybrid security.''

[60] In the Proposing Release, the requirement that an OTC derivatives dealer issue or reacquire its issued securities through a fully regulated broker or dealer (other than an OTC derivatives dealer) was set forth in proposed Rule 3b–12(a)(2), as well as in proposed Rule 15a–1(a)(1)(ii), regarding the permissible securities activities of an OTC derivatives dealer. This requirement, however, has been omitted from final Rule 3b–12, and included only in final Rule 15a–1(c). In this regard, while the securities transactions of an OTC derivatives dealer generally must be effected through an affiliated fully regulated broker-dealer, an OTC derivatives dealer may issue and reacquire its issued securities through an unaffiliated fully regulated broker-dealer. *See* Rule 15a–1(c) (17 CFR 240.15a–1(c)) (discussed in Section II.C.3. below).

In addition, Rule 3b–12 expressly states that an OTC derivatives dealer's securities activities may not consist of any securities activities other than those included in the rule, including engaging in any transaction in any security that is not an eligible OTC derivative instrument, except for cash management securities activities, ancillary portfolio management securities activities, and such other securities activities that the Commission may designate by order. This position is consistent with the general principle that a broker-dealer is not permitted to move dealer activities in cash market instruments into the OTC derivatives dealer.[61]

As some commenters noted, the ability of the Commission to issue orders under Rule 15a–1(b)(1) identifying other permissible securities activities in which an OTC derivatives dealer may engage should help to mitigate concerns that the definition sets forth specific limitations on the securities activities of these entities.[62] As provided in the Proposing Release, the Commission is amending Rule 30–3 of the Rules of Practice to delegate its authority to issue these orders to the Director of the Division of Market Regulation.[63]

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

An OTC derivatives dealer is permitted to engage in dealer activities in eligible OTC derivative instruments, as that term is defined in Rule 3b–13. As proposed, Rule 3b–13 would have defined ''eligible OTC derivative instrument'' to mean any agreement, contract, or transaction (1) that is not part of a fungible class of agreements, contracts, or transactions that are standardized as to their material economic terms; (2) 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 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;[64] and (3) 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.[65]

Several commenters criticized this proposed definition.[66] For example, the SIA argued that the proposed definition failed to include certain important categories of transactions, such as transactions that are based on the occurrence or nonoccurrence of specified events, but that do not technically relate to one or more securities, commodities, and the like, although they are associated with financial consequences, such as credit derivatives.[67] Morgan Stanley Dean Witter argued that the requirement that eligible OTC derivative instruments be based on at least one of an enumerated list of underlying assets could unnecessarily limit these dealers' activities in rapidly evolving products while Commission approval was being sought on a product-by-product basis.[68]

The SIA also suggested alternative definitions of ''eligible OTC derivative instrument'' and recommended that the Commission clarify that it was not intending to construe or expand the definition of ''security'' under the Exchange Act.[69] Several commenters asked that the Commission clarify what instruments would be considered ''securities'' OTC derivative instruments and ''non-securities'' OTC derivative instruments for purposes of the rules.[70] Merrill Lynch agreed in principle with the approach of proposed Rule 3b–13, but also suggested that an OTC derivatives dealer be able to seek expedited interpretative guidance for new derivative instruments.[71]

Several commenters were also concerned that the proposed definition required that forwards have a duration period of one year or more in order to qualify as an eligible OTC derivative instrument, and suggested shorter periods, such as one month or two weeks.[72] The SIA suggested that, in including a duration period for forwards, the definition should distinguish between government securities forwards and forwards involving non-government securities.[73] In addition, the SIA maintained that those securities forwards having material features of a type described in the definition of eligible OTC derivative instrument should qualify as eligible OTC derivative instruments.[74]

Several commenters raised concerns with the use of concepts from the CEA in defining the term eligible OTC derivative instrument. In its comment letter, the Commodity Futures Trading Commission (''CFTC'') noted that the proposed definition relied on criteria that were similar to, but not the same as, the criteria for qualifying transactions under the CFTC's part 35 swaps exemption.[75] The CFTC stated that a registered OTC derivatives dealer could effect transactions that would be permissible under the proposed rules, but that would not be exempted under part 35 from the provisions of the CEA, and thus market participants might face legal uncertainty concerns in entering into certain derivatives transactions.

On a similar note, two commenters were concerned that the proposed

[61] As stated in the Proposing Release, except to the extent expressly permitted under the rules and rule amendments, an OTC derivatives dealer may not 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 includes, but is not limited to, without regard to the security, (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 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 Rule 15a–1; (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. *See* Proposing Release, Section II.A.4., n.24, 62 FR at 67944, n.24.

[62] *See, e.g.,* SIA Letter I, pp. 6–7. *See also* Rule 15a–1(b)(1) (17 CFR 240.15a–1(b)(1)) and Section II.C.2. below, discussing the ability of the Commission to issue orders under Rule 15a–1(b) (17 CFR 240.15a–1(b)) regarding the securities activities of OTC derivatives dealers.

[63] Proposing Release, Section II.C., n.27, 62 FR at 67944, n.27. *See* Rule 30–3(a)(64) (17 CFR 200.30–3(a)(64)).

[64] The concern with forwards is that an OTC derivatives dealer should not be able to engage in dealer activities in short-dated securities forwards that may in effect replicate cash market instruments or in certain government securities forwards, such as Government National Mortgage Association (GNMA) forwards.

[65] Proposing Release, Section II.A.2., 62 FR at 67942.

[66] *See* letters cited in Section IV.B. of the Comment Summary.

[67] SIA Letter I, pp. 9–10; *see also* Merrill Lynch Letter, p. 7.

[68] MSDW Letter, p. 6.

[69] SIA Letter I, p. 10. *See also* Comment Letter from SIA, dated October 16, 1998 (''SIA Letter II''), pp. 2–3.

[70] EUDA Letter, p. 2; GFOA Letter, p. 1; Comment Letter from the New York Stock Exchange (''NYSE Letter''), p. 3.

[71] Merrill Lynch Letter, p. 7.

[72] SIA Letter I, pp. 9–10; Merrill Lynch Letter, p. 7; Comment Letter from D.E. Shaw & Co. L.P. (''DESCO Letter''), p. 7.

[73] SIA Letter II, p. 2.

[74] *Id.*

[75] CFTC Letter, pp. 11–12. The CFTC's Part 35 regulations exempt certain swap transactions from most provisions of the CEA, provided that the transaction is conducted solely between ''eligible swap participants,'' as defined in part 35 (17 CFR part 35).

definition adopted concepts from the CEA in excluding transactions that were standardized or traded on ''an exchange, an electronic marketplace, or similar facility supervised or regulated by the Commission, or any other multilateral transaction execution facility.'' [76] The SIA argued that the text potentially could exclude from the definition a broad range of transactions involving exempt securities, as well as transactions that did not involve securities at all, which it believed should not be excluded from the proposed definition. The SIA also opined that the proposed language would spawn significant uncertainty over its scope.[77] Morgan Stanley Dean Witter similarly claimed that the use of terms contained in the CEA that were not commonly understood in the securities law context caused the definition of ''eligible OTC derivative instrument'' to be ambiguous.[78]

In response to these comments, the Commission has revised the definition of eligible OTC derivative instrument in several ways. As adopted, Rule 3b–13 defines eligible OTC derivative instrument to mean, subject to certain exceptions, any contract, agreement, or transaction that provides, in whole or in part, on a firm or contingent basis, for the purchase or sale of, or is based on the value of, or any interest in, one or more commodities, securities, currencies, interest or other rates, indices, quantitative measures, or other financial or economic interests or property of any kind, or that involves any payment or delivery that is dependent on the occurrence or nonoccurrence of any event associated with a potential financial, economic, or commercial consequence, or any combination or permutation of the foregoing.[79] The term eligible OTC derivative instrument, however, does not include certain forwards on securities, securities listed or traded on a national securities exchange or on Nasdaq, or fungible securities derivative instruments that are standardized as to their material economic terms.[80]

Rule 3b–13 defines eligible OTC derivative instrument broadly to encompass the wide range of securities and non-securities OTC derivative instruments currently existing in the derivatives markets, as well as to allow for the inclusion of reasonably similar instruments that market participants may develop in the future. The types of instruments that generally satisfy the criteria set forth in Rule 3b–13 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. Other types of instruments also satisfy the criteria in the rule.

The definition of eligible OTC derivative instrument has also been revised to omit terms commonly understood in the context of the CEA. As a technical matter, exchange-traded futures will now fall within the definition of eligible OTC derivative instrument. As discussed in Section II.A.1. above, however, the rules limit only the *securities* activities of an OTC derivatives dealer, and, subject to appropriate capital treatment and compliance with internal risk management controls requirements, an OTC derivatives dealer generally may engage in any non-securities activities. Thus, the new regulatory structure does not limit an OTC derivatives dealer's ability to engage in futures activities, which is consistent with the current approach toward the regulation of general securities broker-dealers. The activities of an OTC derivatives dealer, however, must comply with any and all applicable laws, including the CEA to the extent it applies to any particular transaction.

In response to comments raised by the SIA,[81] the final rule also distinguishes between government securities forwards and other securities forwards with respect to duration periods. Rule 3b–13 generally excludes from the definition of eligible OTC derivative instrument forwards on a government security that settle within twelve months, and certain other securities forwards that satisfy the definition of ''eligible forward contract'' [82] that settle within four months.[83] Although the duration period for an ''eligible forward contract'' is shorter than the original proposal of one year for all securities forwards, the periods better reflect the manner in which an OTC derivatives business is conducted and will continue to constrain an OTC derivatives dealer from improperly engaging in the types of forward transactions that should occur in its fully regulated broker-dealer affiliate.[84] The final rule has also been revised to include as eligible OTC derivative instruments those securities forwards that have material economic features primarily of a type described in the definition of eligible OTC derivative instrument (other than the provision for the purchase and sale of a security on a firm basis).

The definition of eligible OTC derivative instrument excludes securities derivative instruments that are listed or traded on an exchange or on Nasdaq. Similarly, the definition excludes those securities derivative instruments that are one of a class of fungible instruments that are standardized as to their material economic terms. With respect to the exclusion for certain fungible instruments, the Commission has retained the authority under Rule 15a–1(b)(2) to determine by order that a securities derivative instrument that is one of a class of fungible instruments that are standardized as to their material economic terms is within the scope of eligible OTC derivative instrument. This

[76] SIA Letter I, pp. 9–10; MSDW Letter, pp. 7–8.

[77] SIA Letter I, p.9.

[78] MSDW Letter, pp. 7–8.

[79] Rule 3b–13(a) (17 CFR 240.3b–13(a).

[80] *See* Rule 3b–13(b) (17 CFR 240.3b–13).

[81] *See supra* note 73.

[82] For purpose of Rule 3b–13, the term ''eligible forward contract'' means ''a forward contract that provides for the purchase or sale of a security other than a government security, provided that, if such contract provides for the purchase or sale of margin stock (as defined in Regulation U of the Regulations of the Board of Governors of the Federal Reserve System, 12 CFR part 221), such contract either (1) provides for the purchase or sale of such stock by the issuer thereof (or an affiliate that is not a bank or a broker or dealer); or (2) provides for the transfer of transaction collateral in an amount that would satisfy the requirements, if any, that would be applicable assuming the OTC derivatives dealer party to such transaction were not eligible for the exemption from Regulation T of the Regulations of the Board of Governors of the Federal Reserve System, 12 CFR part 220, set forth in (Rule 36a1–1).

[83] In its comment letter, the SIA requested guidance regarding the application of the duration requirement for securities forwards in the context of certain transaction structures that require a forward to be market-to-market and repriced. *See* SIA Letter II, p. 2, n.1. For example, a contract may provide that it is to be periodically marked-to-market and repriced with a settlement payment to be made on each repricing date in an amount equal to the change in the value of the underlying security. *Id.* In response to the SIA's request, under Rule 3b–13, where a securities forward transaction provides for reset or repricing dates, such dates will be viewed as settlement dates, and will cause the forward to be separated into shorter duration periods, only if the parties can close out the transaction on such dates. For example, if a one-year securities forward resets monthly to mitigate the credit risk associated with the transaction, and the parties can close out the forward on the reset date, for purposes of Rule 3b–13, the transaction will be regarded as separate one-month forward transaction. If, however, the parties are not able to close out the forward, or otherwise discharge their obligations under the contract by accelerating all or part of the originally scheduled physical settlement, on the reset dates, then the reset dates will not be viewed as separate settlement dates.

[84] A fully regulated broker-dealer is not permitted to move its securities book to the OTC derivatives dealer by forwarding out its positions and then reversing those transactions. *See* Rule 15a–1(a) (17 CFR 240.15a–1(a).

authority will permit the Commission, in limited circumstances, to expand the types of securities derivative instruments in which an OTC derivatives dealer may engage in dealer activities. The Commission is amending Rule 30–3 of the Rules of Practice to delegate this authority to the Director of the Division of Market Regulation.[85]

As noted above, the Commission responded to commenters' concerns by adopting an expansive definition of eligible OTC derivative instrument, with few exclusions. The final rule thereby permits an OTC derivatives dealer to deal in a broad array of financial instruments in order to accommodate current business practices.[86] Because of this accommodation, however, the Commission has also reserved the authority under Rule 15a–1(b) to issue orders clarifying whether certain contracts, agreements, or transactions are within the scope of eligible OTC derivative instrument.[87]

The final rules, however, do not define the term ''securities OTC derivative instrument,'' which is intended to encompass OTC derivative instruments that are securities. The term ''security'' is defined in section 3(a)(10) of the Exchange Act,[88] and the final rules do not interpret or amend the definition of ''security'' under the Exchange Act. Staff guidance will continue to remain available regarding the applicability of the federal securities laws to any particular OTC derivative instrument.[89]

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

Proposed Rule 3b–14 defined those entities and natural persons that would have been eligible to engage in an OTC derivatives transaction with an OTC derivatives dealer. As the Proposing Release noted, these persons included the same persons who currently are eligible to effect transactions with swaps dealers under the CFTC's Part 35 regulations.[90] The Proposing Release also sought specific comment on whether the definition of permissible derivatives counterparty should be expanded to include natural persons having at least $5 million in total assets who entered into OTC derivatives transactions to hedge existing or anticipated assets or liabilities.[91]

Most commenters suggested that a broad range of persons should be able to act as permissible derivatives counterparties, and believed that the definition should be expanded, at a minimum, to include natural persons having at least $5 million in total assets as proposed.[92] The SIA opined that these natural persons were appropriate counterparties and would benefit from having access to risk mitigation products that could be tailored to their individual circumstances and objectives.[93]

A few commenters, however, raised concerns that the proposed group of permissible derivatives counterparties could include unsophisticated persons who would need the protections provided by the securities sales practice requirements.[94] D.E. Shaw & Co. noted that an OTC derivatives dealer would have to rely upon information provided by the counterparty as to its total assets or net worth, and suggested that an OTC derivatives dealer should only be required to have a ''reasonable belief'' that the counterparty was a ''permissible derivatives counterparty.''[95]

The CFTC, in turn, raised concerns that conflicts might arise between the Commission's rules and the CFTC's rules in connection with the proposed definition of permissible derivatives counterparty, particularly if the definition were expanded to include parties who would not be eligible swap participants under the CFTC's Part 35 regulations. The CFTC suggested that if an OTC derivatives dealer were to enter into a transaction with a permissible derivatives counterparty that was not an eligible swap participant, the transaction would be outside the exemption of the Part 35 regulations, and could therefore constitute an illegal futures or commodity option contract.[96]

In response to commenters' concerns, and in light of the protections afforded through other provisions of the alternative regulatory framework, the final rules do not restrict the persons that may act as counterparties in OTC derivatives transactions with an OTC derivatives dealer. Instead, the final rules contain certain safeguards designed to protect an OTC derivatives dealer's counterparties, as well as to prevent trading in standardized and fungible OTC derivative instruments that are securities.

In particular, Rule 15a–1 requires, subject to limited exceptions, an OTC derivatives dealer to effect any securities transaction through its fully regulated broker-dealer affiliate, subject to all applicable sales practice requirements.[97] In addition, Rule 3b–13 excepts from the definition of eligible OTC derivative instrument those securities contracts that are one of a class of fungible instruments that are standardized as to their material economic terms.[98] The elimination of counterparty restrictions also addresses concerns that confusion about the applicability of the CEA could arise as a result of any differences between the terms ''permissible derivatives counterparty'' and ''eligible swap participant.'' As noted above, this rulemaking does not affect the applicability of the CEA to any particular transaction.

4. Proposed Rule 3b–16; Definition of Hybrid Security

As proposed, Rule 3b–16 would have defined hybrid security to 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). The definition of hybrid security did not raise many comments.

The CFTC, however, expressed concerns that, in proposing a definition of hybrid security, no consideration was given to the scope of the exemption for hybrid instruments contained in the CFTC's Part 34 regulations.[99] The CFTC

[85] *See* Rule 30–3(a)(65) (17 CFR 200.30–3(a)(65). *See also* Section II.C.2. below, discussing the ability of the Commission to issue orders under rule 15a–1(b) (17 CFR 240.15a–1(b) regarding the securities activities of OTC derivatives dealers.

[86] The Commission will consider the economic realities of a securities transaction, and not the label assigned to the transaction, for purposes of determining whether a particular transaction is permitted under the alternative regulatory framework. *See, e.g., In the Matter of BT Securities Corporation,* Exchange Act Release No. 35136 (Dec. 22, 1994). For example, an OTC derivatives dealer may not engage in a forward transaction that would otherwise not be permitted under the framework in the guise of options or other permitted transactions.

[87] *See* Rule 15a–1(b)(3) (17 CFR 240.15a–1(b)(3). Unlike other provisions contained in these rules that permit the expansion of OTC derivatives dealers' activities, this authority has not been delegated to the staff.

[88] 15 U.S.C. 78c(a)(10).

[89] Questions on this subject should be addressed to the Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW, Mail Stop 10–1, Washington, DC 20549, (202) 942–0073

[90] Proposing Release, Section II.A.3., 62 FR at 67942.

[91] *Id.*

[92] *See* letters cited in Section IV.C. of the Comment Summary.

[93] SIA Letter I, p. 10.

[94] *See, e.g.,* NYSE Letter, p. 3; EUDA Letter, p. 2.

[95] DESCO Letter, pp. 7–8.

[96] CFTC Letter, p. 12.

[97] Rule 15a–1(c) (17 CFR 240.15a–1(c)).

[98] Rule 3b–13(b)(2)(ii) (17 CFR 240.3b–13(b)(2)(ii)).

[99] CFTC Letter, p. 13. Hybrid instruments are depository instruments or securities instruments, such as debt or equity securities, that have one or more commodity-dependent components with payment features similar to commodity futures or

noted that some of the instruments that would qualify as ''acceptable'' hybrid securities were actually futures or commodity option contracts that were not exempted under the CFTC's Part 34 regulations and could thus be illegal under the CEA.[100]

The term hybrid security, however, is limited to *securities* that incorporate the enumerated payment features. In addition, the alternative regulatory framework employs the term only in the context of an OTC derivatives dealer's ability to issue and reacquire its issued securities (including hybrid securities) under Rules 3b–12 and 15a–1. Moreover, as stated previously, an OTC derivatives dealer remains subject to all other applicable statutes, rules, and regulations. To the extent that the offer and sale of hybrid securities by an OTC derivatives dealer are covered by the CEA, the transactions would need to be structured to qualify for available exemptions. Nevertheless, because of the limited use of the term under the alternative regulatory framework, the Commission is not adopting a separate rule defining ''hybrid security,'' but rather is including a definition of the term only for purposes of Rules 3b–12 and 15a–1.

Certain revisions have been made to the definition of ''hybrid security'' to achieve conformity with the revisions to the final definition of eligible OTC derivative instrument as set forth in Rule 3b–13.[101] Accordingly, for purposes of Rules 3b–12 and 15a–1, a ''hybrid security'' is defined to mean a security that incorporates payment features economically similar to options, forwards, futures, swap agreements, or collars involving currencies, interest or other rates, commodities, securities, indices, quantitative measures, or other financial or economic interests or property of any kind, or any payment or delivery that is dependent on the occurrence or nonoccurrence of any event associated with a potential financial, economic, or commercial consequence (or any combination, permutation, or derivative of such contract or underlying interest).[102]

5. Rules 3b–14 and 3b–15; Definitions of Cash Management Securities Activities and Ancillary Portfolio Management Securities Activities

Proposed Rule 3b–15 would have permitted an OTC derivatives dealer to engage in a limited range of securities activities, described under the rule as ''permissible 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 alternate regulatory system for OTC derivatives dealers is to permit U.S. securities firms to establish a separately capitalized booking vehicle for an OTC derivatives business. However, in order to operate a competitive business, an OTC derivatives dealer must also be able to engage in limited securities trading activities in connection with its OTC derivatives dealing business. This includes the ability to take possession of and sell counterparty collateral, to invest short-term cash balances, to engage in certain financing transactions, and to manage risks associated with its OTC derivatives positions or its issuance of securities.

These related securities activities, however, must be subject to appropriate limitations to prevent an OTC derivatives dealer from engaging in dealing activity in cash market instruments. An OTC derivatives dealer should not be provided with an unfair regulatory advantage over a fully regulated broker-dealer due to the availability of modified capital and margin requirements. In addition, an entity that engages in comprehensive securities dealing activity should be subject to full broker-dealer regulation, including existing capital and margin requirements, and be subject to supervision by an SRO.

Moreover, appropriate limitations on the related securities activities of an OTC derivatives dealer must be in place to prevent the dealer from engaging in substantial proprietary securities trading activities. The alternative regulatory framework is not intended to allow an OTC derivatives dealer to operate in a manner similar to an active securities trader, such as a hedge fund. Accordingly, under the final rules, an OTC derivatives dealer may not engage in any transaction in any security that is not an eligible OTC derivative instrument, with the exception of activities permitted under final Rules 3b–14 and 3b–15, as discussed below.[103]

Under the regulatory framework, as proposed, the definition of ''permissible risk management, arbitrage, and trading transactions'' attempted to carefully define activities associated with managing the risk of an OTC derivatives dealer's business, while excluding other securities dealing and proprietary trading activities. Based on the comments received on the scope of ''permissible risk management, arbitrage, and trading transactions,'' however, the final rules have been restructured to more accurately reflect the types of cash management and portfolio management activities engaged in by dealers in OTC derivative instruments. Therefore, as noted above, the Commission is not adopting a definition of ''permissible risk management, arbitrage, and trading transactions,'' but rather is defining two new terms: ''cash management securities activities'' and ''ancillary portfolio management securities activities.'' [104]

a. *Rule 3b–14; Cash Management Securities Activities.* An OTC derivatives dealer may engage in ''cash management securities activities,'' as defined in Rule 3b–14. Under the rule, an OTC derivatives dealer may engage in cash management securities activities in connection with its securities activities as permitted under Rule 15a–1 (discussed in Section II.C.1. below) or its non-securities activities that involve eligible OTC derivative instruments or other financial instruments. Cash management securities activities are limited to (1) any taking possession of, and any subsequent sale or disposition of, collateral provided by a counterparty, or any acquisition of, and any subsequent sale or disposition of, collateral to be provided to a counterparty; (2) cash management; and (3) financing of certain positions of the dealer. Each of these three categories of cash management securities activities is discussed in more detail below.

i. Counterparty Collateral. Proposed Rule 3b–15(a) would have allowed an OTC derivatives dealer to take possession of and sell counterparty collateral, in connection with the dealer's business as a counterparty in eligible OTC derivative instruments and as an issuer of securities. The SIA

commodity option contracts. Under the CFTC's part 34 regulations, such instruments may be exempt from regulation under the CEA if the sum of the commodity-dependent values of the commodity-dependent components of the instrument is less than the commodity-dependent value of the commodity-independent component. 17 CFR part 34.

