

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-72444; File No. SR-FINRA-2014-025)

June 20, 2014

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Adopt a Supplemental Schedule for Inventory Positions Pursuant to FINRA Rule 4524 (Supplemental FOCUS Information)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “SEA”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on June 16, 2014, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to adopt a supplemental schedule for inventory positions pursuant to FINRA Rule 4524 (Supplemental FOCUS Information).

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA, and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in Items II.A., II.B., and II.C. below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Pursuant to SEA Rule 17a-5,<sup>3</sup> most firms are required to file with FINRA reports concerning their financial and operational status using the Financial and Operational Combined Uniform Single (FOCUS) Report.<sup>4</sup> In general, firms with a FOCUS filing requirement must either file a FOCUS Report Part II if they clear transactions or carry customer accounts<sup>5</sup> or file a FOCUS Report Part IIA if they do not.<sup>6</sup> Firms that are government securities broker-dealers registered under Section 15C of the Act<sup>7</sup> do not file a FOCUS Report and instead are required to file reports concerning their financial and operational status using the Report on Finances and Operations of Government Securities Brokers and Dealers (FOGS Report).<sup>8</sup> These firms are required to file a FOGS Report Part I and either a FOGS Report Part II if they clear transactions or carry customer accounts or FOGS Report Part IIA if they do not.<sup>9</sup>

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<sup>3</sup> 17 CFR 240.17a-5.

<sup>4</sup> SEC Form X-17A-5.

<sup>5</sup> Firms that calculate net capital using Appendix E to SEA Rule 15c3-1 file FOCUS Report Part II CSE, rather than FOCUS Report Part II.

<sup>6</sup> 17 CFR 240.17a-5.

<sup>7</sup> 15 U.S.C. 78o-5.

<sup>8</sup> Department of the Treasury Form G-405.

<sup>9</sup> 17 CFR 405.2; 17 CFR 240.17a-5.

FINRA Rule 4524 (Supplemental FOCUS Information) requires each firm, as FINRA shall designate, to file such additional financial or operational schedules or reports as FINRA may deem necessary or appropriate for the protection of investors or in the public interest as a supplement to the FOCUS Report.<sup>10</sup> Pursuant to FINRA Rule 4524, FINRA is proposing the adoption of a supplemental schedule to the FOCUS Report Part II, FOCUS Report Part IIA and the FOGS Report Part I that would provide more detailed information of inventory positions held by firms. The proposed Supplemental Inventory Schedule (“SIS”) would be due 20 business days after the end of a firm’s FOCUS or FOGS reporting period.<sup>11</sup>

The proposal requires the SIS to be filed by firms that are required to file FOCUS Report Part II, FOCUS Report Part IIA or FOGS Report Part I with inventory positions as of the end of the FOCUS or FOGS reporting period with two exceptions. The first exception is for firms that have a minimum net capital or liquid capital requirement<sup>12</sup> of less than \$100,000. Such firms are not allowed to engage in dealer activities and are limited to 10 proprietary transactions per year. Further, such firms are not permitted to self-clear or carry customer accounts. The second exception is for firms that have inventory positions consisting only of money market mutual funds. Money market mutual funds limit their investments to short-term, high-quality debt securities and are permitted to sell and redeem shares at a stable price, typically at \$1.00 per

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<sup>10</sup> The reference to FOCUS reports under FINRA Rule 4524 includes FOGS Reports required to be filed by government securities broker-dealers registered under Section 15C of the Act in lieu of FOCUS Reports.

<sup>11</sup> Firms that file FOCUS Report Part II CSE would not be subject to the proposed SIS. As part of FOCUS Report Part II CSE, the Aggregate Securities and OTC Derivative Positions schedule requires firms to provide information that is similar to the proposed SIS.

<sup>12</sup> Firms that file the FOCUS Report must comply with a minimum net capital requirement, while firms that file the FOGS Report must comply with a minimum liquid capital requirement.

share, without regard to small variations in the value of the funds' underlying securities.<sup>13</sup> A firm with inventory positions consisting only of money market mutual funds would need to affirmatively indicate through functionality on the eFOCUS system that no SIS filing is required for the reporting period. FINRA believes that firms that meet either of these two criteria pose significantly less risk to customers and other market participants. These exceptions will not only minimize the burden on firms, but also will allow FINRA to focus its resources where the risk is most concerning.

The proposed SIS is intended to capture more details of a firm's long and short inventory positions than what is captured on the FOCUS Report Part II, FOCUS Report Part IIA and FOGS Report Part I. For example, FOCUS Report Part II, FOCUS Report Part IIA and FOGS Report Part I require total inventory of securities sold short to be reported in aggregate (Item 1620), providing no information on the types of securities sold short by firms. In addition, FOGS Report Part I requires that all long inventory be reported in aggregate (Item 850). Further, on FOCUS Report Part II and IIA, long inventory is reported in categories that aggregate securities with different market risk profiles (e.g., the Corporate Obligations category on the FOCUS Report Part II (Item 400) and Debt Securities category on the FOCUS Report Part IIA (Item 419) include single name corporate bonds, private-label mortgage-backed securities and foreign issuer debt obligations). The proposed SIS would enhance FINRA's ongoing surveillance monitoring of firms' financial condition by providing greater transparency into the market risk posed by a firm's inventory positions and the potential impact to a firm's net capital or liquid capital, as well as related funding and liquidity needs. In addition, the information

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<sup>13</sup> See Securities Act Release No. 9408 (June 5, 2013), 78 FR 36834, 36835 (June 19, 2013) (Proposed Rule: Money Market Fund Reform; Amendments to Form PF).

provided by the proposed SIS would enable FINRA staff to perform more targeted examinations of firms' market risk exposure.