[100] CFTC Letter, p. 13.

[101] *See* discussion at Section II.A.2. above *See also* SIA Letter II, p. 3, n.2.

[102] *See* Rules 3b–12(d) (17 CFR 240.3b–12(d)) and 15a–1(e) (17 CFR 240.15a–1(e)).

[103] *See* Rules 3b–12(c) (17 CFR 240.3b–12(c)) and 15a–1(a)(3) (17 CFR 240.15a–1(a)(3)).

[104] With certain exceptions (*see* Section II.C.3. below), all cash management securities activities and ancillary portfolio management securities activities must be effected through an OTC derivatives dealer's fully regulated broker-dealer affiliate. *See* Rule 15a–1(c) (17 CFR 240.15a–1(c)).

argued that this provision unduly restricted the scope of activities, and requested that the rule be modified to allow an OTC derivatives dealer to engage in (1) any disposition of collateral provided by a counterparty; and (2) the acquisition of, and any subsequent sale or disposition of, collateral to be provided to a counterparty.[105]

To allow an OTC derivatives dealer to take appropriate action with respect to counterparty collateral, an OTC derivatives dealer's activities should not be limited to taking possession of and selling collateral, but should also extend to other dispositions of the collateral. Therefore, Rule 3b–14(a), as adopted, has been revised to expand the permissible activities of an OTC derivatives dealer with respect to counterparty collateral.

Rule 3b–14(a), like proposed Rule 3b–15(a), does not limit any use of the counterparty collateral consistent with the agreements entered into between dealers and their counterparties. As the End-Users of Derivatives Association, Inc. (''EUDA'') noted, many end-users deny counterparties free use of posted collateral because it may expose the pledging party to significant additional credit risk.[106] In this regard, Rule 3b–14 is not intended to have any effect on individually negotiated collateral support agreements or any rehypothecation rights contained in these agreements.

ii. Cash Management. Rule 3b–14(b), as adopted, permits an OTC derivatives dealer to engage in cash management activities in connection with the dealer's securities activities (as permitted under Rule 15a–1) or its non-securities activities that involve eligible OTC derivative instruments or other financial instruments.[107] Rule 3b–14(b) applies only to managing cash of the OTC derivatives dealer, and not of its affiliates. Thus, any securities trading activities associated with cash management by an OTC derivatives dealer must be at a level commensurate with the OTC derivatives dealer's bona fide operational needs, taking into consideration the Commission's capital requirements for the OTC derivatives dealer and the amount of capital needed to satisfy the credit requirements of counterparties.

Cash management securities activities must also be limited to trading in instruments that are sufficiently liquid and otherwise recognized as appropriate cash management instruments. In addition, these activities may not involve moving government securities repurchase agreement or other trading books from a fully regulated broker-dealer into its OTC derivatives dealer affiliate.

iii. Financing. Under proposed Rule 3b–15(d), an OTC derivatives dealer generally would have been permitted to engage in financing transactions in connection with its business as a counterparty in eligible OTC derivative instruments and as an issuer of securities. The proposed rule would also have required that these financing activities be limited to transactions involving securities positions established through the taking possession of or sale of counterparty collateral, cash management, or hedging activity. The SIA regarded these limitations as unduly restrictive, and believed that an OTC derivatives dealer should be permitted to finance any aspect of its permitted activities, subject to compliance with Section 7(c) or (d) of the Exchange Act, as applicable.[108]

In response to these concerns, Rule 3b–14(c) provides that an OTC derivatives dealer may finance through securities transactions any position of the dealer acquired in connection with its permissible securities activities or its non-securities activities that involve eligible OTC derivative instruments or other financial instruments. Proposed Rule 3b–15 would have permitted financing of certain securities positions by means of repurchase and reverse repurchase agreements, buy/sell transactions,[109] and lending and borrowing transactions. The final rule eliminates the list of restrictions on the types of transactions in which an OTC derivatives dealer may engage to finance its positions. However, a broker-dealer may not run such things as a repurchase agreement, stock lending, or buy/sell book out of an affiliated OTC derivatives dealer in order, for example, to have access to financing for the OTC derivatives dealer's business.

b. *Rule 3b–15; Ancillary Portfolio Management Securities Activities.* In addition to cash management securities activities, an OTC derivatives dealer may engage in ''ancillary portfolio management securities activities,'' as defined in Rule 3b–15. Under the rule, these securities activities must be limited to transactions in connection with the OTC derivatives dealer's dealer activities in eligible OTC derivative instruments, the issuance of securities by the dealer, or such other securities activities that the Commission may designate by order. They must also (1) be conducted for the purpose of reducing the market or credit risk of the dealer or consist of incidental trading activities for portfolio management purposes; and (2) be limited to risk exposures within the market, credit, leverage, and liquidity risk parameters set forth in both the trading authorizations granted to the associated person (or to the associated person's supervisor) who executes the transaction for, or on behalf of, the dealer, and the written guidelines approved by the dealer's governing body and included in the dealer's internal risk management control system.[110] Rule 3b–15 also requires that ancillary portfolio management securities activities be conducted only by associated persons of the dealer who perform substantial duties for or on behalf of the dealer in connection with its dealer activities in eligible OTC derivative instruments.

The limitations on an OTC derivatives dealer's portfolio management activities under Rule 3b–15 are aimed at preventing the fully regulated broker-dealer from moving its securities book into its OTC derivatives dealer affiliate, establishing a proprietary trading desk in the OTC derivatives dealer, or authorizing personnel or trading units specifically to engage in proprietary trading activities.[111] These activities are not within the scope of an OTC derivatives dealer's primary role as a booking vehicle for OTC derivatives transactions, and a firm engaging in

[105] SIA Letter I, p. 8.

[106] EUDA Letter, p. 3.

[107] As proposed, Rule 3b–15(b) would have permitted an OTC derivatives dealer to engage in transactions involving cash management, in connection with the dealer's business as a counterparty in eligible OTC instruments and as an issuer of securities. Proposing Release, Section II.A4., 62 FR at 67943. No commenters specifically addressed permitted cash management practices.

[108] SIA Letter I, p. 8.

[109] A buy/sell transaction is in many respects the economic equivalent of a repurchase transaction. The principal respect in which it differs is that title to the instrument that is the subject of the transaction passes to another party. *See* Proposing Release, Section II.A.4., n.22, 62 FR at 67943, n.22.

[110] As discussed in Section II.H.3. below, Rule 15c3–4 (17 CFR 240.15c3–4) requires an OTC derivatives dealer to establish, document, and maintain a system of internal controls for monitoring and managing risk associated with its business activities.

[111] *See also* Section II.A.1. above, discussing the limitations on securities activities imposed under Rule 3b–12. In short, the scope of permissible portfolio management securities activities is further limited by the requirement under Rule 3b–12 that the securities activities of an OTC derivatives dealer consist primarily of engaging in dealer activities in eligible OTC derivative instruments that are securities, issuing and requiring securities that are issued by the dealer, and cash management securities activities. *See* Rule 3b–12(b) (17 CFR 240.3b–12(b)).

these activities would be in violation of the rules.[112]

Rule 3b–15, however, does permit an OTC derivatives dealer to engage in incidental securities trading activities for portfolio management purposes. In permitting this, the rule recognizes that an OTC derivatives dealer may to a limited extent engage in a securities trading activity for portfolio management purposes that may not necessarily be for the specific purpose of reducing the dealer's market or credit risk.[113] This provision of the rule, however, is not intended to permit an OTC derivatives dealer to engage in substantial securities trading that is not for the purpose of reducing the dealer's market or credit risk arising out of its dealer activities in eligible OTC derivative instruments (or its issuance of securities).

As discussed more fully below, the Commission has responded to commenters by easing the restrictions on the non-dealing securities activities of OTC derivatives dealers and by broadly defining ancillary portfolio management securities activities. The final rules are intended to be flexible and to accommodate current business practices of OTC derivatives dealers. Because, as drafted, the rule defines a broad scope of permissible activities, the restrictions on proprietary trading and dealing in cash markets may prove inadequate. Thus, Rule 15a–1(b)(4) preserves the Commission's ability to clarify, by order, whether certain securities activities of an OTC derivatives dealer are within the scope of ancillary portfolio management securities activities.[114]

Because the commenters generally focused on the categories of activities identified in the definition of ''permissible risk management, arbitrage, and trading transactions'' under proposed Rule 3b–15, each of these categories is discussed separately below.

i. Hedging. Under proposed Rule 3b–15(c), an OTC derivatives dealer would have been permitted to ''hedge 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.'' This is the only section of the proposed rules that specifically addressed the risk management practices of an OTC derivatives dealer. For that reason, some commenters believed that the Commission should more clearly define what activities would be considered ''hedging activity.'' [115] They essentially did not want an OTC derivatives dealer to be limited to hedging only those risks arising in connection with the dealer's business as a counterparty in eligible OTC derivative instruments and as an issuer of securities, but rather wanted the firm to be able to manage risks on a portfolio-wide basis through hedging or other risk management techniques.

For instance, the SIA regarded the limitation on the ''hedging'' activities listed in the proposed rule as unduly restrictive, and believed that an OTC derivatives dealer should be permitted to ''engage in any risk management transaction that is designed to implement management's decision as to the market risk profile the firm wishes to obtain.'' [116] In this regard, the SIA commented that dealers do more than just hedge their positions, and that many dealers take on levels of risk consistent with certain risk parameters. The SIA also claimed that an OTC derivatives dealer should be permitted to manage the risks associated with cash management, financing, and other permissible securities positions, in addition to the risks arising from permissible derivative and hybrid positions.[117] D.E. Shaw & Co., in turn, stated that an OTC derivatives dealer should also be able to engage in risk management activities that involve the hedging of ''liquidity, legal, or operational risks, or any other risks for which derivative hedging products are developed.'' [118]

As discussed earlier, in response to comments received regarding the manner in which dealers in OTC derivative instruments conduct their business activities, the Commission has restructured the final rules to better reflect current firm practices. As a result, Rule 3b–15, as adopted, incorporates the concept of managing risk on a portfolio-wide basis, and omits any reference to the term ''hedging.'' Thus, the rule does not expressly limit the range of permissible portfolio management securities activities. Instead, these activities are limited by the requirement that they not give rise to risk exposures that, on an aggregate portfolio basis, exceed the risk limits adopted for the dealer's business under Rule 15c3–4,[119] as well as other requirements that serve to ensure that the OTC derivatives dealer does not engage in dealer activities in cash market securities or substantial proprietary trading activities.

ii. Arbitrage. Under proposed Rule 3b–15(e), an OTC derivatives dealer would have been permitted to engage in a transaction involving arbitrage, provided that any arbitrage involving securities was limited to arbitrage of a securities position that was acquired in connection with the taking possession of or selling of counterparty collateral, cash management, or hedging activity.[120] The SIA requested that

[112] *See* Rule 15a–1 (17 CFR 240.15a–1), and discussion in Section II.C. below.

[113] For example, a firm that has a long position in equity volatility as a result of OTC derivatives transactions with counterparties is not required to engage in ancillary portfolio management securities activities that reduce that volatility exposure. Instead, for example, a firm that believes that equity volatility exposure. Instead, for example, a firm that believes that equity volatility is underpriced in the market could enter into exchange-listed derivatives transactions to create or increase existing long volatility exposure. Similarly, a firm whose OTC derivatives portfolio included risk exposure to a particular asset category or credit could enter into non-OTC derivatives transactions in securities that would effectively convert that exposure to a different asset category or credit.

[114] *See* Rule 15a–1(b)(4) (17 CFR 240.15a–1(b)(4)). The Commission is not delegating this authority to its staff.

[115] *See, e.g.*, Comment Letter from the Association of the Bar of the City of New York, Committee on Futures Regulation (''ABCNY Committee Letter''), p. 3; *see also* letters cited in Section IV.F.1.b. of the Comment Summary.

[116] SIA Letter I, p. 8.

[117] *Id. See also* Merrill Lynch Letter, p. 5. In a later comment letter, the SIA also stated that, so long as an OTC derivatives dealer's securities activities consisted primarily of conducting an OTC derivatives dealing business, an OTC derivatives dealer should be permitted to engage in cash market securities trading activities for portfolio management purposes, provided that these activities did not give rise to portfolio risk exposures that, on an aggregate basis, exceeded the risk management parameters for the dealer's business pursuant to proposed Rule 15c3–4. SIA Letter II, p. 1. It maintained that this approach would permit the dealers to engage in portfolio management activities consistent with the manner in which such firms currently manage their OTC derivatives businesses, but would still preclude firms from establishing OTC derivatives dealers to conduct a proprietary trading business in cash market securities. *Id.* While Rule 3b–15, as adopted, has been revised in response to the SIA's comments, the rule includes additional limitations as a means of permitting reasonable portfolio management securities activities, while also prohibiting overly broad securities trading activities.

[118] DESCO Letter, p. 7.

[119] In addition to the risk parameters set forth in the written guidelines included in the dealer's internal risk management control system under Rule 15c3–4 (17 CFR 240.15c3–4), the appropriate levels of risk assumed by an OTC derivatives dealer are also to be determined by the dealer through trading authorizations or limits placed on the associated person executing a transaction on the dealer's behalf. *See* Rule 3b–15(a)(3)(i) (17 CFR 240.3b–15(a)(3)(i)).

[120] The Proposing Release further stated that permissible arbitrage transactions would be limited to transactions involving closely related cash market and derivative instruments that were 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

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permissible arbitrage activities be expanded to include (1) arbitrage of eligible OTC derivatives instruments; (2) arbitrage of short securities positions; and (3) arbitrage of prospective securities purchases or sales under permitted forward arrangements.[121]

The final rules do not use the term ''arbitrage'' in describing the scope of risk management activities in which an OTC derivatives dealer may engage. Instead, the rules are intended to permit any portfolio management transaction, including arbitrage transactions, that meet the conditions in the rules. As a practical matter, however, a firm engaging in an OTC derivatives business typically does not engage in ''arbitrage'' transactions that would not otherwise qualify as an ancillary portfolio management securities activity. Rule 3b–15 allows a firm to manage its positions and make a profit, provided that the activities occur in connection with its derivatives dealing business (or the issuance of securities) and meet the other conditions set forth in the rule.

iii. Trading. To avoid inadvertent violations of the proposed rules through an inability to properly document the purpose of a transaction, proposed Rule 3b–15(f) would have allowed the OTC derivatives dealer to engage in a limited number of certain additional trading transactions. In particular, an OTC derivatives dealer generally would have been permitted to engage in no more than 150 additional securities transactions per year relating to a securities position acquired in connection with the taking possession of or selling of counterparty collateral, cash management, or hedging activity. Proposed Rule 3b–15(f) would have further required an OTC derivatives dealer engaging in any such trading transaction to maintain and enforce written policies and procedures reasonably designed to achieve compliance with the other provisions of proposed Rule 3b–15.

Commenters generally criticized proposed Rule 3b–15(f).[122] This provision was essentially crafted to create a limited ''safe harbor'' to protect dealers from committing inadvertent violations of the proposed rules because of their inability to properly document the purpose of a transaction. The majority of commenters, however, had difficulty understanding or applying the provision. For example, the SIA expressed concern that the limitation on trading activities might inadvertently exclude the purchase or disposition of securities delivered or received, or to be delivered or received, by the OTC derivatives dealer pursuant to the terms of an eligible OTC derivative instrument.[123] It also recommended that the proposed 150 transaction basket be clarified to indicate that the basket was not intended to place a limit on the number of securities transactions that could be entered into by an OTC derivatives dealer if such transactions could be demonstrated to relate to permitted activities.

Several commenters thought the 150 transaction limit was too low. For example, the SIA believed that the proposed basket was potentially too small and would not adequately reflect the character and scope of a particular firm's activities.[124] As an alternative, several commenters recommended that the size of any such basket be related to the scope of the OTC derivatives dealer's activities rather than a specified number of transactions.[125] The Committee on Futures Regulation of the Association of the Bar of the City of New York suggested that, instead of an arbitrary number of ''allowable'' transactions per year, the Commission, through its examination process, make determinations of whether a securities transaction was entered into with a good faith belief that it satisfied one of the purposes set forth in the rule.[126]

In response to these comments, the Commission has not included a safe harbor provision in either Rule 3b–14 or Rule 3b–15 allowing for inadvertent violations of the rules. Rather, under the final rules, an OTC derivatives dealer may engage in cash management securities activities and ancillary portfolio management securities activities, as those terms are defined in Rules 3b–14 and 3b–15.

iv. Documentation of Activities. Proposed Rule 3b–15(f), which contained the 150 transaction ''safe harbor,'' also generated concern regarding whether an OTC derivatives dealer would be required to document the purpose of each individual transaction. Commenters argued that, to the extent the rules required individual transaction documentation, they were inconsistent with portfolio management practices. Instead, commenters suggested that dealers be allowed to demonstrate on a portfolio-wide basis that their cash market transactions were consistent with the restrictions set forth in the rules.[127]

As discussed in the Proposing Release, the nature of risk management activities makes it difficult to determine whether a particular transaction satisfies the requirements set forth in the rules.[128] The requirement that an OTC derivatives dealer develop reasonable procedures for ensuring compliance with the restrictions in the rules was intended, in fact, to accommodate current portfolio risk management practices. The rules do not require that documentation of the intended purposes of individual securities trades be maintained by the OTC derivatives dealer. Rather, an OTC derivatives dealer must develop reasonable procedures for ensuring compliance with the restrictions set forth in the rules and for demonstrating the relationship between its risk management activities and the positions it maintains on a portfolio-wide basis.[129]

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

Under the proposed amendments to Rule 15b1–1,[130] a firm seeking to register as an OTC derivatives dealer would have been required to register with the Commission by filing Form BD, the Uniform Application for Broker-Dealer Registration.[131] No comments were received regarding these proposed amendments. Accordingly, the amendments to Rule 15b1–1 are being adopted as proposed.

A firm that elects to register as an OTC derivatives dealer must file an application for registration on Form BD, in accordance with the instructions on the form. The form must be filed with the Central Registration Depository, a computer system operated by the NASD. In completing Item 10 of the form, which asks an applicant to disclose its planned business activities, an OTC derivatives dealer must respond by checking ''other'' and writing in that it proposes to engage in the business of an OTC derivatives dealer.[132] Some OTC

security that were effected close together in time, taking into consideration market liquidity and hours of market operations. Proposing Release, Section II.A.4., n.23, 62 FR at 67943, n.23.

[121] SIA Letter I, p. 8. *See also* Section IV.F.1.d. of the Comment Summary.

[122] *See* Section IV.F.1.e. of the Comment Summary.

[123] SIA Letter I, pp. 8–9.

[124] *Id.*

[125] *E.g.*, SIA Letter I, p. 9; Merrill Lynch Letter, p. 6.

[126] ABCNY Committee Letter, p. 3.

[127] *See* Section IV.F.2. of the Comment Summary.

[128] Proposing Release, Section II.A.4., 62 FR at 67943.

[129] *See* Section II.H.3. below, discussing Rule 15c3–4 (17 CFR 240.15c3–4), which addresses internal risk management control systems for OTC derivatives dealers.

[130] 17 CFR 240.15b1–1.

[131] 17 CFR 249.501.

[132] *See also* Section II.F.3.b.i. below, discussing the requirement that an OTC derivatives dealer send an application to the Commission with respect to the dealer's use of VAR models to calculate net capital.

derivatives dealers may also be required to comply with Exchange Act provisions applicable to government securities activities.[133] For instance, if an OTC derivatives dealer were to write an option on a government security, it would be considered to be a government securities dealer. Pursuant to Section 15C(a)(1)(B)(i),[134] a broker or dealer effecting, inducing, or attempting to induce the purchase or sale of a government security must file with the appropriate regulatory agency written notice that it is a government securities broker or dealer.[135] As a result, an OTC derivatives dealer that engages in government securities transactions must also file notice of such activities with the Commission, by checking ''yes'' in response to Item 13A on Form BD.

C. Rule 15a–1; Securities Activities of OTC Derivatives Dealers

1. Scope of Permissible Securities Activities

Proposed Rule 15a–1 would have permitted an OTC derivatives dealer to (1) engage as a counterparty in transactions in eligible OTC derivative instruments with permissible derivatives counterparties; (2) issue and reacquire issued securities, including warrants on securities, hybrid securities, and structured notes; and (3) engage in other securities transactions that the Commission designated by order. In connection with these activities, an OTC derivatives dealer would also have been permitted to engage in permissible risk management, arbitrage, and trading transactions, as defined in proposed Rule 3b–15.

Because Rule 15a–1 describes the securities activities in which an OTC derivatives dealer may engage, it parallels the requirements contained in Rule 3b–12, which defines the term ''OTC derivatives dealer.'' Thus, the comments addressing proposed Rule 15a–1 were generally consistent with those concerning proposed Rule 3b–12.[136] The SIA urged that the rule be simplified by (1) making the proposed regulatory category available to ''dealers who are not engaged in the business of buying and selling securities other than securities that are eligible OTC derivative instruments''; and (2) deleting the proposed restrictions on non-dealing activities in securities contained in proposed Rule 15a–1.[137]

As discussed earlier, however, the new regime is not intended to permit an OTC derivatives dealer to engage in substantial proprietary securities trading activities. Rather, the purpose of the alternative regulatory framework is to allow U.S. securities firms to elect to establish a separately capitalized vehicle in which to book a client-oriented OTC derivatives business. As a result, the restrictions on these activities in Rule 15a–1 are necessary.

For the reasons discussed above and in Section II.A.1. with respect to the definition of OTC derivatives dealer, the Commission has revised Rule 15a–1 to provide that the securities activities of OTC derivatives dealer must be limited to (1) engaging in dealer activities in eligible OTC derivative instruments that are securities; (2) issuing and reacquiring securities that are issued by the dealer, including warrants on securities, hybrid securities, and structured notes;[138] (3) engaging in cash management securities activities; (4) engaging in ancillary portfolio management securities activities; and (5) engaging in such other securities activities that the Commission designates by order. In addition, an OTC derivatives dealer's securities activities must consist primarily of engaging in dealer activities in eligible OTC derivative instruments that are securities, issuing and reacquiring its issued securities, and engaging in cash management securities activities.[139]

The alternative regulatory framework for OTC derivatives dealers, as adopted, also includes a provision requiring that the dealer develop procedures to help ensure that it does not engage in securities activities beyond those permitted under Rule 15a–1. As discussed further in Section II.H.3. below, new Rule 15c3–4 requires an OTC derivatives dealer to establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities. As part of its obligations under Rule 15c3–4, an OTC derivatives dealer's written guidelines must include and discuss the dealer's procedures to prevent it from engaging in securities transactions that are not permitted under Rule 15a–1. In addition, Rule 15c3–4 requires the OTC derivatives dealer's management to periodically review the dealer's business activities for consistency with risk management guidelines, including whether procedures are in place to prevent the dealer from engaging in any impermissible securities transaction.

2. Commission Orders Regarding OTC Derivatives Dealers' Activities

Under Rule 15a–1(b), the Commission by order, entered upon its own initiative or after considering an application for exemptive relief, may clarify or expand the scope of permissible securities activities in which an OTC derivatives dealer may engage or the scope of eligible OTC derivative instruments. As discussed in earlier sections of this release, such orders may (1) identify other permissible securities activities in which an OTC derivatives dealer may engage; (2) determine that a class of fungible instruments that are standardized as to their material economic terms is within the scope of eligible OTC derivative instrument; (3) clarify whether certain contracts, agreements, or transactions are within the scope of eligible OTC derivative instrument; or (4) clarify whether certain securities activities are within the scope of ancillary portfolio management securities activities.

Applications for exemptive orders under Section 15a–1(b) should be filed

[133] In this regard, the SIA noted in its comment letter that an OTC derivatives dealer registered with the Commission that engages in transactions in eligible OTC derivative instruments that government securities would exempt from registration as a government securities dealer under Exchange Act Section 15C (15 U.S.C. 78o–5), subject to the notice requirement under Exchange Act section 15c(a)(1)(B) (15 U.S.C. 78o–5(a)(1)(B). SIA Letter I, p. 13.

[134] 15 U.S.C. 78o–5(a)(1)(B)(i).

[135] It must similarly file a written notice when it ceases to act as a government securities broker or dealer. 15 U.S.C. 78o–5(a)(1)(B)(i). *See also* Section 3(a)(44) of the Exchange Act (15 U.S.C. 78c(a)(44)) (defining government securities dealer).

[136] *See* Section II.A.1. above. For example, several commenters believed that the scope of permissible securities transactions under proposed Rule 15a–1 should be expanded, and that the proposed rule would unduly restrict the activities of an OTC derivatives dealer. *See, generally,* letters cited in Sections IV.A. and IV.E. of the Comment Summary.

[137] SIA Letter I, pp. 6–7.

[138] D.E. Shaw & Co. requested clarification regarding the ability of an OTC derivatives dealer to issue and reacquire its issued securities through a fully regulated broker-dealer. It asked whether the phrase meant that the fully regulated broker-dealer must be the issuer of the security or whether the fully regulated broker-dealer must act as principal or agent in the purchase of securities from, or the sale of securities to, the customer. D.E. Shaw & Co. also asked whether the OTC derivatives dealer could be the issuer of the security, as long as the OTC derivatives dealer complied with the registration, confirmation, and similar requirements set forth in the proposed rule. DESCO Letter, p. 9. In short, under Rule 15a–1, an OTC derivatives dealer may only issue its own securities, or reacquire its own securities, through a fully regulated broker-dealer; it may not act in a sales capacity or directly reacquire its securities from holders of such securities, except in limited circumstances with respect to certain counterparties. *See* Rule 15a–1(c) (17 CFR 240.15a–1(c)).

[139] As noted in Section II.A.1. above, although the rules limit the securities activities of OTC derivatives dealers, the Commission has retained the authority under Rule 15a–1 to identify other permissible securities activities for these entities. *See* Rule 15a–1(b)(1) (17 CFR 240.15a–1(b)(1)). This authority has been delegated to the Director of the Division of Market Regulation. *See* Rule 30–3(a)(64) (17 CFR 200.30–3(a)(64).

in accordance with Commission procedures set forth in Rule 0–12 under the Exchange Act.[140] The Commission may issue such orders to the extent they are necessary or appropriate in the public interest, and consistent with the protection of investors. In considering such orders, the Commission will consider whether the securities activities are of the type and nature of activities in which an OTC derivatives dealer may engage under Rule 15a–1, including whether such activities are integrated into, or integral to, the OTC derivatives dealing business of OTC derivatives dealers.

3. Intermediation of Securities Transactions

Proposed Rule 15a–1 would have required an OTC derivatives dealer to effect all securities transactions through a fully regulated broker-dealer. Accordingly, under proposed Rule 15a–1, all applicable SRO sales practice requirements would have applied to the securities transactions of an OTC derivatives dealer.

Several commenters argued that a fully regulated broker-dealer should not be required to intermediate every securities transaction.[141] The SIA maintained that the interpositioning of a broker-dealer was not necessary, particularly given the sophisticated character of the permissible derivatives counterparties, the active participation by such counterparties in structuring instruments to fulfill their particular needs, and the consensual negotiation of the terms of individual transactions.[142] The SIA further stated that, at a minimum, an OTC derivatives dealer should not be required to effect securities transactions through a fully regulated broker-dealer (1) where the counterparty to the transaction was a bank, broker-dealer, government securities broker, government securities dealer, or supranational organization; or (2) in connection with risk management, financing, arbitrage, or other trading transactions in which the OTC derivatives dealer was not acting in its capacity as a dealer, but rather as an investor or end-user.[143] The SIA also objected to the intermediation requirement in the context of offshore transactions involving foreign securities.[144]

D.E. Shaw & Co. also questioned whether an OTC derivatives dealer needed to effect a securities transaction through an *affiliated broker-dealer.* It claimed that an OTC derivatives dealer should also be able to effect these transactions through a bank or broker-dealer with which it had a working relationship.[145] Other commenters questioned the proposed rule's distinction between securities transactions and non-securities transactions, and claimed that if sales practice protection was warranted for securities transactions, then counterparties should receive similar protection for non-securities transactions undertaken with an OTC derivatives dealer.[146] The Chicago Board Options Exchange (''CBOE''), in turn, sought clarification as to which specific SRO sales practice rules would apply to a fully regulated broker-dealer effecting securities transactions for an OTC derivatives dealer's counterparties.[147]

Based on the comments received, Rule 15a–1, as adopted, provides certain limited exceptions to the requirement that securities transactions of an OTC derivatives dealer be effected through its fully regulated broker-dealer affiliate.[148] However, the rule has not been revised, as requested by some commenters, to eliminate the intermediation requirement in connection with cash management or ancillary portfolio management securities transactions in which the OTC derivatives dealer is not acting as a dealer, but rather as an investor or end-user.[149] Accordingly, all cash management securities activities and ancillary portfolio management securities activities of an OTC derivatives dealer must be effected by a fully regulated broker-dealer, unless the transaction is subject to one of the limited exceptions discussed below.[150]

The requirement that securities transactions be effected through a fully regulated broker-dealer is designed, in part, to ensure that all securities transactions remain subject to existing sales practice standards.[151] The requirement is also intended to prevent any regulatory disparity from arising between an OTC derivatives dealer, which is subject to modified capital and margin requirements, and a fully regulated broker-dealer in connection with conducting securities transactions. In addition, it is designed to reduce the risk that counterparties will mistakenly view an OTC derivatives dealer as a fully regulated broker-dealer, rather than as a booking vehicle for derivatives transactions.[152]

However, if the counterparty to a securities transaction is acting as principal and is itself either a registered broker or dealer (including another OTC

[140] 17 CFR 240.0–12.

[141] *See* letters cited in Section IV.E.1. of the Comment Summary.

[142] SIA Letter I, p. 11.

[143] SIA Letter I, p. 11. Similarly, D.E. Shaw & Co. argued that, in order to level the playing field with non-U.S. broker-dealers, an OTC derivatives dealer should be permitted to transact business directly (without a U.S. broker-dealer intermediary) with all parties with whom a non-U.S. broker-dealer could effect business under Rule 15a–6(a)(4) under the Exchange Act (17 CFR 240.15a–6(a)(4)), including a registered broker or dealer or a bank acting in a broker or dealer capacity. Likewise, it believed that where the OTC derivatives dealer itself is the counterparty to a securities derivatives transaction, the OTC derivatives dealer should not be required to effect the securities transaction through a fully regulated broker-dealer in connection with risk management, financing, arbitrage, or other trading transactions. DESCO Letter, p. 4.

[144] SIA Letter II, pp. 3–4. The SIA argued that the proposed broker-dealer intermediation requirement in the context of offshore transactions involving foreign securities could create significant burdens on registrants, without meaningful corresponding benefits. According to the SIA, if offshore transactions involving foreign securities are required to be intermediated by the fully regulated broker-dealer affiliate, firms might be required to register their non-U.S. offices as branch offices of their fully regulated U.S. broker-dealer (with potentially adverse tax, licensing, or other regulatory consequences) or to confront prohibitive logistical obstacles to compliance with the proposed requirement. The SIA was also concerned about the application of this provision to OTC derivatives transactions arranged and effected by employees resident in a foreign office of an OTC derivatives dealer with a counterparty that is also resident in a foreign jurisdiction. In this regard, it noted that local law may require that the transaction be effected through a locally registered entity, so that a transaction would have to be intermediated by two separate entities. For that reason, it suggested an exception to Rule 15a–1 for permissible securities transaction with foreign counterparties that are arranged and effected by non-U.S. resident employees of an OTC derivatives dealer.

[145] DESCO Letter, p. 3. D.E. Shaw & Co. stated that the restriction to use affiliates limited flexibility and placed an unnecessary burden on U.S. firms conducting a domestic derivatives business.

[146] *See, e.g.,* GFOA Letter, pp. 2–3; EUDA Letter, p. 2.

[147] Comment Letter from the Chicago Board Options Exchange (''CBOE Letter''), p. 5. The CBOE asserted that there is currently a disparity between NASD and NYSE options sales practice rules as applied to listed options, and argued that this disparity, as well as any other disparity between sales practice rules' application to qualified counterparties' OTC derivatives transactions and their listed options transactions, should be remedied.

[148] As noted earlier, an OTC derivative dealer may issue and reacquire its issued securities through an unaffiliated fully regulated broker-dealer. *See* Rule 15a–1(c) (17 CFR 240.15a–1(c)).

[149] *See supra* note 143 and accompanying text.

[150] In addition, the Commission has not revised Rule 15a–1 to extend sales practice requirements to non-securities transactions. As a general matter, sales practice requirements arising under the federal securities laws and SRO rules apply only to the securities transactions of broker-dealers.

[151] Unless otherwise expressly provided in the rules and rule amendments, the fully regulated broker-dealer must comply with all applicable sales practice requirements when effecting any securities transaction for, or on behalf of, an OTC derivatives dealer.

[152] For these same reasons, an OTC derivatives dealer may not effect a securities transaction through an unaffiliated broker-dealer, except in limited circumstances, or through a bank.

derivatives dealer), a bank acting in a dealer capacity, a foreign broker or dealer,[153] or an affiliate of the OTC derivatives dealer,[154] the counterparty is less likely to require the protections afforded by sales practice requirements. In addition, these counterparties are not likely to mistakenly believe that an OTC derivatives dealer is a fully regulated broker-dealer engaging in general securities transactions. Therefore, an OTC derivatives dealer is not required to use its fully regulated broker-dealer affiliate to effect securities transactions with these listed entities. This exception, however, applies only when the counterparty is acting as a principal (that is, for its own account), and not as agent for one of its customers.[155]

There is a second limited exception to Rule 15a–1(c), as adopted. If an OTC derivatives dealer engages in a transaction that is an ancillary portfolio management securities activity involving a foreign security,[156] it is not required to effect that transaction through its fully regulated broker-dealer affiliate if a registered broker or dealer, a bank, or a foreign broker or dealer is acting as agent for the OTC derivatives dealer.[157] This exception will permit an OTC derivatives dealer to select one of these professional intermediaries to represent it in foreign markets when purchasing or selling foreign securities for hedging or portfolio management purposes.

4. Communications Regarding Securities Transactions

The requirement that securities transactions be effected through a fully regulated broker-dealer means that the OTC derivatives dealer's counterparties in these transactions will be considered customers of the fully regulated broker-dealer. Therefore, any person that solicits a potential counterparty to engage in a securities transaction with an OTC derivatives dealer, or otherwise has any contact with the counterparty regarding the transaction, generally must be a registered representative of the fully regulated broker-dealer affiliate.[158] As noted in the Proposing Release, these persons may be dual employees of the fully regulated broker-dealer and the OTC derivatives dealer, subject to appropriate supervision by both firms.[159]

The SIA, however, argued that all employees of the OTC derivatives dealer having contact with counterparties to OTC derivatives transactions effected through a fully regulated broker-dealer should not have to be employees of the fully regulated broker-dealer and be licensed as registered representatives of that firm.[160] D.E. Shaw & Co. claimed that the requirement for any person discussing the terms of a securities transaction with a counterparty to be a registered representative of the fully regulated broker-dealer was broader than current NASD requirements. It therefore requested clarification that the proposed rule would not expand the types of activities that would require registration of associated persons.[161]

Under the final rule, whether a registered representative of an OTC derivatives dealer's fully regulated broker-dealer affiliate must be involved in all contacts with a counterparty relating to a securities transaction depends on the nature of the counterparty. Under Rule 15a–1(d), if the counterparty is a registered broker or dealer, a bank acting in a dealer capacity, a foreign broker or dealer, or an affiliate of the OTC derivatives dealer, a registered representative of the fully regulated broker-dealer affiliate does not have to be involved in the contact. Thus, employees of the OTC derivatives dealer may solicit or otherwise contact these enumerated counterparties, even if the employees are not also registered representatives of the fully regulated broker-dealer.[162]

In addition, in some circumstances, registered representatives of the fully regulated broker-dealer affiliate are not required to be involved in contacts with foreign counterparties. Under Rule 15a–1(d), contacts with a foreign counterparty may generally be conducted by an associated person of a foreign broker or dealer who is not resident in the United States, if the foreign broker or dealer is affiliated with the OTC derivatives dealer and is registered by a foreign financial regulatory authority in the jurisdiction in which the counterparty is resident or the associated person is located.[163] Any resulting securities transaction, however, must generally be effected through the OTC derivatives dealer's fully regulated broker-dealer affiliate.

The new regulatory structure for OTC derivatives dealers does not expand on the types of activities that require registration of associated persons under existing SRO rules. For example, to the extent contact with an OTC derivatives dealer's counterparty regarding a securities transaction involves only clerical or ministerial activities that currently may be conducted by an unregistered associated person of a fully regulated broker-dealer, then the employee of the OTC derivatives dealer performing such activities need not be a registered representative.[164] Persons performing clerical and ministerial

[153] The term ''foreign broker or dealer'' as used in Rule 15a–1 means ''any person not resident in the United States (including any U.S. person engaged in business as a broker or dealer entirely outside the United States, except as otherwise permitted by § 240.15a–6 (17 CFR 240.15a–6)) that is not an office or branch of, or a natural person associated with, a registered broker or dealer, whose securities activities, if conducted in the United States, would be described by the definition of 'broker' in section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) or 'dealer' in section 3(a)(5) of the Act (15 U.S.C. 78c(a)(5)).'' *See* See 15a–1(g) (17 CFR 240.15a–1(g)). In general, a foreign bank may be able to satisfy the terms of this definition.

[154] For purposes of Rule 15a–1, the term ''affiliate'' means ''any organization (whether incorporated or unincorporated) that directly or indirectly controls, is controlled by, or is under common control with, the OTC derivatives dealer.'' *See* Rule 15a–1(f) (17 CFR 240.15a–1(f)).

[155] With respect to offshore transactions involving foreign securities, Rule 15a–1 has not been revised to the extent suggested by some commenters (*see supra* note 144), in part because of concerns regarding the application of sales practice protections to foreign counterparties and the proper maintenance of books and records regarding those transactions. However, the general requirement that communications regarding securities transactions be conducted by associated persons of the affiliated fully regulated broker-dealer has been revised to reflect the fact that firms operate OTC derivatives businesses on a global basis, *See* Rule 15a–1(d) (17 CFR 240.15a–1(d)) (further discussed in Section II.C.4. below).

[156] For purposes of Rule 15a–1, the term *foreign security* means ''any security (including a depositary share issued by a United States bank, provided that the depositary share is initially offered and sold outside the United States in accordance with Regulation S (17 CFR 230.901 through 230.904)) issued by a person not organized or incorporated under the laws of the United States, provided the transaction that involves such security is not effected on a national securities exchange or on a market operated by a registered national securities association; or a debt security (including a convertible debt security) issued by an issuer organized or incorporated under the laws of the United States that is initially offered and sold outside the United States in accordance with Regulation S (17 CFR 230.901 through 230.904).'' *See* Rule 15a–1(h) [17 CFR 240.15a–1(h)].

[157] *See* Rule 15a–1(c)(2) (17 CFR 240.15a–1(c)(2)). Rule 15c3–4 (17 CFR 240.15c3–4) requires that an OTC derivatives dealer's written guidelines include the dealer's procedures to prevent it from improperly relying on the exceptions to Rule 15a–1(c) and (d) (discussed in Section II.C.4. below).

[158] *See* Rule 15a–1(d) (17 CFR 240.15a–1(d)).

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

[160] SIA Letter I, p. 12.

[161] DESCO Letter, p. 4.

[162] This is consistent with the exception set forth in Rule 15a–1(c)(1) (17 CFR 240.15a–1(c)(1)).

[163] See Rule 15a–1(d) (17 CFR 240.15a–1(d)) and Rule 15a–1(i) (17 CFR 240.15a–1(i)). *See also supra* note 155 and accompanying text. This approach responds to commenters' concerns that it would be inefficient and impractical to require a registered representative of the OTC derivatives dealer's fully regulated broker-dealer affiliate to conduct all contacts with all foreign counterparties concerning permissible securities activities with the OTC derivatives dealer.

[164] *See* Rule 15a–1(d) (17 CFR 240.15a–1(d)).

functions may also be dual employees of the OTC derivatives dealer and the fully regulated broker-dealer affiliate.

5. Confirmation of Securities Transactions

Rule 10b–10 under the Exchange Act [165] 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. The Proposing Release stated that in a securities transaction between an OTC derivatives dealer and a counterparty (or 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 counterparty under the rule.[166] It further stated that certain customers could choose not to receive two confirmations for each securities transaction, but rather could instruct the OTC derivatives dealer and the fully regulated broker-dealer to send one joint confirmation on behalf of both parties.[167]

The SIA agreed that the counterparty to any securities transaction would be a customer of the fully regulated broker-dealer and that the fully regulated broker-dealer would have an obligation to deliver a confirmation to the counterparty; however, the SIA argued that the counterparty would not be a customer of the OTC derivatives dealer and, accordingly, the OTC derivatives dealer should not be required to deliver a confirmation.[168] D.E. Shaw & Co. also questioned whether there were any benefits in requiring multiple confirmations that would justify the additional costs and paperwork. Instead, it believed that the fully regulated broker-dealer should take responsibility for sending out a joint confirmation accurately disclosing the respective roles of the fully regulated broker-dealer and the OTC derivatives dealer.[169] In addition, the SIA and D.E. Shaw & Co. noted that if each dealer were jointly and severally liable for a joint confirmation, then the requirement to obtain customer consent to the sending of a joint confirmation was unnecessary and burdensome.[170]

In response to the comments, the proposed requirement that the fully regulated broker-dealer and the OTC derivatives dealer each have to send a separate confirmation, unless the customer instructs them to send a single joint confirmation, has been revised. Although generally both the fully regulated broker-dealer and the OTC derivatives dealer will be responsible for sending a confirmation, disclosing their respective roles in the transactions, the two firms may establish procedures through which the fully regulated broker-dealer will send a joint confirmation on behalf of both firms in satisfaction of Rule 10b–10.[171]

6. Position Limits

Several commenters questioned the application of SRO position limits to an OTC derivatives dealer's activities.[172] The SIA, for example, argued that an OTC derivatives dealer should either be subject to a more realistic SRO position limit regime than was currently applicable under NASD rules or be exempted from the application of SRO position limits with respect to OTC securities options booked through a fully regulated broker-dealer affiliate.[173] The CBOE argued that the rules would result in a competitive disparity between OTC and listed index derivatives, because, as stated by the CBOE, an OTC derivatives dealer's transactions in OTC equity options would be exempt from NASD and CBOE position limits, but transactions in listed index and equity options would not be exempt.[174] As a result, it recommended that the Commission eliminate listed options position limits entirely.[175]

The final rules and rule amendments do not change the current application of position limits to securities transactions effected by a broker-dealer on behalf of an OTC derivatives dealer. Therefore, securities OTC derivatives transactions that are effected through fully-regulated broker-dealers, which are members of SROs, will continue to be subject to applicable SRO position limits.[176] However, in order to permit an OTC derivatives dealer to carry out its business using portfolio risk management techniques, the Commission encourages the NASD to revise its rules to recognize as ''hedged'' those OTC option positions of an OTC derivatives dealer that are hedged on a delta neutral basis.[177]

D. Exemptions for OTC Derivatives Dealers

Collectively, the rules and rule amendments adopted in this final rulemaking establish a new class of broker-dealers that will enjoy certain exemptions from full broker-dealer registration and regulation, subject to special requirements and conditions on their operations. Although an OTC derivatives dealer will be exempt from SRO membership, regular broker-dealer margin requirements, and SIPA (as discussed below), an OTC derivatives dealer's securities activities will be limited by Rule 15a–1.[178]

1. Rule 15b9–2; Exemption From SRO Membership

Proposed Rule 15b9–2 would have exempted an OTC derivatives dealer from membership in a SRO,[179] provided that it entered into an agreement with

[165] 17 CFR 240.10b–10.

[166] Proposing Release, Section 11.C., n.28, 62 FR at 67944, n.28.

[167] *Id.*

[168] SIA Letter I, pp. 11–12.

[169] DESCO Letter, p. 5.

[170] SIA Letter I, p. 12; DESCO Letter, p. 5.

[171] A joint confirmation, sent on behalf of both the OTC derivatives dealer and the fully regulated broker-dealer effecting the transaction must 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 SIPC, 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 will be considered fully responsible for the contents of the joint confirmation. The decision by the two firms to send a joint confirmation will not otherwise affect the obligations of either party to the customer under the anti-fraud provisions of the federal securities laws. In addition, in the event that an OTC derivatives dealer engages in a securities transaction that is not required to be effected through a fully regulated broker-dealer under rule 15a–1 (17 CFR 240.15a–1), then the OTC derivatives dealer must comply with the provisions of Rule 10b–10 (17 CFR 240.10b–10), to the extent such provisions apply to the transaction.

[172] *See* Section IV.J.1. of the Comment Summary.

[173] SIA Letter I, p. 16. D.E. Shaw & Co. also sought clarification that the requirement for executing securities OTC derivatives transactions through a fully regulated broker-dealer was not intended to subject OTC derivatives dealers to the options position limits set forth in NASD rules. In is view, these position limits constituted a competitive disadvantage for U.S. securities firms as against banks and foreign dealers. DESCO Letter, pp. 2–3.

[174] CBOE Letter, p. 2.

[175] CBOE Letter, p. 3.

[176] *See* Rule 2860 of the NASD's Conduct Rules.

[177] The Commission's support for recognizing options positions hedged on a delta neutral basis as properly exempted from SRO position limits is equally applicable to all option market participants for options traded over-the-counter or on exchanges. Therefore, the NASD and options exchange SROs are encouraged to submit rule changes that will recognize delta neutral hedges for both listed and OTC options.

[178] *See supra* Section II.C.

[179] In general, registered broker-dealers must become members of an SRO. *See* Section 15(b)(8) of the Exchange Act (15 U.S.C. 78o(b)(8)). This SRO membership requirement ensures that securities transactions meet SRO sales practice requirements, that employees of SRO member firms who sell securities satisfy certain 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. *See* sections 15(b)(8) and 15A(g)(3) of the Exchange Act (15 U.S.C. 78o(b)(8); 15 U.S.C. 78o–3(g)(3)).

the examining authority designated pursuant to section 17(d) of the Exchange Act [180] for its registered broker-dealer affiliate. Under this agreement, the DEA would have been expected to conduct a review of the activities of the OTC derivatives dealer, report to the Commission any potential violation of the Commission's rules, and evaluate the dealer's procedures and controls designed to prevent violations.[181] The OTC derivatives dealer would also have been subject to direct examination by Commission staff.

The SRO commenters believed that an OTC derivatives dealer should become a *member* of either the DEA of its registered broker-dealer affiliate or another SRO.[182] In supporting this position, these commenters noted such things as (1) the DEA is in the best position to examine the OTC derivatives dealer given its surveillance and examination knowledge of the registered broker-dealer affiliate; (2) SRO rules impose certain supervisory obligations directly on each member; and (3) SRO membership is necessary to ensure an OTC derivatives dealer's cooperation during an examination.[183] In order to avoid conflict between the new regime and SRO rules, however, both the NYSE and the NASDR recognized that an OTC derivatives dealer member should not be subject to all SRO rules (such as margin rules), but should only be subject to rules that applied to the dealer's unique business.[184]

In contrast, securities firms generally opposed any plan that would require OTC derivatives dealers to become members of an SRO.[185] More than one commenter suggested that the oversight function should be performed only by Commission staff, and that it might be appropriate to establish a new SRO designed to oversee the activities of OTC derivatives dealers.[186]

The Commission has determined that 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 at this time. Moreover, because the NYSE and the NASD expressed serious concerns with overseeing OTC derivatives dealers on a contractual basis, the Commission staff will examine OTC derivatives dealers to ensure compliance with Commission rules. This approach will provide the Commission staff with valuable experience regarding the activities of dealers in OTC derivative instruments. In addition, the expected small number of initial registrants also supports direct Commission examination of OTC derivatives dealers at this time.

In granting the Commission authority under Section 15(b)(9) to exempt a class of brokers or dealers from the requirement of SRO membership, Congress recognized that certain types of broker-dealers could be regulated effectively by the Commission without the direct oversight of an SRO. Given that certain SRO rules, such as margin rules, are not consistent with the OTC derivatives dealer regulatory scheme and that securities transactions generally will be effected through a broker-dealer that will be a member of an SRO,[187] the Commission believes that SRO membership and the additional regulation it would entail is not currently warranted. Accordingly, the Commission finds that exempting OTC derivatives dealers from the SRO membership requirement is consistent with the public interest and the protection of investors.

2. Rule 36a1–1; Exemption From Certain Margin Requirements

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 currently depend on the regulatory status of the dealer. Federal regulations that govern the collateral, or margin, that must be collected by dealers in connection with securities transactions have created certain competitive inequalities between registered broker-dealers and other entities, including bank dealers, that conduct an OTC derivatives business. Registered broker-dealers that extend credit for the purpose of purchasing or carrying securities are required to comply with the provisions of Regulation T.[188] The margin requirements for banks are contained in Regulation U.[189]

As noted above, despite the recent amendments to Regulation T,[190] there remain several differences between Regulation T and Regulation U.[191] For example, the two regulations differ with respect to the margin requirements for short OTC options. Compliance with the more restrictive requirements of Regulation T places broker-dealers at a competitive disadvantage 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 the other dealers.

Under proposed Rule 36a1–1, extensions of credit by an OTC derivatives dealer in permissible securities transactions generally would have been exempt from Section 7 of the Exchange Act (and Regulation T), provided that the OTC derivatives dealer complied with other federal margin requirements applicable to non-broker-dealer lenders (*i.e.,* Regulation U). While the SIA noted its full support for the proposal, it raised certain technical issues that could result from the codification of the proposed provisions.[192] Morgan Stanley Dean Witter also supported the proposed rule, and stated that application of Regulation U would provide sufficient safeguards against excessive leverage and would permit an OTC derivatives dealer to extend credit on a broader range of OTC derivative products.[193] It also stated that the SIA's clarifications were appropriate, and encouraged the Commission to reassess whether additional exemptive relief would be warranted in the future.[194]

In response to the comments received, the Commission has revised Rule 36a1–1 to clarify that transactions involving the extension of credit by an OTC derivatives dealer are exempt from the provisions of section 7(c) of the Exchange Act,[195] provided that the OTC derivatives dealer complies with section

[180] 15 U.S.C. 78q(d).

[181] *See* Proposing Release, Section II.D.2., 62 FR at 67946.

[182] NYSE Letter, p. 2; Comment Letter from NASD Regulation (''NASDR Letter''), pp. 1–2. The NYSE objected to any structure that would cause the DEA to be considered merely an agent of the Commission, in part because it believed that such an approach would have broad procedural ramifications. It also stated that the proposal to have the DEA review the activities of OTC derivatives dealers on a contractual basis, absent membership, would be prohibited by the Exchange's Constitution. NYSE Letter, p. 2. NASDR also opposed the proposal that an OTC derivatives dealer would not be required to be a member of an SRO if it entered into an agreement with the DEA for its broker-dealer affiliate, because it believed it would create a difficult precedent and might impede effective oversight of this new type of entity. NASDR Letter, pp. 1–2.

[183] *See* section IV.H. of the Comment Summary.

[184] NYSE Letter, p. 2; NASDR Letter, p. 3.

[185] SIA Letter I, p. 14; MSDW Letter, pp. 20–21; DESCO Letter, p. 3, n.2.

[186] *See, e.g.,* SIA Letter I, p. 14.

[187] *See* Rule 15a–1(c) (17 CFR 240.15a–1(c)).

[188] 12 CFR 220.1.

[189] 12 CFR 220.1.

[190] *See* Securities Credit Transactions, Borrowing by Brokers and Dealers, Docket Nos. R–0905, R–0923, and R–0944, 63 FR 2806 (Jan. 16, 1998).

[191] *See* Section I.C.4.b. above.

[192] SIA Letter I, pp. 14–15.

[193] MSDW Letter, pp. 19–20.

[194] MSDW Letter, App. A, p. ii.

[195] 15 U.S.C. 78g(c).

7(d) of the Exchange Act.[196] Because Regulation U is promulgated pursuant to section 7(d), an OTC derivatives dealer remains subject to that provision. The final rule continues to provide that the exemption from section 7(c), and Regulation T thereunder, does not apply to extensions of credit made directly by a registered broker-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.[197]

The Commission believes that application of Regulation U in lieu of Regulation T is appropriate for the lending that occurs in the OTC derivatives market, given the nature of the bilateral financial instruments and the relative sophistication of the counterparties. Applying Regulation U to extensions of credit by OTC derivatives dealers will provide sufficient safeguards, while allowing OTC derivatives dealers to extend credit in accordance with their normal business practices.[198]

Because application of Regulation U will promote competition and efficiency in the OTC derivatives market and will result in suitable margin regulation for OTC derivatives dealers and their counterparties, the Commission finds that exempting OTC derivatives dealers from Section 7(c) of the Exchange Act is necessary or appropriate in the public interest and consistent with the protection of investors. This exemption is conditioned on the OTC derivatives dealer's compliance with Section 7(d) of the Exchange Act.[199]

3. Rule 36a1–2; Exemption From SIPA

Under Rule 36a1–2, OTC derivatives dealers are exempt from the provisions of SIPA,[200] including membership in SIPC. As stated in the Proposing Release, 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.[201] As a result, 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.[202] This uncertainty could impair the ability of securities firms electing to register as OTC derivatives dealers to compete effectively with banks and foreign dealers, which are not subject to similar legal uncertainty.

The commenters addressing this issue generally believed that the SIPA exemption was both necessary and appropriate.[203] In particular, Morgan Stanley Dean Witter agreed with the statement in the Proposing Release that the exemption was necessary to avoid potential legal uncertainty about the rights of counterparties in transactions with registered OTC derivatives dealers in the event of dealer insolvency.[204] Two other commenters noted that the exemptive relief from SIPA and SIPC membership was critical to the commercial viability of an OTC derivatives dealer.[205]

In response to the comments received, the exemption for OTC derivatives dealers from the provisions of SIPA, including from membership in SIPC, is being adopted in its proposed form. The purposes of SIPA would not be promoted by its application to OTC derivatives dealers, and could in fact result in legal uncertainty for OTC derivatives dealers' counterparties. As a result, the Commission finds that Rule 36a1–2, exempting OTC derivatives dealers from SIPA, is necessary or appropriate in the public interest and consistent with the protection of investors.[206]

E. Rule 11a1–6; Transactions for Certain Accounts of OTC Derivatives Dealers

In response to the Proposing Release's general request for comment on whether additional amendments or exemptions would be needed for OTC derivatives dealers,[207] the SIA requested that the Commission clarify that an exchange member may execute transactions on a national securities exchange for the account of its affiliated OTC derivatives dealer without violating Section 11(a)(1) of the Exchange Act.[208] Section 11(a)(1)[209] makes it unlawful for a member of a national securities exchange to effect transactions on that exchange for certain accounts, including its own account or the account of an associated person of the member.

This general prohibition, however, is subject to numerous exceptions.[210] Among these is a general exception provided in section 11(a)(1)(G)[211] for a member's proprietary transactions where (1) the member is primarily engaged in a public securities business (the ''business mix'' test);[212] and (2) the transactions ''yield,'' in accordance with Commission rules, priority, parity, and

[196] 15 U.S.C. 78g(d).

[197] OTC derivatives dealers that extend credit in securities transactions that are required to be effected through a fully regulated broker-dealer, however, may rely on the exemption form section 7(c) and Regulation T provided under Rule 36a1–1.

[198] While the CBOE supported allowing the OTC derivatives positions of counterparties carried on the books of OTC derivatives dealers to be exempt from Regulation T conditioned on the application of Regulation U, it believed that application of Regulation U would result in competitive disparities between OTC and listed options markets. Accordingly, it requested a similar margin treatment for listed options transactions. CBOE Letter, p.3. The Commission, however, is not extending a similar margin treatment to listed options at this time. The new regulatory framework is intended to allow U.S. securities firms to compete more effectively in global OTC derivatives markets. Any revisions to the regulatory standards for exchange markets would require, among other things, careful consideration of the differences between exchange markets and OTC derivatives markets.

[199] Rule 36a1–1 applies only to extensions of credit *by* an OTC derivatives dealer. Section 7 of the Exchange Act, however, continues to apply to persons extending credit *to* an OTC derivatives dealer. Credit extended to an OTC derivatives dealer, like credit extended to a fully regulated broker-dealer, however, is excepted from section 7 of the Exchange Act if it satisfies the conditions for such exceptions contained in section 7.

[200] 15 U.S.C. 78aaa *et seq.*

[201] Proposing Release, Section II.G., 62 FR at 67949–50. 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. 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. 555 (contractual right to liquidate a securities contract); *id.* at section 559 (contractual right to liquidate a repurchase agreement).

[202] Under the typical relationship where a counterparty delivers collateral to an OTC derivatives dealer in order to cover its contractual obligations to the dealer, the counterparty and the OTC derivatives dealer have a relationship more analogous to a debtor-creditor relationship than a fiduciary one. Accordingly, these counterparties are not the type of investor intended to be protected under SIPA. *See Securities Investor Protection Corporation v. Executive Services Corp.*, 423 F. Supp. 94 (S.D.N.Y. 1976), *aff'd*, 556 F.2d 98 (2d Cir. 1977).

[203] SIA Letter I, p. 14; DESCO Letter, p. 13; MSDW Letter, p. iv.

[204] MSDW Letter, p. iv.

[205] SIA Letter I, p. 14; DESCO Letter, p. 13.

[206] Section 2 of SIPA states that the provisions of the Exchange Act generally apply as if SIPA ''constituted an amendment to, and was included as a section of'' the Exchange Act. 15 U.S.C. 78bbb.

[207] Proposing Release, Section III, 62 FR at 67952.

[208] SIA Letter II, p. 4.

[209] 15 U.S.C. 78k(a)(1).

[210] The Commission is also authorized to determine, by rule, that additional types of transactions are excepted from the general prohibition of section 11(a)(1). *See* section 11(a)(1)(I) of the Exchange Act (15 U.S.C. 78k(a)(1)(I)). In adopting such a rule, the Commission must find that such transactions are consistent with the purposes of section 11(a), the protection of investors, and the maintenance of fair and orderly markets. *Id.*

[211] 15 U.S.C. 78k(a)(1)(G).

[212] In order to take advantage of this exception, the member must be ''primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, and acting as broker, or any one or more of such activities, and whose gross income normally is derived principally from such business and related activities.'' 15 U.S.C. 78k(a)(1)(G)(i).

precedence to transactions for accounts of persons who are not members, or associated with members, of the exchange.

Rule 11a1–2 under the Exchange Act[213] generally provides that a member may effect a transaction for the account of an associated person if the member would have been permitted, under section 11(a) and the rules thereunder, to effect the transaction for its own account. The rule, however, specifically limits the circumstances in which a member may use the rule to rely on section 11(a)(1)(G) for transactions for the account of an associated person. In that situation, the associated person must independently meet the ''business mix'' test.[214] Because an OTC derivatives dealer will be a newly created entity, it will not be able to demonstrate that it meets this test. Thus, the exchange member with which it is associated will not be able to rely on section 11(a)(1)(G) for transactions it effects for the account of the OTC derivatives dealer.

In response to this concern, the Commission is adopting Rule 11a1–6. This new rule, which is modeled after Rule 11a1–2, will allow a fully regulated broker-dealer member to effect a transaction on a national securities exchange for the account of an associated person that is an OTC derivatives dealer if the member would have been permitted to effect the transaction for its own account under section 11(a) and the rules thereunder, other than Rule 11a1–2. Rule 11a1–6 permits the fully regulated broker-dealer to rely on the exception provided under section 11(a)(i)(G) for transactions it effects for its OTC derivatives dealer affiliate even if that affiliate does not meet the ''business mix'' test. The fully regulated broker-dealer and the OTC derivatives dealer, however, must comply with all other requirements of section 11(a). Thus, for example, transactions effected by the fully regulated broker-dealer for the account of the OTC derivatives dealer must continue to yield priority, parity, and precedence to transactions for accounts of persons who are not members, or associated with members, of the exchange.

Although Rule 11a1–6 will allow a fully regulated broker-dealer to execute securities transactions on behalf of its OTC derivatives dealer affiliate, public customers will continue to receive priority and precedence in the execution of their securities orders. Moreover, excepting these transactions from the general prohibition of section 11(a)(1) is consistent with Congressional intent in enacting this section. The Commission, therefore, finds that Rule 11a1–6 is consistent with the purposes of section 11(a)(1), the protection of investors, and the maintenance of fair and orderly markets.

F. Net Capital Requirements for OTC Derivatives Dealers

1. Overview of Amendments to Rule 15c3–1

The Commission is amending the net capital rule, Rule 15c3–1 under the Exchange Act,[215] as it applies to OTC derivatives dealers. In general, the net capital rule requires every registered broker-dealer to maintain certain specified minimum levels of net liquid assets, or net capital, to enable each firm that falls 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, on its securities positions. The haircuts were designed not only to cover market risk, but also other risks faced by the firm, such as credit and liquidity risk.

As noted in the Proposing Release, U.S. securities firms generally state that firms avoid to the extent feasible booking swaps and other types of OTC derivative instruments in the registered broker-dealer because of the charges for these transactions under the net capital rule./216/ In general, the rule requires a firm to subtract most unsecured credits from its net worth when calculating its net capital, and limits the hedging allowance against positions if OTC derivatives dealers have unsecured credit exposures. The net capital rule's treatment of OTC derivatives transactions generally requires broker-dealers to reserve more capital with respect to these transactions than do capital rules governing banks or foreign securities firms.

The Commission is amending Rule 15c3–1 to provide alternative methods for OTC derivatives dealers to calculate capital charges on OTC derivatives transactions in several respects. Under Appendix F of Rule 15c3–1, which is being adopted substantially as proposed, an OTC derivatives dealer is permitted to add back to its net worth any unsecured credits arising from transactions in eligible OTC derivative instruments.[217] These will include unsecured accrued receivables as well as unsecured counterparty exposure in the OTC instruments. Appendix F also allows an OTC derivatives dealer to use VAR models to compute its market risk charges on proprietary positions instead of using the haircut structure under paragraph (c)(2)(vi) of the current rule. As mentioned above, the current haircut approach allows more limited offsetting among positions than the normal VAR model would permit when computing capital charges. Appendix F also allows an OTC derivatives dealer to use a less severe regime for credit risk, as described below.

Currently, some dealers use VAR models as part of their risk management systems. These firms use VAR modeling to analyze, control, and report the level of market risk from their trading activities. A VAR estimate is the loss that is not expected to be exceeded at the chosen confidence level for some time period. 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.[218]

[213] 17 CFR 240.11a1–2.

[214] This means that the associated person for whom the member is effecting the transaction must have derived, during its preceding fiscal year, more than 50% of its gross revenues from one or more of the sources specified in Section 11(a)(1)G)(i). *See* Rule 11a1–2 (17 CFR 240.11a1–2).

[215] 17 CFR 240.15c3–1.

[216] *See* Proposing Release, Section II.E.1., 62 FR at 67946.

[217] An unsecured receivable from an affiliated entity must be deducted to the extent the receivable is not collateralized with readily marketable securities.

[218] 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

Continued

2. Reasons for Allowing OTC Derivatives Dealers To Use Value-at-Risk Models

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'')[219] with respect to the use of proprietary VAR models to determine bank capital requirements for market risk.[220]

Further, 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'') have adopted rules implementing the Capital Accord[221] for U.S. banks and bank holding companies.[222] Appendix F is generally consistent with the U.S. Banking Agencies' rules, and incorporates the qualitative and quantitative conditions imposed on banking institutions.

By allowing OTC derivatives dealers to use VAR models in calculating their net capital requirement, the Commission has an opportunity to gain valuable experience with the use of these models by entities within its jurisdiction. This experience will enable the Commission to reassess its current rules for determining capital charges for market risk and determine whether more intensive subjective examinations are needed to ensure compliance with Commission regulations concerning the use of models.

The adoption of a more flexible approach for determining capital requirements for OTC derivatives dealers is appropriate because of the special nature of their business and the additional financial responsibility requirements applicable to these firms. The final rule requires an OTC derivatives dealer to maintain a minimum of $100 million in tentative net capital[223] and at least $20 million in net capital. OTC derivatives dealers are 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 are, however, allowed to hold counterparty collateral or owe money or securities to counterparties, but only as a result of contractual commitments. Finally, OTC derivatives dealers are required to establish risk management controls pursuant to Rule 15c3–4.

3. Discussion of Net Capital Requirements

a. *Rule 15c3–1(a)(5).* Under paragraph (a)(5) of Rule 15c3–1, OTC derivatives dealers are required to maintain tentative net capital of not less than $100 million and net capital of not less than $20 million. In the Proposing Release, the Commission requested 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.[224] Many commenters declined to comment on the minimum required amount.[225] One commenter opposed any minimum tentative net capital requirement because other U.S. broker-dealers are not required to maintain minimum tentative net capital under the net capital rule, and because it believed that U.S. firms, and particularly small-sized, medium-sized, and newly established OTC derivatives dealers, would be at a competitive disadvantage.[226]

The final rule contains the minimum requirements of $100 million in tentative net capital and $20 million in net capital. The minimum tentative net capital and net capital requirements are necessary to ensure against excessive leverage and risks other than credit or market risk, all of which are now factored into the current haircuts. Further, while the mathematical assumptions underlying VAR may be useful in projecting possible daily trading losses under ''normal'' market conditions, VAR may not help firms measure losses that fall outside of normal conditions, such as during steep market declines.[227] Accordingly, the minimum capital requirements provide additional safeguards to account for possible extraordinary losses or decreases in liquidity during times of stress which are not incorporated into VAR calculations.

b. *Appendix F.* Appendix F applies only to an OTC derivatives dealer that elects to be subject to the Appendix and has its application to use Appendix F approved by the Commission. An OTC derivatives dealer that elects to be subject to Appendix F is required to calculate specific capital charges for market and credit risk. It is also required to maintain a VAR model that meets certain minimum qualitative and quantitative requirements described in Appendix F, and it must adopt risk management control procedures as provided in Rule 15c3–4.

i. Application Requirement. An OTC derivatives dealer must be authorized by the Commission to compute capital charges for market and credit risk pursuant to Appendix F. To request this authorization, an OTC derivatives dealer must file an application with the Commission describing its VAR model, including whether the firm has developed its own model, whether the firm intends to use VAR or alternative methods to calculate net capital, and how the qualitative and quantitative aspects described in Appendix F are incorporated into the model, and a description of its risk management and control procedures.[228]

More specifically, the application must include (1) an executive summary of information provided in the application; (2) a description of the

Policy Review, April 1996, at 39 (examining twelve approaches to VAR modeling 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).

[219] 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.

[220] 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.

[221] 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.

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

[223] For an OTC derivatives dealer that elects to compute its market risk charges under Appendix F, the term ''tentative net capital'' means the net capital of an OTC derivatives dealer before deducting charges for market and credit risk as computed pursuant to Appendix F and increased by the balance sheet value (including counterparty net exposure) resulting from transactions in eligible OTC derivative instruments which would otherwise be deducted by virtue of paragraph (c)(2)(iv) of Rule 15c3–1.

[224] Proposing Release, Section II.E.3.a., 62 FR at 67947.

[225] *See* Section V.A.1. of the Comment Summary.

[226] DESCO Letter, pp. 9–10.

[227] Models such as the one specified in Appendix F typically measure exposure at the first percentile, and steep market declines are, by definition, below the first percentile.

[228] *See* Sections II.F.3.b.iv. and v. below for a description of the qualitative and quantitative requirements.

statistical models used for pricing OTC derivative instruments and for computing VAR, a description of the applicant's controls over those models, and a statement regarding whether the firm has developed its own internal VAR model; and (3) a description of the policies and procedures which the dealer employs in association with its internal risk management control systems.[229] The application must also describe any alternative methods that the OTC derivatives dealer intends to use to compute its market risk charge for equity instruments, and categories of securities having no ready market or which are below investment grade. Further, an OTC derivatives dealer that wants to use internal credit ratings for counterparties that are not rated by a nationally recognized statistical rating organization (''NRSRO'' or ''rating organization'') must also include in its application a description of its credit rating categories and rating procedures.

The Commission is amending Rule 30–3 of the Rules of Practice to delegate its authority to approve or deny, in full or in part, applications of OTC derivatives dealers to use Appendix F of Rule 15c3–1 to the Director of the Division of Market Regulation.[230] A denial of an application by the Division would be reviewable by the Commission.[231] The Commission will grant the application and authorize the OTC derivatives dealer to compute its net capital under Appendix F if the dealer has adopted (1) the internal risk management control systems required under Rule 15c3–4; and (2) a VAR model that meets the criteria in paragraphs (e)(1) and (e)(2) of Appendix F. All application information submitted will be kept confidential, in accordance with the rules.

Commenters noted the importance of including provisions for the review of risk management practices, policies, and procedures employed by OTC derivatives dealers, to assure that they are being executed in accordance with their intended purposes.[232] Accordingly, pursuant to the final rule, an OTC derivatives dealer is required to obtain authorization from the Commission before it may adopt any material changes to its VAR or other models, including changes in the qualitative or quantitative aspects of VAR models, before it may materially change the categories of non-marketable securities it wishes to include in its VAR model, or before it may materially alter its internal risk management control systems. If an OTC derivatives dealer desires to materially change its VAR model or internal risk management control systems, it must file an amended application with the Commission describing the changes. The OTC derivatives dealer will be authorized by the Commission to implement the proposed changes if the Commission determines that the changes meet the compliance standards of Rule 15c3–4 and Appendix F, and the amended application complements the internal review requirements imposed by those provisions. The final rule also clarifies that an OTC derivatives dealer will be in violation of the net capital rule if it fails to comply in all material respects with the internal risk management control systems under Rule 15c3–4.

ii. Market Risk. OTC derivatives dealers electing to apply Appendix F pursuant to the final rule must deduct from their net worth a capital charge for market risk[233] that is equal to the sum of its VAR charge, alternative charges for equity instruments and non-marketable securities, and the charge for residual positions. First, OTC derivatives dealers may use the 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 VAR method, a market risk capital charge is equal to the VAR of its positions multiplied by a factor specified in Appendix F.[234]

Second, an OTC derivatives dealer may use an alternative method of computing the market risk capital charge for equity instruments, including OTC options. This alternative method may 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 must 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.[235] The OTC derivatives dealer is permitted to use its own theoretical pricing model as long as it contains the minimum pricing factors set forth in Appendix A.[236]

Third, an OTC derivatives dealer may not use a VAR model to determine a capital charge for any category of securities having no ready market or any category of debt securities which are below investment grade, or any derivative instrument based on the value of these categories of securities, unless the Commission has granted, pursuant to paragraph (a)(1) of Appendix F, its application to use its VAR model for any such category of securities. However, the dealer may apply, pursuant to paragraph (a)(1) of Appendix F, for an alternative treatment for any such category of securities, rather than calculate the market risk capital charge for such category of securities under paragraph (c)(2) (vi) and (vii) of the new capital rule.

Fourth, to the extent that a position has not been included in the calculation of the market risk charge for VAR, or the alternative method for equity instruments or for non-marketable securities, the market risk charge for the position shall be computed under paragraph (c)(2)(vi) of Rule 15c3–1.

iii. Credit Risk. An OTC derivatives dealer electing to apply Appendix F must deduct from its net worth a capital charge for credit risk.[237] This charge has two parts and is computed on a counterparty-by-counterparty basis. First, for each counterparty with an investment or speculative grade rating, an OTC derivatives dealer must take a capital charge equal to the net replacement value in the account of the counterparty (''net replacement value'')[238] multiplied by 8%, and

[229] *See* Section II.H.3. below for a description of the risk management controls that are required by Rule 15c3–4 (17 CFR 240.15c3–4)

[230] *See* Rule 30–3(a)(7)(v) (17 CFR 200.30–3(a)(7)(v)).

[231] *See* Rules 430 and 431 (17 CFR 201.430 and 17 CFR 201.431).

[232] *See* Comment Letter from the Working Group of the Risk Management, OTC Derivative Products, and Capital Committees of the Securities Industry Association (''SIA Working Group Letter''), pp. 1–5.

[233] 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.

[234] *See* Section II.F.3.b.iv. below for a discussion of how an OTC derivatives dealer determines the appropriate multiplication factor.

[235] 17 CFR 240.15c3–1a. The Commission recently amended Appendix A to include theoretical pricing models. Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997).

[236] 17 CFR 240.15c3–1a(b)(1)(B). The minimum pricing factors under Appendix A include:

(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.

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

[238] For purposes of calculating credit risk charges, net replacement value in the account of a counterparty means the aggregate value of all receivables due from that counterparty (computed by marking the value of such receivables to market

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further multiplied by a counterparty factor. The counterparty factor is based on the counterparty's rating by an NRSRO. The counterparty factors 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 organization as a basis, the counterparty factors 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 is assessed for counterparties rated below speculative grade or that are insolvent, or in bankruptcy, or that have senior unsecured long-term debt in default.

The second part of the credit risk charge consists of a concentration charge that applies 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 is also based on the counterparty's rating by an NRSRO. For counterparties that are highly rated, the concentration charge equals 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 increases 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.

In the rule as proposed, the credit risk concentration charge included a further provision that if the aggregate net replacement values of all counterparties exceeded 300% of the OTC derivatives dealer's tentative net capital, the OTC derivatives dealer would deduct 100% of the excess from its net worth. In the Proposing Release, the Commission requested comment on whether the 300% threshold for determining an overall concentration charge would result in excessive concentration risk charges.[239] Commenters suggested that the charge would have to be eliminated in order for the proposal to be viable.[240] The final rule does not contain this further provision.

If a counterparty is not rated by a rating organization, an OTC derivatives dealer is permitted to use its own ratings of the counterparty to calculate its credit risk charge. In these situations, however, the OTC derivatives dealer must demonstrate that its ratings categories and due diligence procedures, including procedures for the initial analysis and ongoing review of the counterparty (including review of the total leverage of the counterparty), are equivalent to those used by NRSROs. Several commenters requested that the Commission clarify whether the OTC derivatives dealer's demonstration must be on a counterparty-by-counterparty basis, and whether an affiliate of the dealer could rate non-NRSRO counterparties.[241] It is anticipated that authorization of an OTC derivatives dealer's credit rating methodology will occur as a whole rather than as to each counterparty. Further, the final rule provides that such ratings may be made by an affiliated bank or an affiliated broker-dealer of the OTC derivatives dealer, provided that the affiliate's methodology has been authorized by the Commission.

In the Proposing Release, the Commission requested comment on alternatives to relying on the ratings of NRSROs for approximating the risk that a counterparty may default.[242] Several commenters advocated the use of internal credit ratings of counterparties instead of or in addition to NRSRO ratings to calculate counterparty default risk.[243] Where available, NRSRO ratings are a reliable indicator of the perceived risk that a counterparty may default. Therefore, it is only in cases where a counterparty is not rated by an NRSRO that an OTC derivatives dealer is permitted to use its own ratings of a counterparty to calculate the credit risk charge.

Commenters also requested that the Commission allow the use of internal VAR models to assess credit risk regulatory capital, instead of or in addition to the proposed percentage-based credit risk capital charges. While the adoption of the current rule will provide valuable experience with the use of VAR models to assess market risk for regulatory capital purposes, the Commission has less confidence in the use of VAR for credit risk. Therefore, the Commission has determined at this time not to allow OTC derivatives dealers to employ credit risk VAR modeling in calculating net capital requirements. The Commission, however, expects to consider this issue in the future.

iv. Qualitative Requirements for Value-at-Risk Models. OTC derivatives dealers that elect to apply Appendix F are required to have VAR models that meet certain minimum qualitative requirements. The qualitative requirements address four aspects of an OTC derivatives dealer's risk management system. First, an OTC derivatives dealer's VAR model must be integrated into, and thus relied upon, in the OTC derivatives dealer's daily risk management process. Second, an OTC derivatives dealer's policies and procedures must identify and provide for appropriate stress tests.[244] The OTC derivatives dealer's policies and procedures must identify the procedures to follow in response to the results of the stress tests as well as backtests, and the OTC derivatives dealer is required to follow these procedures. Third, an OTC derivatives dealer's VAR model and risk management systems are required to undergo both periodic reviews that are performed by internal audit staff and annual reviews that are conducted by an independent public accountant.[245] Fourth, an OTC derivatives dealer is required to conduct backtesting of its VAR model.

As to the fourth element, the OTC derivatives dealer is required to conduct backtesting by comparing each of its most recent 250 business days' actual net trading profits or losses with the corresponding daily VAR measures. In addition, 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, exceeds the corresponding daily VAR measure. The number of exceptions determines the multiplication factor the

daily), including the effect of legally enforceable netting agreements and the application of liquid collateral.

[239] Proposing Release, Section II.E.3.b.ii., 62 FR at 67948.

[240] *See, e.g.*, SIA Letter I, p. 3; Goldman Sachs Letter, p. 4; Salomon Smith Barney Letter, p. 2; MSDW Letter, pp.18–19, iii; Merrill Lynch Letter, p. 3.

[241] *See* letters cited in Section V.A.2.b.i. of the Comment Summary.

[242] Proposing Release, Section II.E.3.b.ii., 62 FR at 67948.

[243] *See, e.g.*, ISDA Letter, p. 4; SIA Letter I, pp. 3–4; Salomon Smith Barney Letter, p. 2; MSDW Letter, pp. 15–17; Merrill Lynch Letter, p. 4.

[244] Stress tests are used to evaluate changes in the value of a firm's portfolio under extreme market conditions. Stress tests must 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.

[245] The OTC derivatives dealer must discuss the timing and nature of the periodic review by internal audit staff as part of the application process. *See* Section II.F.3.b.i. above.

OTC derivatives dealer will be required to use for the following quarter, and which will continue to apply until the next quarter's backtesting results are obtained, unless the Commission determines that a different adjustment or other action is appropriate. Depending on the number of exceptions, the multiplication factors 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 requiring an OTC derivatives dealer that uses an inappropriate model to increase its net capital reserves. Although the multiplication factor increases an OTC derivatives dealer's market risk charge and corresponding capital requirement, firms are expected to work to improve the reliability of their models rather than set aside additional capital for an unreliable model.

v. *Quantitative Requirements for Value-at-Risk Models.* Appendix F also contains 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 rule imposes certain requirements on VAR models to address regulatory capital-related concerns where a longer time horizon is appropriate. For example, OTC derivatives dealers are 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. The final rule also requires a one-year historical observation period, and addresses risks to be accounted for in VAR measures.

G. Rules 8c–1, 15c2–1, 15c3–2, and 15c3–3

The proposed rules would have excluded from the definition of customer, pursuant to Rules 8c–1,[246] 15c2–1,[247] and 15c3–3 under the Exchange Act,[248] a counterparty to an OTC derivatives transaction that has consented, after receiving appropriate disclosures, to the unrestricted use of its collateral by an OTC derivatives dealer. Rules 8c–1, 15c2–1, 15c3–2,[249] and 15c3–3 generally restrict a broker-dealer's use of customer funds and securities to finance its business activities.

The SIA commented that the proposed exclusions should be expanded to include counterparties to permissible cash management, risk management, and financing transactions.[250] In addition, the SIA suggested that the Commission clarify that the disclosure requirement could be met in any instance in which a counterparty has entered into an agreement explicitly authorizing the repledging, rehypothecation, substitution, or other disposition of collateral provided by the counterparty.[251] Further, the SIA sought to verify that counterparties to transactions effected through a fully regulated broker-dealer would not be considered a customer of the OTC derivatives dealer for purposes of Rules 8c–1, 15c2–1, 15c3–2, and 15c3–3.[252]

The amendments to Rules 8c–1, 15c2–1, 15c3–2, and 15c3–3 as adopted clarify the original intent of the proposal. Further, an OTC derivatives dealer that has received collateral from a counterparty will not be carrying a free credit balance for the account of a customer for the purposes of Rule 15c3–2 if the counterparty is not a customer of the dealer pursuant to Rules 8c–1, 15c2–1, and 15c3–3. A counterparty that has delivered collateral to an OTC derivatives dealer pursuant to a transaction in an eligible OTC derivative instrument or pursuant to the OTC derivatives dealer's cash management securities activities or ancillary portfolio management securities activities is not a customer for purposes of Rules 8c–1, 15c2–1, 15c3–2, and 15c3–3, but only if the counterparty has received a prominent written notice from the OTC derivatives dealer that, at a minimum, discloses that (1) except as otherwise agreed in writing by the OTC derivatives dealer and the counterparty, the OTC derivatives dealer may repledge or otherwise use the collateral in its business; (2) in the event of the dealer's failure, the counterparty will likely be considered an unsecured creditor of the dealer as to that collateral; (3) SIPA does not protect the counterparty; and (4) the collateral will not be subject to the requirements of Rules 8c–1, 15c2–1, 15c3–2, or 15c3–3.

H. Recordkeeping and Reporting

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

The Proposing Release[253] stated that OTC derivatives dealers, like other registered broker-dealers, are required to comply with the books and records requirements of Rules 17a–3[254] and 17a–4[255] under the Exchange Act. Rule 17a–3 would also have been amended to require an OTC derivatives dealer to compile a register of all derivatives transactions. In addition, Rule 17a–4 would have been amended to require OTC derivatives dealers to retain records required to be made pursuant to proposed Rules 15c3–4 and 17a–12.[256]

The Commission is adopting the amendments to Rules 17a–3 and 17a–4 as proposed. As several commenters have requested, the rules have been clarified to allow the OTC derivatives dealer's books and records to be maintained by an affiliated fully regulated broker-dealer. However, the OTC derivatives dealer remains responsible for ensuring that its books and records are properly maintained in accordance with Rules 17a–3 and 17a–4.

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

In the Proposing Release, the Commission stated that an OTC derivatives dealer would be subject to the provisions of Rule 17a–11 under the Exchange Act,[257] which requires a

[246] 17 CFR 240.8c–1.

[247] 17 CFR 240.15c2–1.

[248] 17 CFR 240.15c3–3.

[249] 17 CFR 240.15c3–2. The Commission did not propose to amend Rule 15c3–2 in the Proposing Release. Rule 15c3–2 restricts the use by a broker or dealer of funds arising out of any free credit balance carried for the account of any customer unless the broker or dealer complies with certain notice requirements.

[250] SIA Letter I, pp. 12–13.

[251] SIA Letter I, p. 13.

[252] *Id.*; SIA Letter II, p. 5.

[253] Proposing Release, Section II.H.1., 62 FR at 67950.

[254] 17 CFR 240.17a–3. In general, Rule 17a–3 under the Exchange Act 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.

[255] 17 CFR 240.17a–4. Rule 17a–4 under the Exchange Act 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.

[256] *See* Proposing Release, Section II.H.1., 62 FR at 67950.

[257] 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 DEA 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

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broker-dealer to report capital and other operational problems to the Commission and the broker-dealer's examining authority within specified time periods.[258] In addition, Rule 17a–11 would have been amended to take into consideration the new tentative net capital requirements that would apply to an OTC derivatives dealer. An OTC derivatives dealer would have been required to provide notice to the Commission and to its examining authority when its tentative net capital dropped below 120 percent of its required minimum and when its tentative net capital dropped below its required minimum.[259]

The Commission did not receive any comments that addressed the proposed amendments to Rule 17a–11. However, as discussed in Section II.D.1. above, the Commission is not requiring an OTC derivatives dealer to enter into an agreement with the examining authority for one of its registered broker-dealer affiliates that would require the examining authority to conduct a review of the activities of the OTC derivatives dealer. Therefore, the adopted amendments to Rule 17a–11 require an OTC derivatives dealer to provide the required notices only to the Commission. With respect to tentative net capital, an OTC derivatives dealer is required to provide notice to the Commission when its tentative net capital drops below 120 percent of its required minimum and when its tentative net capital drops below its required minimum. The Commission is also amending Rule 17a–11 to require an OTC derivatives dealer to notify the Commission of backtesting exceptions identified pursuant to Appendix F of Rule 15c3–1.

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

Pursuant to proposed Rule 15c3–4, an OTC derivatives dealer would have been required to establish a system of internal controls for monitoring and managing risks associated with its business activities. More specifically, proposed Rule 15c3–4 would have established the basic elements for the design, implementation, and review of an OTC derivatives dealer's risk management control system. The proposed rule would have required an OTC derivatives dealer to assess a number of aspects about its business environment when creating its risk management control system. For example, an OTC derivatives dealer would have been required 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. In addition, proposed Rule 15c3–4 would have required certain elements be included in an OTC derivatives dealer's internal control systems. For example, the proposed rule would have required the unit at the firm responsible for monitoring risks to be separate from and senior to the trading units whose activity created the risks.

The SIA Working Group commented [260] that an OTC derivatives dealer's internal risk management control system should specifically address operational risk,[261] market risk,[262] credit risk,[263] liquidity risk,[264] and legal risk.[265] In response to the comment, the Commission has revised Rule 15c3–4 to clarify the specific risks to be addressed by the OTC derivatives dealer's system of internal risk management controls. In particular, Rule 15c3–4 requires that an OTC derivatives dealer's system of internal risk management controls specifically address market risk, credit risk, leverage risk, liquidity risk, legal risk, and operational risk.

Rule 15c3–4 has also been revised to require that an OTC derivatives dealer's written guidelines include the dealer's procedures to prevent it from engaging in any securities transaction that is not permitted under Rule 15a–1 or from improperly relying on certain exceptions set forth in Rule 15a–1 (including procedures to determine whether a counterparty is acting in the capacity of principal or agent).[266] Under Rule 15c3–4, the dealer's management must also periodically review the dealer's business activities for consistency with risk management guidelines. The rule has been revised to require management, as part of this process, to review whether procedures are in place to prevent the dealer from engaging in impermissible securities transactions and from improperly relying on the exceptions contained in Rule 15a–1.[267]

4. Rule 17a–12; Reports to be Made by OTC Derivatives Dealers

Proposed Rule 17a–12 would have required an OTC derivatives dealer to file quarterly Financial Operational Combined Uniform Single Reports (''FOCUS'' reports),[268] and to include with its filing the enhanced reporting information and evaluation of risks in relation to capital provisions of the Framework for Voluntary Oversight of the Derivatives Policy Group (''DPG'').[269] Proposed Rule 17a–12 would also have required an OTC derivatives dealer to file annually its audited financial statements, a corresponding audit report, and three supplemental audit reports regarding (1) material inadequacies and reportable conditions; (2) derivatives pricing and modeling procedures; and (3) compliance with internal risk management controls. The proposed rule would have established guidelines for the content and form of the annual report, accountant qualifications, the process for designating an accountant, and audit objectives. For example, among other things, the annual audit report would have been required to include a statement of financial condition, a statement of income, a statement of cash flows, a statement of

instances, the broker-dealer is required to submit a report detailing steps being taken to correct the inadequacy.

[258] Proposing Release, Section II.H.2., 62 FR at 67950.

[259] Under proposed Rule 15b9–2, an OTC derivatives dealer would have been required to enter into an agreement with the examining authority for one or more of its registered broker-dealer affiliates. Under this agreement, the examining authority would have agreed to conduct a review of the activities of the OTC derivatives dealer. *See supra* note 181 and accompanying text.

[260] SIA Working Group Letter, p. 1.

[261] 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.

[262] Market risk involes 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.

[263] Credit risk comprises risk of loss resulting from counterparty default on loans, swaps, options, and other similar financial instruments during settlement.

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

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

[266] *See* Rule 15c3–4(c)(5)(xiii) and (xiv) (17 CFR 240.15c3–4(c)(5)(xiii) and (xiv)). *See also* Rule 15a–1 (17 CFR 240.15a–1) and Section II.C.1. above, discussing revisions to proposed Rule 15a–1.

[267] *See* rule 15c3–4(d)(8) and (9) (17 CFR 240.15c3–4(d)(8) and (9)).

[268] Form X–17A–5 (17 CFR 249.617).

[269] *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.

changes in owners' equity, and a statement of changes in subordinated liabilities.

The SIA requested clarification as to the scope of the auditor's report regarding inventory pricing and modeling procedures.[270] More specifically, the SIA sought clarification that the objective of the review of the inventory pricing and modeling procedures was to confirm that (1) the pricing and modeling procedures relied upon by the OTC derivatives dealer conform to the procedures submitted to the Commission as part of its OTC derivatives dealer application; and (2) the procedures comply with the qualitative and quantitative standards set forth in proposed Rule 15c3–1f.[271] Further clarification was sought by the SIA and other commenters as to whether an OTC derivatives dealer would be required to file its FOCUS report monthly or quarterly and whether an OTC derivatives dealer would be required to comply with Rule 17a–5 under the Exchange Act.[272]

Rule 17a–12 has been amended to clarify the scope of the auditor's report on inventory pricing and modeling procedures. The rule requires that, at a minimum, the accountant's report on inventory pricing and modeling procedures confirm that (1) the pricing and modeling procedures relied upon by the OTC derivatives dealer conform to the procedures submitted to the Commission as part of its OTC derivatives dealer application; and (2) the procedures comply with the qualitative and quantitative standards set forth in Rule 15c3–1f. This does not imply any lessening of the auditor's normal role in the audit of the financial statements of the OTC derivatives dealer. Finally, the rule provides that an OTC derivatives dealer must file its FOCUS report quarterly, unless otherwise directed by the Commission, and amends Rule 17a–5 to clarify that an OTC derivatives dealer may comply with Rule 17a–5 by complying with the provisions of Rule 17a–12.

5. Amendments to Form X–17A–5

Proposed Rule 17a–12 would have required 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 have provided for the 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 have been revised to reflect the proposed net capital requirements for OTC derivatives dealers. Other changes would have included 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 have been required to include certain new 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 have been required to provide, where applicable, a detailed summary of all long and short securities and commodities positions, including all OTC derivatives contracts. The SIA suggested several minor changes to the proposed amendments to Form X–17A–5.[273] For example, these suggestions included expanding the scope of covered OTC instruments to include all relevant sources of, or offsets to, market risk in an OTC derivatives dealer's portfolio. The SIA's suggestions have been incorporated into the amendments to Form X–17A–5, as adopted.

III. Costs and Benefits of the Rules and Rule Amendments

The rules and rule amendments adopted by the Commission today create a limited regulatory scheme for dealers active in the OTC derivatives market and allow U.S. securities firms to establish separately capitalized OTC derivatives dealer affiliates. OTC derivatives dealers may act as dealers in eligible OTC derivative instruments, which include both securities and non-securities OTC derivative instruments. Registration as an OTC derivatives dealer is optional and is an alternative to registration as a fully regulated broker-dealer or to conducting a more limited OTC derivatives business through an unregistered affiliate.

Under the limited regulatory scheme, an OTC derivatives dealer is able to conduct its business more efficiently and at lower cost than if it were a fully regulated broker-dealer. This is, in fact, because an OTC derivatives dealer is subject to specifically tailored capital, margin, and other broker-dealer regulatory requirements. With respect to margin in particular, OTC derivatives dealers are exempted from the margin requirements of Section 7(c) of the Exchange Act and Regulation T thereunder, provided that they comply with Section 7(d) of the Exchange Act and the requirements of Regulation U. Regulation U generally allows OTC derivatives dealers to extend credit on OTC derivative instruments on more flexible terms than Regulation T.

While registered OTC derivatives dealers will benefit from the new regulatory scheme, regulators and financial markets will also benefit if an unregistered derivatives dealer elects to register as an OTC derivatives dealer. Net capital requirements and other financial responsibility requirements imposed on registered OTC derivatives dealers help to protect against excessive leverage and business risk, and provide a cushion of capital against market declines and other risks. In addition, Commission oversight authority, including reporting and notice requirements, enable the Commission to monitor the financial and operational condition and securities activities of OTC derivatives dealers. Moreover, because an OTC derivatives dealer must adopt certain internal risk management controls that promote financial responsibility, the risk that significant losses by a single firm could undermine the securities markets as a whole is reduced.

A. Comments and Survey

In the Proposing Release, the Commission requested comment on the costs and benefits associated with the proposed rules and rule amendments.[274] More specifically, the Commission requested comment on the one-time costs of any modifications to accounting, information management, and recordkeeping systems required to implement the proposed rules and rule amendments, as well as on the continuing costs arising from compliance with the proposed rules and rule amendments. The Commission also requested comment on the benefits from the modified capital, margin, and other regulatory requirements. Commenters indicated that the new regulatory structure would result in lower capital requirements and would allow them to compete more effectively with banks and foreign dealers.[275] However, the Commission did not receive any specific cost or benefit data in response to the Proposing Release.

In an effort to obtain more specific information on the potential costs and

[270] SIA Letter I, p. 4.

[271] *Id.*

[272] 17 CFR 240.17a–5. *See* Section V.D.4.a. of the Comment Summary.

[273] SIA Letter I, pp. 16–17.

[274] Proposing Release, Section IV., 62 FR at 67952.

[275] *See* Section VI. of the Comment Summary.

benefits of operating as an OTC derivatives dealer, Commission staff asked broker-dealers to provide more specific estimates of the costs and benefits of moving OTC derivatives business to, and conducting business in the form of, an OTC derivatives dealer. Five firms that believed OTC derivative dealer registration would be cost effective provided cost information, and requested confidential treatment of the data provided to the Commission.[276] Most firms responding expected significant benefits from registering as an OTC derivatives dealer because of regulatory capital savings, increased capital efficiency, and efficiencies resulting from business consolidation. These benefits generally outweighed increased one-time and continuing operating costs associated with combining activities currently conducted in a registered broker-dealer with activities conducted in other unregistered entities. The firms that responded to the survey also stated that the margin requirements applicable to OTC derivatives dealers are beneficial in instances where the less stringent Regulation U applies to transactions instead of Regulation T, but costly to the extent Regulation U applies to offshore business not previously subject to either U.S. margin requirement.

Responses to the survey varied in terms of length and detail. Some were more qualitative than quantitative. At times respondents combined categories, making comparability and averaging more difficult. Where possible, estimated costs and benefits are provided below.

B. Benefits

1. Regulatory Capital Effects

Most firms responding to the survey identified regulatory capital effects as the most significant benefit resulting from operation as an OTC derivatives dealer. By applying Appendix F instead of taking traditional haircuts under paragraph (c)(2)(vi) of Rule 15c3–1, OTC derivatives dealers will be required to reserve less regulatory capital than they would if this business was conducted on the books of their fully regulated broker-dealer affiliates.[277] The five firms that provided estimated regulatory capital savings figures estimated an aggregate difference in net capital requirements of $1.25 billion if they registered as OTC derivatives dealers. Additionally, assuming that these firms would otherwise conduct their derivatives business through a fully regulated broker-dealer, the staff estimated that their reduced capital requirements would yield an aggregate annual benefit for the use of this capital of approximately $138 million.[278]

2. Operational Cost Savings

The firms surveyed generally predicted that they would not experience significant operational savings from operating as an OTC derivatives dealer. They predicted, but did not quantify, potential operational benefits from the consolidation of businesses into one entity. These benefits include:

- Streamlined transaction processing if all OTC derivatives activity were consolidated into one entity;
- Consolidated netting of counterparty credit exposures, and margining of counterparty net balances; and
- Consolidated transaction documentation by counterparty.

3. Decreased Margin Requirements

Most firms stated that the modified margin requirements would not be a significant benefit of registering as an OTC derivatives dealer, and did not quantify this benefit. The firms noted that margin requirements under Regulation U would be more flexible when extending credit than Regulation T, which applies to broker-dealers. They also noted, however, that with respect to business previously conducted offshore, which was not subject to Federal Reserve Board margin requirements, complying with Regulation U would increase the cost of doing business.

C. Costs

1. Costs of Combining Activities Into One Operation

A firm electing to register as an OTC derivatives dealer would incur costs to combine activities currently conducted in a registered broker-dealer with activities conducted in other unregistered entities. It also would incur continuing costs to comply with the applicable rules and rule amendments. Respondents to the survey identified, but did not uniformly quantify, the costs associated with operating as an OTC derivatives dealer. These costs include:

- Forming and registering as an OTC derivatives dealer;
- Adjusting risk management practices to conform with Rules 15c3–1 and 15c3–4;
- Enhancing and developing VAR and credit risk systems;
- Complying with minimum capital requirements;
- Making and retaining required books and records;
- Preparing and submitting FOCUS reports and annual audited financial statements;
- Responding to examination requests;
- Developing systems for compliance with the margin requirements of Regulation U;
- Subjecting offshore activities to Regulation U; and
- Hiring compliance personnel.

Five firms responding to the survey estimated that their annual operating costs would increase by at least $36 million in the aggregate to conduct business as an OTC derivatives dealer. Respondents' individual estimates of increased costs ranged from $900,000 to $26 million per year. However, they stated that the increases in operating costs were far outweighed by estimated positive regulatory capital effects. Although survey results were not uniformly comparable, estimates of some specific operational costs follow.

2. Registration as an OTC Derivatives Dealer

One firm estimated that the cost of registering an entity as an OTC derivatives dealer would be as high as $50,000. This firm noted that set-up and registration costs would likely decrease for later registrants, after the process becomes standardized.

3. Risk Management Adjustments

One firm did not consider the costs of further developing its VAR and other statistical risk models to be attributable to the OTC derivatives dealer specifically, because such development would be required in any event. This firm and another firm each estimated the cost of conforming their VAR model to the regulatory requirements to be approximately $200,000. A third firm estimated the cost of obtaining risk management systems and procedures that meet the regulatory requirements to be at least $250,000. One firm stated that the additional cost of compensating model-related personnel would be approximately $650,000 per year.

[276] Two additional firms submitted responses to the survey, but these responses are not reflected in this analysis. One firm provided limited cost information that was excluded because the firm indicated that, due to the small size of its OTC derivatives business, it is not likely to register as an OTC derivatives dealer. A second firm's response was excluded because it gave qualitative, rather than quantitative, information. A summary of the responses to the survey has been placed in Public Reference File No. S7–30–97 and is available for inspection in the Commission's Public Reference Room.

[277] Many of these firms may currently conduct their OTC derivatives business in unregistered or offshore affiliates not subject to regulatory net capital requirements.

[278] The total annual benefit was computed by multiplying the regulatory capital savings of $1.25 billion by 11%, which is the average of three estimated incremental rates of return provided by three responding firms.

4. Books and Records Requirements

Apart from a likely increase in outside auditor fees, firms generally stated that the cost of compliance with books and records and reporting requirements were not significant. One firm estimated that the cost of systems changes necessary to create and maintain OTC derivatives dealer books and records, as well as the cost of necessary compliance personnel would be $500,000 in the first year. A second firm estimated that the cost of compensating additional regulatory compliance staff would be approximately $75,000 per year. A third firm expected increased costs of $400,000 per year for audit and related services, and for hiring additional personnel in the areas of compliance, operations, and reporting.

5. Regulatory Reporting

One firm estimated that the cost for an OTC derivatives dealer to prepare the required regulatory reports would be approximately $38,000 per year. This firm also estimated that internal and external auditor fees would be $100,000 per year. Another firm estimated the cost of preparation for regulatory examinations as $75,000 per year.

6. Regulation U Margin Requirements

One firm estimated the cost of maintaining OTC derivative dealer margin to be approximately $75,000. The Commission has also considered whether systemic risk would be created by permitting OTC derivatives dealers to comply with the reduced margin requirements of Regulation U as opposed to Regulation T. Although the collection of less margin in some transactions may increase risk for OTC derivatives dealers, the systemic risk is no greater for OTC derivatives dealers than for their banking competitors. Further, this risk is offset in part by financial responsibility safeguards applicable to OTC derivatives dealers, such as the minimum capital requirements in Rule 15c3–1 and the internal risk management control systems required by Rule 15c3–4.

D. Conclusion

Based on the survey results and its own analysis, the Commission believes that the rules and rule amendments adopted today provide firms that are active in the OTC derivatives market with a cost effective alternative to conducting this business through a fully regulated broker-dealer. In addition, it is important to note that registration as an OTC derivatives dealer is optional. Thus, a firm can perform its own cost and benefit analysis to determine whether registration as an OTC derivatives dealer is an appropriate alternative for that firm.

IV. Efficiency, Competition, and Capital Formation

Section 23(a)(2) of the Exchange Act[279] requires the Commission, in adopting Exchange Act rules, to consider the impact any such rule would have on competition and to not adopt a rule that would impose a burden on competition not necessary or appropriate in furthering the purposes of the Exchange Act. Furthermore, section 3(f) of the Exchange Act[280] provides that whenever the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The Commission has considered the rules and rule amendments in light of the standards cited in sections 23(a)(2) and 3(f) of the Exchange Act.

In the Proposing Release, the Commission requested comment on the effect of the proposed rules and rule amendments on competition, efficiency, and capital formation.[281] Commenters generally indicated that the reduced capital, margin, and other regulatory requirements would allow an OTC derivatives dealer to compete more effectively with banks and foreign dealers. However, commenters did not provide detailed information or analysis on the limited regulatory scheme's effect on competition, efficiency, or capital formation.[282]

The rules and rule amendments adopted by the Commission today increase the ability of certain highly capitalized broker-dealers to compete effectively in global securities markets by removing substantial regulatory and economic barriers. Because registration as an OTC derivatives dealers is optional and is an alternative to registration as a fully regulated broker-dealer or to conducting a more limited OTC derivatives business in an unregistered entity, a firm can make its own analysis of the competitive advantages of being registered as an OTC derivatives dealer.

Major dealers in the OTC derivatives market are generally large, highly capitalized banks and securities firms. One commenter opposed any minimum tentative net capital requirement, arguing that other U.S. broker-dealers are not required to maintain minimum tentative net capital under the net capital rule, and that U.S. firms, and particularly small-sized, medium-sized, and newly established OTC derivatives dealers, would be at a competitive disadvantage.[283] It is likely that smaller firms in the OTC derivatives business will not be able to register as OTC derivatives dealers because they cannot satisfy the minimum capital requirements. This will not prevent competition, however, because these smaller firms may continue to conduct their OTC derivatives business outside of the OTC derivatives dealer regulatory structure, although they will not receive the benefits of the new rules. Further, reducing minimum capital requirements would not be consistent with investor protection.

The minimum capital requirements imposed on OTC derivatives dealers are necessary to help protect against excessive leverage and the risks associated with conducting an OTC derivatives business, and to provide a cushion of capital against severe market disturbances. It would not be appropriate, for example, to require less capital from less active OTC derivatives dealers. Firms of all sizes face risks, such as legal risk, liquidity risk, and operational risk, which are not typically incorporated into VAR calculations. Further, VAR may not measure losses that fall outside of normal conditions, such as during steep market declines. The minimum capital requirements provide additional safeguards to account for possible extraordinary losses or decreases in liquidity during times of market stress.

Two commenters suggested that the Commission address certain competitive disparities that they argued exist between exchange-traded products and seemingly similar products available in the OTC derivatives market.[284] The rules adopted today are only designed to address competitive disparities between market participants within the OTC derivatives market. They are not intended to address actual or perceived competitive disparities between OTC products and any other product or service.

The rules and rule amendments promote market efficiency and capital formation. The limited regulatory scheme provides U.S. broker-dealers with an optional alternative to conducting OTC derivatives

[279] 15 U.S.C. 78w(a)(2).

[280] 15 U.S.C. 78c(f).

[281] Proposing Release, Sections IV. and V., 62 FR at 67952–53.

[282] *See* Section VI. of the Comment Summary.

[283] DESCO Leter, pp. 9–10.

[284] CBOE Letter, pp. 1–2; Comment Letter from the Chicago Mercantile Exchange, p. 2.

transactions through fully regulated broker-dealers, but does not create significant impediments to competition. As a result of the new regulatory structure, the Commission will be better able to monitor the financial and operational activities of OTC derivatives dealers. Finally, minimum capital requirements will provide a cushion against severe market disturbances, thus reducing the risk that a single firm will experience significant losses and trigger such losses by other market participants.

V. Summary of Final Regulatory Flexibility Analysis

A Final Regulatory Flexibility Analysis (''FRFA'') regarding the rules and rule amendments under the Exchange Act that tailor capital, margin, and other broker-dealer regulatory requirements to the activities of OTC derivatives dealers has been prepared in accordance with 5 U.S.C. 604. The FRFA notes that registration as an OTC derivatives dealer is optional, and therefore will not impose any reporting requirements for those entities choosing not to become registered as OTC derivatives dealers. Those entities choosing to register as OTC derivatives dealers under the new regulatory system will be subject to the reporting requirements applicable to broker-dealers under the Exchange Act.

A. Need for the Rules and Rule Amendments

As discussed more fully in the FRFA, the rules and rule amendments are intended to give U.S. securities firms an opportunity to conduct business in a vehicle subject to modified regulation appropriate to OTC derivatives markets, and thereby to improve the efficiency and competitiveness of U.S. securities firms participating in global OTC derivatives markets. These improvements will be realized through a limited regulatory structure that is expected 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 requirements of Regulation T should make it feasible for firms to conduct a business involving both securities and non-securities OTC derivative instruments within the United States. Commenters generally commended the Commission for its efforts to improve competition and efficiency.

B. Small Entities Subject to the Rules

These rules and rule amendments will not significantly affect a substantial number of small entities, as defined in the Commission's rules.[285] At the time of the Proposing Release, a broker-dealer (including any person that would be an OTC derivatives dealer) generally would be considered a small entity if (1) it had 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 (2) it is not affiliated with any person (other than a natural person) that is not a small business or small organization.[286]

The Commission requested comment with respect to the Initial Regulatory Flexibility Analysis (''IRFA'') that was prepared when the new regulatory regime was proposed. The Commission did not receive any comments specifically concerning the IRFA. However, some of the commenters addressed aspects of the rules that could potentially affect small businesses. These comments are discussed below.

Under the amendments to Rule 15c3–1, OTC derivatives dealers are required to maintain at least $100 million in tentative net capital and at least $20 million in net capital. Based on these minimum capital requirements, the FRFA 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 capital requirements for OTC derivatives dealers have been tailored 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.

Registration as an OTC derivatives dealer is optional. The rules and rule amendments do not require any broker-dealer to use this alternative. Instead, all broker-dealers may consider whether, given the nature of their business or any other relevant considerations, they want to register as an OTC derivatives dealer. Accordingly, the rules and rule amendments do not impose any additional costs on any entity, including any small business, currently engaging in the business of effecting transactions in OTC derivative instruments.

The rules and rule amendments guard against excessive leverage and the risk associated with conducting an OTC derivatives business, and provide a cushion of capital against severe market disturbances. In order to do so, the final rules require that an OTC derivatives dealer maintain $100 million in tentative net capital and $20 million in net capital. Lesser net capital requirements for small entities seeking to register as OTC derivatives dealers likely would not afford sufficient protection against these risks.

Given the level of these net capital requirements, the Commission is not aware of any small business or small organizations, as defined in Rule 0–10, that could operate as OTC derivatives dealers under the rule. In any event, the Commission is not aware of any small business or small organizations, as defined in Rule 0–10, that currently are active as dealers in OTC derivatives markets. In the Proposing Release, the Commission specifically requested comment on whether there were small entities that act as dealers in OTC derivatives, and what effect, if any, the proposed rules and rule amendments would have on their activities. No small entities, as defined in Rule 0–10 under the Exchange Act, submitted comments addressing this issue. Only one commenter, which is not a small entity under the Commission's rules, addressed the impact of the rules on small entities that might wish to take advantage of the new regulatory regime, noting that the $100 million tentative net capital requirement could have anti-competitive consequences for small-and medium-sized firms and newer entrants to the OTC derivatives business.

The final rules and rule amendments contain no limitations on the ability of small entities to participate as counterparties in OTC derivatives transactions with registered OTC derivatives dealers. Under proposed Rule 3b–14, the term ''permissible derivatives counterparty'' would have included a range of financial institutions, corporations, and other institutional entities with whom OTC

[285] On June 24, 1998, several months after the Proposing Release was published, the Commission amended its definitions of small entities. *See* Exchange Act Release No. 40122 (June 24, 1998), 63 FR 35508 (June 30, 1998). The Commission's revised definition applicable to broker-dealers, effective as of July 30, 1998, maintains the capital standard set forth in the prior version, but also expands the affiliation standard applicable to broker-dealers. *See* Rule 0–10 under the Exchange Act (17 CFR 240.0–10). Although the FRFA analyzes the rules and rule amendments under the previous definition, the analysis applies equally under the Commission's new definition.

[286] Rule 0–10 (17 CFR 240.0–10).

derivatives dealers would have been permitted to enter into OTC derivatives transactions. Like OTC derivatives dealers, these institutional counterparties are frequently large, well-capitalized entities. Nevertheless, the proposed definition may have also included potential counterparties that would be considered small entities for purposes of the Regulatory Flexibility Act (''RFA'').[287]

The Commission specifically requested 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 Commission also specifically requested 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. No comments from small entities addressing this issue were received. Numerous comments, however, were received regarding the proposed definition of ''eligible derivatives counterparty.''

The majority of commenters on this issue suggested that a broad range of persons should be able to act as permissible derivatives counterparties, and believed that the definition should be expanded, at a minimum, to include natural persons having at least $5 million in total assets as proposed. Other commenters raised concerns that the proposed group of permissible derivatives counterparties could include unsophisticated persons who would need the protections provided by the securities sales practice requirements.

In response to commenters' concerns, and in light of the protections afforded through requiring intermediation of securities transactions, the final rules do not limit the persons with whom an OTC derivatives dealer may engage in transactions. Thus, to the extent that a small entity could act as a counterparty to an OTC derivatives transaction prior to the adoption of this new regulatory regime, it may still act as a counterparty to an OTC derivatives dealer under the new rules and rule amendments. Nothing in these rules, therefore, affects the ability of a small entity to participate in an OTC derivatives transaction. Other provisions of the rules that require broker-dealer intermediation will help assure protection of small entities.

[287] 5 U.S.C. 601 *et seq.*

C. Projected Reporting, Recordkeeping, and Other Compliance Requirements

Because no small entity would be eligible to meet the requirements of an OTC derivatives dealer, there is no compliance requirement for small entities. The adopting release details the cost, benefits, and compliance requirements for non-small entities that elect to register as OTC derivatives dealers.

As explained in the FRFA, none of the recordkeeping, reporting, or other compliance requirements under the rules and rule amendments are expected to apply directly to counterparties that enter into transactions with OTC derivatives dealers. No small entities commented on this aspect of the proposal, and no commenters addressed the costs, if any, on small entities that acted as counterparties to OTC derivatives transactions with OTC derivatives dealers. Nevertheless, the ability of an OTC derivatives dealer to consolidate its OTC derivatives activities into a single entity under the new regulatory regime with lower capital and margin requirements could result in lower transactional costs to counterparties, including small entities.

D. Alternatives To Minimize Effect on Small Entities

As discussed further in the FRFA, the Commission has considered alternatives to the rules and rule amendments that would minimize the effects of the rules on small entities, but would still accomplish the stated objectives of improving the efficiency and competitiveness of U.S. securities firms participating in global OTC derivatives markets, and make it feasible for these firms to conduct a business involving securities and non-securities OTC derivative instruments within the United States. Several of these alternatives were considered but rejected, while other alternatives were taken into account in the final rules. The final rules and rule amendments meet the Commission's stated goals by tailoring capital, margin, and other regulatory requirements to the activities of OTC derivatives dealers, while still providing sufficient protections.

Registration as an OTC derivatives dealer is an alternative to registration as a fully regulated broker-dealer, and is optional. The Commission is not imposing any additional costs on any entity, including any small businesses, currently engaging in the business of effecting transactions in OTC derivative instruments, which could remain subject to full regulation. The proposed capital requirements, in particular, provide OTC derivatives dealers with significant alternatives for computing risk charges. Thus, firms choosing to register as OTC derivatives dealers may individually tailor the methodology they will employ to calculate their net capital on an on-going basis, subject to Commission staff authorization. This flexibility should enable firms to keep costs of compliance as low as possible.

The final rules and rule amendments guard against excessive leverage and the risks associated with conducting an OTC derivatives business, and provide a cushion of capital against severe market disturbances. In order to do so, the final rules require that an OTC derivatives dealer maintain $100 million in tentative net capital and $20 million in net capital. Lesser net capital requirements for small entities seeking to register as OTC derivatives dealers would not afford sufficient protection against these risks, and this alternative was therefore rejected. Similarly, additional exemptions from specific broker-dealer regulations under the Exchange Act for small businesses engaging in an OTC derivatives business, if there are any, would not be warranted. Moreover, the Commission is not aware of any small businesses that are currently engaged as dealers in OTC derivative instruments.

Counterparties are expected to benefit from the final rules and rule amendments by being able to engage in transactions in both securities and non-securities OTC derivative instruments with a class of registered dealers subject to Commission oversight. To the extent that a small entity could act as a counterparty to an OTC derivatives transaction prior to adoption of the new regulatory regime, it would still be able to act in that capacity after adoption of the new rules and rule amendments. Nothing in the Commission's optional regulatory regime for OTC derivatives dealers affects a counterparty's ability to enter into an OTC derivatives transaction with an OTC derivatives dealer. A copy of the FRFA may be obtained by contacting Laura S. Pruitt, Special Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Mail Stop 10–1, Washington, DC 20549, (202) 942–0073.

VI. Paperwork Reduction Act

As set forth in the Proposing Release, Rules 15c3–4, 17a–12, Appendix F to Rule 15c3–1, and the amendments to Rule 17a–3 contain collections of information within the meaning of the Paperwork Reduction Act of 1995

(''PRA'').[288] Accordingly, the collection of information requirements contained in the rules and rule amendments were submitted to the Office of Management and Budget (''OMB'') for review and were approved by OMB which assigned the following control numbers: Rule 15c3–4, control number 3235–0497; Rule 17a–12, control number 3235–0498; Appendix F to Rule 15c3–1, control number 3235–0496; and amendments to Rule 17a–3, control number 3235–0033. The collections of information are in accordance with Section 3507 of the PRA.[289]

The collection of information obligations imposed by the rules and rule amendments are mandatory. However, it is important to note that registration as an OTC derivatives dealer is optional. The information collected, retained, and/or filed pursuant to the rules and rule amendments will 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.

The collections of information are necessary for persons to obtain certain benefits or to comply with certain requirements. As described in the Proposing Release, the rules and rule amendments to which the collections of information are related implement a limited regulatory system under the Exchange Act for OTC derivatives dealers. Under this limited regulatory system, OTC derivatives dealers are permitted to engage in dealing activities with respect to certain types of securities and non-securities OTC derivatives instruments, and to issue and reacquire their issued securities, without being required to comply with the full range of capital, margin, and other regulatory requirements applicable to other regulated broker-dealers.

The Proposing Release solicited comments on the proposed collections of information. No comments were received that addressed the PRA submission. However, the Commission did receive comments on other aspects of the proposal. After carefully considering the comments received, the Commission is retaining its collection of information burden estimate. Thus the descriptions and estimated burdens of the collection of information requirements have not changed, and are set forth in the Proposing Release.

[288] 44 U.S.C. 3501 *et seq.*

[289] 44 U.S.C. 3507.

VII. 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), 11(a), 15(a), 15(b), 15(c), 17(a), 23, and 36 thereof (15 U.S.C. 78c(b), 78k(a), 78o(a), 78o(b), 78o(c), 78q(a), 78w, and 78mm)).

Text of Rules and 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.

For the reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as set forth below.

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, 78*ll*(d), 78mm, 79t, 77sss, 80a–37, 80b–11, unless otherwise noted.

* * * * *

2. Section 200.30–3 is amended by removing the period after paragraph (a)(7)(iv) and in its place adding ''; and'' and by adding paragraphs (a)(7)(v), (a)(64), (a)(65) and (a)(66) to read as follows:

§ 200.30–3 Delegation of authority to Director of Division of Market Regulation.

* * * * *

(a) * * *

(7) * * *

(v) To review applications of OTC derivatives dealers filed pursuant to Appendix F of § 240.15c3–1f of this chapter, and to grant or deny such applications in full or in part.

* * * * *

(64) Pursuant to § 240.15a–1(b)(1) of this chapter, to issue orders identifying other permissible securities activities in which an OTC derivatives dealer may engage.

(65) Pursuant to § 240.15a–1(b)(2) of this chapter, to issue orders determining that a class of fungible instruments that are standardized as to their material economic terms is within the scope of eligible OTC derivative instrument.

(66) Pursuant to § 240.17a–12 of this chapter:

(i) To authorize the issuance of orders requiring OTC derivatives dealers to file, pursuant to § 240.17a–12(a)(ii) of this chapter, 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 and operational information as shall be specified.

(ii) Pursuant to § 240.17a–12(n) of this chapter, to consider applications by OTC derivatives dealers for exemptions from, and extensions of time within which to file, reports required by § 240.17a–12 of this chapter, and to grant or deny such applications.

* * * * *

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

3. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j–1, 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–15 to read as follows:

§ 240.3b–12 Definition of OTC derivatives dealer.

The term *OTC derivatives dealer* means any dealer that is affiliated with a registered broker or dealer (other than an OTC derivatives dealer), and whose securities activities:

(a) Are limited to:

(1) Engaging in dealer activities in eligible OTC derivative instruments that are securities;

(2) Issuing and reacquiring securities that are issued by the dealer, including warrants on securities, hybrid securities, and structured notes;

(3) Engaging in cash management securities activities;

(4) Engaging in ancillary portfolio management securities activities; and

(5) Engaging in such other securities activities that the Commission designates by order pursuant to § 240.15a–1(b)(1); and

(b) Consist primarily of the activities described in paragraphs (a)(1), (a)(2), and (a)(3) of this section; and

(c) Do not consist of any other securities activities, including engaging in any transaction in any security that is not an eligible OTC derivative instrument, except as permitted under paragraphs (a)(3), (a)(4), and (a)(5) of this section.

(d) For purposes of this section, the term *hybrid security* means a security that incorporates payment features economically similar to options,

forwards, futures, swap agreements, or collars involving currencies, interest or other rates, commodities, securities, indices, quantitative measures, or other financial or economic interests or property of any kind, or any payment or delivery that is dependent on the occurrence or nonoccurrence of any event associated with a potential financial, economic, or commercial consequence (or any combination, permutation, or derivative of such contract or underlying interest).

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

(a) Except as otherwise provided in paragraph (b) of this section, the term *eligible OTC derivative instrument* means any contract, agreement, or transaction that:

(1) Provides, in whole or in part, on a firm or contingent basis, for the purchase or sale of, or is based on the value of, or any interest in, one or more commodities, securities, currencies, interest or other rates, indices, quantitative measures, or other financial or economic interests or property of any kind; or

(2) Involves any payment or delivery that is dependent on the occurrence or nonoccurrence of any event associated with a potential financial, economic, or commercial consequence; or

(3) Involves any combination or permutation of any contract, agreement, or transaction or underlying interest, property, or event described in paragraphs (a)(1) or (a)(2) of this section.

(b) The term *eligible OTC derivative instrument* does not include any contract, agreement, or transaction that:

(1) Provides for the purchase or sale of a security, on a firm basis, unless:

(i) The settlement date for such purchase or sale occurs at least one year following the trade date or, in the case of an eligible forward contract, at least four months following the trade date; or

(ii) The material economic features of the contract, agreement, or transaction consist primarily of features of a type described in paragraph (a) of this section other than the provision for the purchase or sale of a security on a firm basis; or

(2) Provides, in whole or in part, on a firm or contingent basis, for the purchase or sale of, or is based on the value of, or any interest in, any security (or group or index of securities), and is:

(i) Listed on, or traded on or through, a national securities exchange or registered national securities association, or facility or market thereof; or

(ii) Except as otherwise determined by the Commission by order pursuant to § 240.15a–1(b)(2), one of a class of fungible instruments that are standardized as to their material economic terms.

(c) The Commission may issue an order pursuant to § 240.15a–1(b)(3) clarifying whether certain contracts, agreements, or transactions are within the scope of eligible OTC derivative instrument.

(d) For purposes of this section, the term *eligible forward contract* means a forward contract that provides for the purchase or sale of a security other than a government security, provided that, if such contract provides for the purchase or sale of margin stock (as defined in Regulation U of the Regulations of the Board of Governors of the Federal Reserve System, 12 CFR Part 221), such contract either:

(1) Provides for the purchase or sale of such stock by the issuer thereof (or an affiliate that is not a bank or a broker or dealer); or

(2) Provides for the transfer of transaction collateral in an amount that would satisfy the requirements, if any, that would be applicable assuming the OTC derivatives dealer party to such transaction were not eligible for the exemption from Regulation T of the Regulations of the Board of Governors of the Federal Reserve System, 12 CFR part 220, set forth in § 240.36a1–1.

§ 240.3b–14 Definition of cash management securities activities.

The term *cash management securities activities* means securities activities that are limited to transactions involving:

(a) Any taking possession of, and any subsequent sale or disposition of, collateral provided by a counterparty, or any acquisition of, and any subsequent sale or disposition of, collateral to be provided to a counterparty, in connection with any securities activities of the dealer permitted under § 240.15a–1 or any non-securities activities of the dealer that involve eligible OTC derivative instruments or other financial instruments;

(b) Cash management, in connection with any securities activities of the dealer permitted under § 240.15a–1 or any non-securities activities of the dealer that involve eligible OTC derivative instruments or other financial instruments; or

(c) Financing of positions of the dealer acquired in connection with any securities activities of the dealer permitted under § 240.15a–1 or any non-securities activities that involve eligible OTC derivative instruments or other financial instruments.

§ 240.3b–15 Definition of ancillary portfolio management securities activities.

(a) The term *ancillary portfolio management securities activities* means securities activities that:

(1) Are limited to transactions in connection with:

(i) Dealer activities in eligible OTC derivative instruments;

(ii) The issuance of securities by the dealer; or

(iii) Such other securities activities that the Commission designates by order pursuant to § 240.15a–1(b)(1); and

(2) Are conducted for the purpose of reducing the market or credit risk of the dealer or consist of incidental trading activities for portfolio management purposes; and

(3) Are limited to risk exposures within the market, credit, leverage, and liquidity risk parameters set forth in:

(i) The trading authorizations granted to the associated person (or to the supervisor of such associated person) who executes a particular transaction for, or on behalf of, the dealer; and

(ii) The written guidelines approved by the governing body of the dealer and included in the internal risk management control system for the dealer pursuant to § 240.15c3–4; and

(4) Are conducted solely by one or more associated persons of the dealer who perform substantial duties for, or on behalf of, the dealer in connection with its dealer activities in eligible OTC derivative instruments.

(b) The Commission may issue an order pursuant to § 240.15a–1(b)(4) clarifying whether certain securities activities are within the scope of ancillary portfolio management securities activities.

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

§ 240.8c–1 Hypothecation of customers' securities.

* * * * *

(b) * * *

(1) The term *customer* shall not 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. The term also shall not include any counterparty who has delivered collateral to an OTC derivatives dealer pursuant to a transaction in an eligible OTC derivative instrument, or pursuant to the OTC derivatives dealer's cash management securities activities or ancillary portfolio management securities activities, and who has received a prominent written

notice from the OTC derivatives dealer that:

(i) Except as otherwise agreed in writing by the OTC derivatives dealer and the counterparty, the dealer may repledge or otherwise use the collateral in its business;

(ii) In the event of the OTC derivatives dealer's failure, the counterparty will likely be considered an unsecured creditor of the dealer as to that collateral;

(iii) The Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa through 78lll) does not protect the counterparty; and

(iv) The collateral will not be subject to the requirements of § 240.8c–1, § 240.15c2–1, § 240.15c3–2, or § 240.15c3–3;

* * * * *

6. By adding § 240.11a1–6 to read as follows:

§ 240.11a1–6 Transactions for certain accounts of OTC derivatives dealers.

A transaction effected by a member of a national securities exchange for the account of an OTC derivatives dealer that is an associated person of that member shall be deemed to be of a kind that is consistent with the purposes of section 11(a)(1) of the Act (15 U.S.C. 78k(a)(1)), the protection of investors, and the maintenance of fair and orderly markets if, assuming such transaction were for the account of a member, the member would have been permitted, under section 11(a) of the Act and the other rules thereunder (with the exception of § 240.11a1–2), to effect the transaction.

7. By adding § 240.15a–1 under the undesignated section heading ''Exemption of Certain OTC Derivatives Dealers'' to read as follows:

§ 240.15a–1 Securities activities of OTC derivatives dealers.

Preliminary Note: OTC derivatives dealers are a special class of broker-dealers that are exempt from certain broker-dealer requirements, including membership in a self-regulatory organization (§ 240.15b9–2), regular broker-dealer margin rules (§ 240.36a1–1), and application of the Securities Investor Protection Act of 1970 (§ 240.36a1–2). OTC derivative dealers are subject to special requirements, including limitations on the scope of their securities activities (§ 240.15a–1), specified internal risk management control systems (§ 240.15c3–4), recordkeeping obligations (§ 240.17a–3(a)(10)), and reporting responsibilities (§ 240.17a–12). They are also subject to alternative net capital treatment (§ 240.15c3–1(a)(5)). This rule 15a–1 uses a number of defined terms in setting forth the securities activities in which an OTC derivatives dealer may engage: ''OTC derivatives dealer,'' ''eligible OTC derivative instrument,'' ''cash management securities activities,'' and ''ancillary portfolio management securities activities.'' These terms are defined under Rules 3b–12 through 3b–15 (§ 240.3b–12 through § 240.3b–15).

(a) The securities activities of an OTC derivatives dealer shall:

(1) Be limited to:

(i) Engaging in dealer activities in eligible OTC derivative instruments that are securities;

(ii) Issuing and reacquiring securities that are issued by the dealer, including warrants on securities, hybrid securities, and structured notes;

(iii) Engaging in cash management securities activities;

(iv) Engaging in ancillary portfolio management securities activities; and

(v) Engaging in such other securities activities that the Commission designates by order pursuant to paragraph (b)(1) of this section; and

(2) Consist primarily of the activities described in paragraphs (a)(1)(i), (a)(1)(ii), and (a)(1)(iii) of this section; and

(3) Not consist of any other securities activities, including engaging in any transaction in any security that is not an eligible OTC derivative instrument, except as permitted under paragraphs (a)(1)(iii), (a)(1)(iv), and (a)(1)(v) of this section.

(b) The Commission, by order, entered upon its own initiative or after considering an application for exemptive relief, may clarify or expand the scope of eligible OTC derivative instruments and the scope of permissible securities activities of an OTC derivatives dealer. Such orders may:

(1) Identify other permissible securities activities;

(2) Determine that a class of fungible instruments that are standardized as to their material economic terms is within the scope of eligible OTC derivative instrument;

(3) Clarify whether certain contracts, agreements, or transactions are within the scope of eligible OTC derivative instrument; or

(4) Clarify whether certain securities activities are within the scope of ancillary portfolio management securities activities.

(c) To the extent an OTC derivatives dealer engages in any securities transaction pursuant to paragraphs (a)(1)(i) through (a)(1)(v) of this section, such transaction shall be effected through a registered broker or dealer (other than an OTC derivatives dealer) that, in the case of any securities transaction pursuant to paragraphs (a)(1)(i), or (a)(1)(iii) through (a)(1)(v) of this section, is an affiliate of the OTC derivatives dealer, except that this paragraph (c) shall not apply if:

(1) The counterparty to the transaction with the OTC derivatives dealer is acting as principal and is:

(i) A registered broker or dealer;

(ii) A bank acting in a dealer capacity, as permitted by U.S. law;

(iii) A foreign broker or dealer; or

(iv) An affiliate of the OTC derivatives dealer; or

(2) The OTC derivatives dealer is engaging in an ancillary portfolio management securities activity, and the transaction is in a foreign security, and a registered broker or dealer, a bank, or a foreign broker or dealer is acting as agent for the OTC derivatives dealer.

(d) To the extent an OTC derivatives dealer induces or attempts to induce any counterparty to enter into any securities transaction pursuant to paragraphs (a)(1)(i) through (a)(1)(v) of this section, any communication or contact with the counterparty concerning the transaction (other than clerical and ministerial activities conducted by an associated person of the OTC derivatives dealer) shall be conducted by one or more registered persons that, in the case of any securities transaction pursuant to paragraphs (a)(1)(i), or (a)(1)(iii) through (a)(1)(v) of this section, is associated with an affiliate of the OTC derivatives dealer, except that this paragraph (d) shall not apply if the counterparty to the transaction with the OTC derivatives dealer is:

(1) A registered broker or dealer;

(2) A bank acting in a dealer capacity, as permitted by U.S. law;

(3) A foreign broker or dealer; or

(4) An affiliate of the OTC derivatives dealer.

(e) For purposes of this section, the term *hybrid security* means a security that incorporates payment features economically similar to options, forwards, futures, swap agreements, or collars involving currencies, interest or other rates, commodities, securities, indices, quantitative measures, or other financial or economic interests or property of any kind, or any payment or delivery that is dependent on the occurrence or nonoccurrence of any event associated with a potential financial, economic, or commercial consequence (or any combination, permutation, or derivative of such contract or underlying interest).

(f) For purposes of this section, the term *affiliate* means any organization (whether incorporated or unincorporated) that directly or indirectly controls, is controlled by, or is under common control with, the OTC derivatives dealer.

(g) For purposes of this section, the term *foreign broker or dealer* means any person not resident in the United States (including any U.S. person engaged in business as a broker or dealer entirely outside the United States, except as otherwise permitted by § 240.15a–6) that is not an office or branch of, or a natural person associated with, a registered broker or dealer, whose securities activities, if conducted in the United States, would be described by the definition of ''broker'' in section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) or ''dealer'' in section 3(a)(5) of the Act (15 U.S.C. 78c(a)(5)).

(h) For purposes of this section, the term *foreign security* means any security (including a depositary share issued by a United States bank, provided that the depositary share is initially offered and sold outside the United States in accordance with Regulation S (17 CFR 230.901 through 230.904)) issued by a person not organized or incorporated under the laws of the United States, provided the transaction that involves such security is not effected on a national securities exchange or on a market operated by a registered national securities association; or a debt security (including a convertible debt security) issued by an issuer organized or incorporated under the laws of the United States that is initially offered and sold outside the United States in accordance with Regulation S (17 CFR 230.901 through 230.904).

(i) For purposes of this section, the term *registered person* is:

(A) A natural person who is associated with a registered broker or dealer and is registered or approved under the rules of a self-regulatory organization of which such broker or dealer is a member; or

(B) If the counterparty to the transaction with the OTC derivatives dealer is a resident of a jurisdiction other than the United States, a natural person who is not resident in the United States and is associated with a broker or dealer that is registered or licensed by a foreign financial regulatory authority in the jurisdiction in which such counterparty is resident or in which such natural person is located, in accordance with applicable legal requirements, if any.

8. 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 that of acting as an OTC derivatives dealer.

* * * * *

9. By adding § 240.15b9–2 to read as follows:

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

An OTC derivatives dealer, as defined in § 240.3b–12, shall be exempt from any requirement under section 15(b)(8) of the Act (15 U.S.C. 78o(b)(8)) to become a member of a registered national securities association.

10. 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 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. The term also shall not include a counterparty who has delivered collateral to an OTC derivatives dealer pursuant to a transaction in an eligible OTC derivative instrument, or pursuant to the OTC derivatives dealer's cash management securities activities or ancillary portfolio management securities activities, and who has received a prominent written notice from the OTC derivatives dealer that:

(i) Except as otherwise agreed in writing by the OTC derivatives dealer and the counterparty, the dealer may repledge or otherwise use the collateral in its business;

(ii) In the event of the OTC derivatives dealer's failure, the counterparty will likely be considered an unsecured creditor of the dealer as to that collateral;

(iii) The Securities Investor Protection Act of 1970 (15 U.S.C 78aaa through 78lll) does not protect the counterparty; and

(iv) The collateral will not be subject to the requirements of § 240.8c–1, § 240.15c2–1, § 240.15c3–2, or § 240.15c3–3;

* * * * *

11. Section 240.15c2–5 is amended by adding paragraph (d) to read as follows:

§ 240.15c2–5 Disclosure and other requirements when extending or arranging credit in certain transactions.

* * * * *

(d) This section shall not apply to a transaction involving the extension of credit by an OTC derivatives dealer, as defined in § 240.3b–12, if the transaction is exempt from the provisions of Section 7(c) of the Act (15 U.S.C. 78g(c)) pursuant to § 240.36a1–1.

12. Section 240.15c3–1 is amended to add a sentence following the first sentence in the introductory text of paragraph (a); adding paragraphs (a)(5) 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, an OTC derivatives dealer shall maintain net capital pursuant to paragraph (a)(5) of this section. * * *

(5) In accordance with Appendix F to this section (§ 240.15c3–1f), the Commission may grant an application by an OTC derivatives dealer when calculating net capital to use the market risk standards of Appendix F as to some or all of its positions in lieu of the provisions of paragraph (c)(2)(vi) of this section and the credit risk standards of Appendix F to its receivables (including counterparty net exposure) arising from transactions in eligible OTC derivative instruments in lieu of the requirements of paragraph (c)(2)(iv) of this section. 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) * * *

(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 to this section (§ 240.15c3–1b). However, for purposes of paragraph (a)(5) of this section, the term *tentative net capital* means the net capital of an OTC derivatives dealer before deducting the charges for market and credit risk as computed pursuant to Appendix F to this section (§ 240.15c3–1f) or paragraph (c)(2)(vi) of this section, if applicable, and increased by the balance sheet value (including counterparty net exposure) resulting from transactions in eligible OTC derivative instruments which would otherwise be deducted by virtue of paragraph (c)(2)(iv) of this section.

* * * * *

13. By adding § 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)

Application Requirements

(a) An OTC derivatives dealer may apply to the Commission for authorization to compute capital charges for market and credit risk pursuant to this Appendix F in lieu of computing securities haircuts pursuant to § 240.15c3–1(c)(2)(vi).

(1) An OTC derivatives dealer's application shall contain the following information:

(i) *Executive summary.* An OTC derivatives dealer shall include in its application an Executive Summary of information provided to the Commission.

(ii) *Description of methods for computing market risk charges.* An OTC derivatives dealer shall provide a description of all statistical models used for pricing OTC derivative instruments and for computing value-at-risk (''VAR''), a description of the applicant's controls over those models, and a statement regarding whether the firm has developed its own internal VAR models. If the OTC derivatives dealer's VAR model incorporates empirical correlations across risk categories, the dealer shall describe its process for measuring correlations and describe the qualitative and quantitative aspects of the model which at a minimum must adhere to the criteria set forth in paragraph (e) of this Appendix F. The application shall further state whether the OTC derivatives dealer intends to use an alternative method for computing its market risk charge for equity instruments and, if applicable, a description of how its own theoretical pricing model contains the minimum pricing factors set forth in Appendix A (§ 240.15c3–1a). The application shall also describe any category of securities having no ready market or any category of debt securities which are below investment grade for which the OTC derivatives dealer wishes to use its VAR model to calculate its market risk charge or for which it wishes to use an alternative method for computing this charge and a description of how those charges would be determined.

(iii) *Internal risk management control systems.* An OTC derivatives dealer shall provide a comprehensive description of its internal risk management control systems and how those systems adhere to the requirements set forth in § 240.15c3–4(a) through (d).

(2) The Commission may approve the application after reviewing the application to determine whether the OTC derivatives dealer:

(i) Has adopted internal risk management control systems that meet the requirements set forth in § 240.15c3–4; and

(ii) Has adopted a VAR model that meets the requirements set forth in paragraphs (e)(1) and (e)(2) of this Appendix F.

(3) If the OTC derivatives dealer materially amends its VAR model or internal risk management control systems as described in its application, including any material change in the categories of non-marketable securities that it wishes to include in its VAR model, the dealer shall file an application describing the changes which must be approved by the Commission before the changes may be implemented. After reviewing the application for changes to the dealer's VAR model or internal risk management control systems to determine whether, with the changes, the OTC derivatives dealer's VAR model and internal risk management control systems would meet the requirements set forth in this Appendix F and § 240.15c3–4, the Commission may approve the application.

(4) The applications provided for in this paragraph (a) shall be considered filed when received at the Commission's principal office in Washington, DC. All applications filed pursuant to this paragraph (a) shall be deemed to be confidential.

Compliance With § 240.15c3–4

(b) An OTC derivatives dealer must be in compliance in all material respects with § 240.15c3–4 regarding its internal risk management control systems in order to be in compliance with § 240.15c3–1.

Market Risk

(c) An OTC derivatives dealer electing to apply this Appendix F shall compute a capital charge for market risk which shall be the aggregate of the charges computed below:

(1) *Value-at-Risk.* An OTC derivatives dealer shall deduct from net worth an amount for market risk for eligible OTC derivative instruments and other positions in its proprietary or other accounts equal to the VAR of these positions obtained from its proprietary VAR model, multiplied by the appropriate multiplication factor in paragraph (e)(1)(iv)(C) of this Appendix F. The OTC derivatives dealer may not elect to calculate its capital charges under this paragraph (c)(1) until its application to use the VAR model has been approved by the Commission.

(2) *Alternative method for equities.* An OTC derivatives dealer may elect to use this alternative method to calculate its market risk for equity instruments, including OTC options, upon approval by the Commission on application by the dealer. Under this alternative method, the deduction for market risk must be the amount computed pursuant to Appendix A to Rule 15c3–1 (§ 240.15c3–1a). In this computation, the OTC derivatives dealer may use its own theoretical pricing model provided that it contains the minimum pricing factors set forth in Appendix A.

(3) *Non-marketable securities.* An OTC derivatives dealer may not use a VAR model to determine a capital charge for any category of securities having no ready market or any category of debt securities which are below investment grade or any derivative instrument based on the value of these categories of securities, unless the Commission has granted, pursuant to paragraph (a)(1) of this Appendix F, its application to use its VAR model for any such category of securities. The dealer in any event may apply, pursuant to paragraph (a)(1) of this Appendix F, for an alternative treatment for any such category of securities, rather than calculate the market risk capital charge for such category of securities under § 240.15c3–1(c)(2)(vi) and (vii).

(4) *Residual positions.* To the extent that a position has not been included in the calculation of the market risk charge in paragraphs (c)(1) through (c)(3) of this section, the market risk charge for the position shall be computed under § 240.15c3–1(c)(2)(vi).

Credit Risk

(d) The capital charge for credit risk arising from an OTC derivatives dealer's transactions in eligible OTC derivative instruments shall be:

(1) The net replacement value in the account of a counterparty (including the effect of legally enforceable netting agreements and the application of liquid collateral) that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default;

(2) As to a counterparty not otherwise described in paragraph (d)(1) of this section, 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%, and further multiplied by the counterparty factor. The counterparty factors are:

(i) 20% for counterparties with ratings for senior unsecured long-term debt or commercial paper in the two highest rating categories by a nationally

recognized statistical rating organization (''NRSRO'');

(ii) 50% for counterparties with ratings for senior unsecured long-term debt in the third and fourth highest ratings categories by an NRSRO; and

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

(3) A concentration charge where the net replacement value in the account of any one counterparty (other than a counterparty described in paragraph (d)(1) of this section) exceeds 25% of the OTC derivatives dealer's tentative net capital, calculated as follows:

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

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

(iii) 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.

(4) Counterparties that are not rated by an NRSRO may be rated by the OTC derivatives dealer, or by an affiliated bank or affiliated broker-dealer of the OTC derivatives dealer, upon approval by the Commission on application by the OTC derivatives dealer. After reviewing the application to determine whether the credit rating procedures and rating categories are equivalent to those used by NRSROs and that such ratings are current, the Commission may approve the application. The OTC derivatives dealer must make and keep current a record of the basis for the credit rating for each counterparty. The record must be preserved for a period of not less than three years, the first two years in an easily accessible place.

VAR Models

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

(1) *Qualitative requirements.* An OTC derivatives dealerapplying 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 appropriate 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; and

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

(A) Beginning one year after the OTC derivatives dealer begins using its VAR model to calculate its net capital, the 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 F 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 5.—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 applying this Appendix F must have a VAR model that meets the following minimum 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 has described its process for measuring correlations in its application to apply this Appendix F and the Commission has approved its application. In the event that the VAR measures do not incorporate empirical correlations across risk categories, the OTC derivatives dealer must add the separate VAR measures for the four major risk categories in paragraph (e)(2)(v) of this Appendix F 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, at a minimum, the following major risk categories: interest rate risk, equity price risk, foreign exchange rate risk, and commodity price risk. For material exposures in the major currencies and markets, modeling techniques must capture, at a minimum, 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, including specific equity risk, if the OTC derivatives dealer intends to utilize its VAR model to compute capital charges for equity price risk.

14. Section 240.15c3–3 is amended to revise paragraph (a)(1) to read as follows, 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, 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 220.1 through 220.19). The term shall not include a general partner or director or principal officer 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 also shall not include a counterparty who has delivered collateral to an OTC derivatives dealer pursuant to a transaction in an eligible OTC derivative instrument, or pursuant to the OTC derivatives dealer's cash management securities activities or ancillary portfolio management securities activities, and who has received a prominent written notice from the OTC derivatives dealer that:

(i) Except as otherwise agreed in writing by the OTC derivatives dealer and the counterparty, the dealer may repledge or otherwise use the collateral in its business;

(ii) In the event of the OTC derivatives dealer's failure, the counterparty will likely be considered an unsecured creditor of the dealer as to that collateral;

(iii) The Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa *et seq.*) does not protect the counterparty; and

(iv) The collateral will not be subject to the requirements of § 240.8c–1, § 240.15c2–1, § 240.15c3–2, or § 240.15c3–3;

* * * * *

15. 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, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.

(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 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 certified 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) 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 the 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 appropriate response by management when internal risk management guidelines have been exceeded;

(x) The procedures to monitor and address the risk that an OTC derivatives 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;

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

(xiii) The procedures to prevent the OTC derivatives dealer from engaging in any securities transaction that is not permitted under § 240.15a–1; and

(xiv) The procedures to prevent the OTC derivatives dealer from improperly relying on the exceptions to § 240.15a–1(c) and § 240.15a–1(d), including the procedures to determine whether a counterparty is acting in the capacity of principal or agent.

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

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

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

(3) 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) Procedures are in place to enable management to take action when internal risk management guidelines have been exceeded;

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

(6) 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) 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) Procedures are in place to prevent the OTC derivatives dealer from engaging in any securities transaction that is not permitted under § 240.15a–1;

(9) Procedures are in place to prevent the OTC derivatives dealer from improperly relying on the exceptions to § 240.15a–1(c) and § 240.15a–1(d), including procedures to determine whether a counterparty is acting in the capacity of principal or agent;

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

(11) Personnel resources with appropriate expertise are committed to implementing the risk monitoring and risk management systems and processes; and

(12) Procedures are in place for the periodic internal and external review of the risk monitoring and risk management functions.

16. 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–5, § 240.17a–12, and § 240.17a–13'' 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 the OTC derivatives dealer has any direct or indirect interest or which it has written or guaranteed, containing, at a minimum, an identification of the security or other instrument, the number of units involved, and the identity of the counterparty.

* * * * *

17. Amend § 240.17a–4 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)''; in paragraph (b)(8)(xv) by revising the phrase ''§ 240.17a–5'' to read ''§ 240.17a–5 and § 240.17a–12''; by adding paragraph (b)(10) to read as follows:

§ 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).

* * * * *

18. Amend § 240.17a–5 by adding paragraph (o) to read as follows:

§ 240.17a–5 Reports to be made by certain brokers and dealers.

* * * * *

(o) *Compliance with § 240.17a–12.* An OTC derivatives dealer may comply with § 240.17a–5 by complying with the provisions of § 240.17a–12.

19. Amend § 240.17a–11 by redesignating paragraph (b) as paragraph (b)(1) and by adding paragraph (b)(2) to read as follows; in paragraph (c) introductory text by revising the phrase ''(c)(1), (c)(2) or (c)(3)'' to read ''(c)(1), (c)(2), (c)(3) or (c)(4)''; by revising paragraph (c)(3) and by adding paragraph (c)(4) 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)''; and in paragraph (h) by revising the phrase ''§ 240.15c3–3(i) and § 240.17a–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) * * *

(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 and tentative net capital requirements, and 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, or 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.

(4) The occurrence of the fourth and each subsequent backtesting exception under § 240.15c3–1f(e)(1)(iv) during any 250 business day measurement period.

* * * * *

20. 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 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.

(2) The reports provided for in this paragraph (a) shall be considered filed when received at the Commission's principal office in Washington, DC. 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 Commission, the Commission may extend the time for filing the information required by this paragraph (a). The written application shall be filed with the Commission at its principal office in Washington DC.

(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 a certified public accountant. Reports filed 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 Commission.

(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 audit 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 a 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 certified 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 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, DC.

(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 certified 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 the State of his principal office.

(e) *Designation of accountant.* (1) Every OTC derivatives dealer shall file no later than December 10 of each year with the Commission's principal office in Washington, DC a statement indicating the existence of an agreement, dated no later than December 1 of that year, with a certified public accountant covering a contractual commitment to conduct the OTC derivatives dealer's annual audit during the following calendar year.

(2) If the agreement is of a continuing nature, providing for successive yearly audits, 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 certified public 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.* A certified public 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, DC not more than 15 business days after:

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

(ii) The OTC derivatives dealer has notified a certified public 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) A certified public accountant has notified the OTC derivatives dealer that it will 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 certified public 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 certified public accountant.

(2) Such notice shall state the date of notification of the termination of the engagement of the former certified public accountant or the engagement of the new certified public accountant, as applicable, and the details of any disagreements 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 disagreements, if not resolved to the satisfaction of the former certified public accountant, would have caused the former certified public accountant to make reference to them in connection with the report on the subject matter of the disagreements.

The disagreements required to be reported in response to the preceding sentence include both those resolved to the former certified public accountant's satisfaction and those not resolved to the former certified public accountant's satisfaction. Disagreements contemplated by this section are those that occur at the decision-making level (*i.e.*, between principal financial officers of the OTC derivatives dealer and personnel of the certified public accounting firm responsible for rendering its report). The notice shall also state whether the certified public 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 certified public accountant to furnish the OTC derivatives dealer with a letter addressed to the Commission stating whether the former certified public accountant agrees with the statements contained in the notice of the OTC derivatives dealer and, if not, stating the respects in which the former certified public accountant does not agree. The OTC derivatives dealer shall file three copies of the notice and the certified public 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 certified public accountant.

(h) *Audit objectives.* (1) The audit shall be made in accordance with U.S. Generally Accepted Auditing Standards and shall include a review of the accounting system, the internal accounting controls, and procedures for safeguarding securities including appropriate tests thereof for the period since the date of the prior audited financial statements. The audit shall include all procedures necessary under the circumstances to enable the certified 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, 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 disclosed:

(i) The accounting system;

(ii) The internal accounting controls; and

(iii) The 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) (1) of this section that must 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; or

(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.

(i) *Extent and timing of audit procedures.* (1) The extent and timing of audit procedures are matters for the certified public accountant to determine on the basis of its review and evaluation of existing internal controls and other audit procedures performed in accordance with U.S. Generally Accepted Auditing Standards and the audit objectives set forth in paragraph (h) of this section.

(2) If, during the course of the audit or interim work, the certified public accountant determines that any material inadequacies exist in the accounting system, internal accounting controls, procedures for safeguarding securities, or as otherwise defined in paragraph (h)(2) of this section, then the certified public accountant shall call it to the attention of the chief financial officer of the OTC derivatives dealer, who shall inform the Commission 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 certified public accountant with a copy of said notice to the Commission by telegram or facsimile within the same 24 hour period. If the certified public accountant fails to receive such notice from the OTC derivatives dealer within that 24 hour period, or if the certified public accountant disagrees with the statements contained in the notice of the OTC derivatives dealer, the certified public accountant shall inform the Commission by report of material inadequacy within 24 hours thereafter as set forth in § 240.17a–11(g). Such report from the certified public 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 certified public accountant shall file a report detailing the aspects, if any, of the OTC derivatives dealer's notice with which the certified public accountant does not agree.

(j) *Accountant's report, general provisions.*—(1) *Technical requirements.* The certified public 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 certified public accountant's report shall state that the audit was made in accordance with U.S. Generally Accepted Auditing Standards; state whether the certified public accountant reviewed the procedures followed for safeguarding securities; and designate any auditing procedures deemed necessary by the certified public accountant under the circumstances of the particular case that 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 certified public 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 certified public accountant's report shall state clearly the opinion of the certified public 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 certified public accountant takes exception shall be clearly identified, explained, and, to the extent practicable, the effect of each such exception on the related financial statements shall be provided.

(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 and reportable conditions.* The OTC derivatives dealer shall file concurrently with the annual audit report a supplemental report by the certified public accountant describing any material inadequacies or any matter that would be deemed to be a reportable condition under U.S. Generally Accepted Auditing Standards that are unresolved as of the date of the certified public accountant's report. The report shall also describe any material inadequacies 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 with regard to any identified material inadequacies or reportable conditions. If the audit did not disclose any material inadequacies or reportable conditions, 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 certified public accountant indicating the certified public accountant's opinion on the OTC derivatives dealer's compliance with its internal risk management controls. 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 certified public accountant indicating the results of the certified public accountant's review of the broker's or dealer's inventory pricing and modeling procedures. This review shall be conducted in accordance with procedures agreed to by the OTC derivatives dealer and by the certified public accountant conducting the review. The purpose of the review is to confirm that the pricing and modeling procedures relied upon by the OTC derivatives dealer conform to the procedures submitted to the Commission as part of its OTC derivatives dealer application, and that the procedures comply with the qualitative and quantitative standards set forth in § 240.15c3–1f.

(2) The agreed-upon procedures are to be performed and the report is to be prepared in accordance with U.S. Generally Accepted Attestation 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, DC. Prior to the commencement of each subsequent review, every OTC derivatives dealer shall file with the Commission's principal office in Washington, DC notice of changes in the agreed-upon procedures.

(n) *Extensions and exemptions.* Upon the 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 a notice of such change with the Commission's principal office in Washington, DC.

(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 Commission.

(p) *Filing requirements.* For purposes of filing requirements as described in § 240.17a–12, these filings shall be deemed to have been accomplished upon receipt at the Commission's principal office in Washington, DC.

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

§ 240.36a1–1 Exemptionfrom Section 7 for OTC derivatives dealers.

Preliminary Note: OTC derivatives dealers are a special class of broker-dealers that are exempt from certain broker-dealer requirements, including membership in a self-regulatory organization (§ 240.15b9–2), regular broker-dealer margin rules (§ 240.36a1–1), and application of the Securities Investor Protection Act of 1970 (§ 240.36a1–2). OTC derivative dealers are subject to special requirements, including limitations on the scope of their securities activities (§ 240.15a–1), specified internal risk management control systems (§ 240.15c3–4), recordkeeping obligations (§ 240.17a–3(a)(10)), and reporting responsibilities (§ 240.17a–12). They are also subject to alternative net capital treatment (§ 240.15c3–1(a)(5)).

(a) Except as otherwise provided in paragraph (b) of this section, transactions involving the extension of credit by an OTC derivatives dealer shall be exempt from the provisions of section 7(c) of the Act (15 U.S.C. 78g(c)), provided that the OTC derivatives dealer complies with Section 7(d) of the Act (15 U.S.C. 78g(d)).

(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.

Preliminary Note: OTC derivatives dealers are a special class of broker-dealers that are exempt from certain broker-dealer requirements, including membership in a self-regulatory organization (§ 240.15b9–2), regular broker-dealer margin rules (§ 240.36a1–1), and application of the Securities Investor Protection Act of 1970 (§ 240.36a1–2). OTC derivative dealers are subject to special requirements, including limitations on the scope of their securities activities (§ 240.15a–1), specified internal risk management control systems (§ 240.15c3–4), recordkeeping obligations (§ 240.17a–3(a)(10)), and reporting responsibilities (§ 240.17a–12). They are also subject to alternative net capital treatment (§ 240.15c3–1(a)(5)).

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

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

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

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

* * * * *

§ 249.617 [Amended]

23. Section 249.617 is amended by revising the phrase ''and § 240.17a–11'' in the section heading to read '', § 240.17a–11, and § 240.17a–12''; and by revising the phrase ''and § 240.17a–11'' to read '', § 240.17a–11, and § 240.17a–12''.

24. 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: October 23, 1998.

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–511B) 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 dealers'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) of Rule 15c3–1 of this chapter (§ 240.15c3–1), the term ''tentative net capital'' mean the net capital of an OTC derivatives dealer before deducting the charges for market and credit risk as computed pursuant to Appendix F and increased by the balance sheet value (including counterparty net exposure) resulting from transactions in eligible OTC derivative instruments which would otherwise be deducted by virtue of paragraph (c)(2)(iv) of Rule 15c3–1.

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) *Value-at-Risk.* 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 VAR model, multiplied by the appropriate multiplication factor. See paragraph (e)(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. An OTC derivatives dealer also may use this alternative method if the Commission does not approve the OTC derivatives dealer's use of VAR models for equity instruments. 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 § 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.

(3) *Non-Marketable Securities.* An OTC derivatives dealer may not use a VAR model a determine a capital charge for any category of securities having no ready market or any category of debt securities which are below investment grade, or any derivative instrument based on the value of these categories of securities, unless the Commission has granted, pursuant to paragraph (a)(1) of Appendix F, its application to use its VAR model for any such category of securities. The dealer in any event may apply, pursuant to paragraph (a)(1) of Appendix F, for an alternative treatment for any such category of securities, rather than calculate the market risk capital charge for such category of securities under paragraphs (c)(2)(vi) and (vii) of § 240.15c3–1.

(4) *Residual Positions.* To the extent that a position has not been included in the calculation of the market risk charge in subparagraph (1) through (3) of this paragraph, the market risk charge for the position shall be computed under paragraph (c)(2)(vi) of § 240.15c3–1.

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 (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 20% for entities with ratings for senior unsecured long term debt or commercial paper in the two highest rating categories by a nationally recognized statistical rating organization (''NRSRO''); 50% for entities with ratings of senior unsecured long term debt in the third and fourth highest ratings categories by and NRSRO; and 100% for entities with ratings for senior unsecured long term debt below the highest rating categories.

(2) The net replacement value for each counterparty (including the effect of legally enforceable netting agreements and the application of liquid collateral) that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default.

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 couterparties with ratings for senior unsecured long-term debt or commercial paper in the two highest rating categories by an NRSRO, 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 ranting for senior unsecured long-term debt in the third and fourth highest rating categories by an NRSRO, 20% of the amount of the net replacement value in excess of 25% of the OTC derivates dealer's tentative net capital; and 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.

Aggregate Securities and OTC Derivatives Positions

Provide information for 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 § 240.17h–1T, the dealer should indicate as such in the appropriate section of this schedule. Where appropriate, indicate long and short positions separately.

Paperwork Reduction Act Disclosure

Part IIB of Form X–17A–5 requires an OTC derivatives dealer to file with the Commission certain financial and operational information. The form is designed to enable the Commission to ascertain the nature and scope of a dealer's over-the-counter derivatives activity and to monitor the dealer's financial condition and risk exposure.

It is estimated that an OTC derivatives dealer will spend approximately 20 hours completing Part IIB of Form X–17A–5. Any member of the public may direct to the Commission any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden.

The information collected pursuant to Part IIB of Form X–17A–5 will be kept confidential.

This collection of information has been reviewed by the Office of Management and Budget (OMB) in accordance with the clearance requirements of 44 U.S.C. 3507. This collection of information has been assigned Control Number 3235–0498 by OMB.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid number. Section 17(a) of the Securities Exchange Act of 1934 authorizes the Commission to collect the information on this Form from registrants. *See* U.S.C. 78q.

BILLING CODE 8010–01–W

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]

OTC DERIVATIVES DEALER

(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) Other [ ] 26

(Name of Dealer) 13

(SEC File No.) 14

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

(Firm I.D. No.) 15

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

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

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

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

(Name) 30

((Area Code) - Telephone No.) 31

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:

CERTIFIED 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 73 74

(City) (State) (Zip Code)

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 F)

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 F)

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. Other 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 ..... _____ 3995
9. Total Revenue ..... $ _____ 4030

EXPENSES

10. Compensation ..... $ _____ 4110
11. 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)

12. 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	
13. Floor brokerage paid to certain brokers (see definition)		4055
14. Commissions and clearance paid to all other brokers (see definition)		4145
15. Clearance paid to non-brokers (see definition)		4135
16. Communications		4060
17. Occupancy and equipment costs		4080
18. Promotional costs		4150
19. Interest expense		4075
A. Includes interest on accounts subject to subordination agreements	4070	
20. Losses in error account and bad debts		4170
21. Data processing costs (including service bureau service charges)		4186
22. Non-recurring charges		4190
23. Regulatory fees and expenses		4195
24. Other expenses		4100
25. Total expenses		$ 4200

NET INCOME

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

MONTHLY INCOME

32. 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 Liabilities 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

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FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIB

OTC Derivatives Dealer:

as of _____

SCHEDULE I
CREDIT-CONCENTRATION REPORT FOR TWENTY LARGEST CURRENT NET EXPOSURES

Counterparty Identifier (1)	Country (2)	Industry Segment (3)	Rating (4)	Gross Replacement Value (5) Receivable (Gross Gain)	Gross Replacement Value (5) Payable (Gross Loss)	Net Replacement Value (6)	Current Net Exposure (7)	Total Credit Exposure (8)	Comments (9)
Totals									

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

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

(3) 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.

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

(5) 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.

(6) 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.

(7) 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.

(8) Report the sum of the current net exposure and the potential additional credit exposure, calculated as the maximum credit exposure expected to be exceeded with a probability of one percent over a two-week period, less current net exposure.

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

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIB

OTC Derivatives 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	Gross Replacement Value (6) 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.

OTC Derivatives 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.

FINANCIAL AND OPERATIONAL COMBINED UNIFORM SINGLE REPORT
PART IIB

OTC Derivatives 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

OTC Derivatives 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 2]	[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)

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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

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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

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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 counterparty.	$ 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 counterparty.	$ 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

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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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