The proposed rule change will be effective upon Commission approval. FINRA will announce the implementation date of the proposed supplemental schedule in a Regulatory Notice to be published no later than 60 days following Commission approval. The due date for the first proposed schedule will be no later than 90 days following Commission approval of the proposed rule change.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>14</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change is consistent with the provisions of the Act noted above in that the proposed SIS will provide FINRA with greater insights into the types of securities held in inventory by firms and the related market risk associated with such inventory positions. In addition, the proposed SIS would enable FINRA staff to assess the related impact on firms' liquidity and funding needs. The information provided on the proposed SIS would be used by FINRA to monitor firms' financial condition and perform more targeted examinations of firms' market risk exposure. The proposed rule change also is consistent with Section 712(b)(3)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>15</sup> in that it is necessary to

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<sup>14</sup> 15 U.S.C. 78o-3(b)(6).

<sup>15</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

enable FINRA to more effectively examine for compliance with, and enforce, its rules on capital adequacy.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. FINRA believes that the economic and operational impact associated with completion of the proposed SIS would be minimal because the required information should be readily available to firms, as it is necessary for purposes of computing the haircut deductions required under SEA Rule 15c3-1.<sup>16</sup> However, FINRA recognizes that there may be an initial one-time cost to map inventory positions to the line items on the proposed SIS. FINRA believes that any burden imposed by the proposed SIS would be outweighed by the benefit to firms in allowing the staff to better understand a firm's market risk, which will lead to more focused reviews during examinations. In addition, the proposal is narrowly tailored to capture those firms that pose the most risk to customers and other market participants. Firms with inventory positions as of the end of the FOCUS or FOGS reporting period will not have to file the proposed SIS if they: (1) have a minimum net capital or liquid capital requirement of less than \$100,000; or (2) have inventory positions consisting only of money market mutual funds. Based on FOCUS Report data, as of June 30, 2013, FINRA estimates that 2,830 out of 4,327 firms (65 percent) have a minimum net capital or liquid capital requirement of less than \$100,000.

As discussed in Item II.C. below, FINRA initially considered exempting from the SIS filing requirement those firms that had inventory positions consisting only of U.S. Treasury securities or money market mutual funds. However, three commenters questioned the U.S.

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<sup>16</sup> 17 CFR 240.15c3-1.

Treasury exemption, noting among other factors the market risk posed by certain U.S. Treasury securities and the risks posed by concentrations in those securities. Alternatively, these commenters suggested exemptions based on a firm's level of excess capital and leverage, for short-term instruments and for small broker-dealers. In response to commenters' suggestions, FINRA is not proposing an exemption for U.S. Treasury securities. However, FINRA is proposing at this time to exempt from the SIS filing requirement those firms that have a minimum net capital or liquid capital requirement of less than \$100,000. FINRA believes that exempting such firms should serve to reduce the compliance burdens for many small firms while also ensuring that FINRA receives the SIS data from those firms that pose higher risk to customers and other market participants.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 13-05 (January 2013) (the "Notice"). Four comments were received in response to the Notice.<sup>17</sup>

Below is a summary of the comments and FINRA's responses.

1. Exemption for U.S. Treasury Securities

In the Notice, FINRA specifically requested comment on whether firms that have inventory positions consisting only of U.S. Treasury securities should be exempt from the filing requirement. One commenter believed that no securities, including U.S. Treasury securities, should be excluded from review as all securities pose certain risks especially if they are

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<sup>17</sup> See Letter from Pat Nelson, dated January 31, 2013 ("Nelson"); letter from Jim Nelson, dated February 7, 2013 ("Jim Nelson"); letter from Wendie L Wachtel, CCO, Wachtel & Co Inc, to Marcia E Asquith, Corporate Secretary, FINRA, dated February 12, 2013 ("Wachtel"); and letter from Howard Spindel, Senior Managing Director, and Cassandra E. Joseph, Managing Director, Integrated Management Solutions USA LLC, dated February 25, 2013 ("IMS").

concentrated.<sup>18</sup> As discussed further below, one commenter believed that the exemption is a poor match with regulatory objectives.<sup>19</sup> Another commenter disagreed with the exemption and questioned “why FINRA would exempt from reporting a firm with a portfolio of longer-term, low coupon U.S. Government bonds that would be significantly more sensitive to market risk than many other debt instruments especially investment-grade ones of much shorter durations.”<sup>20</sup> The commenter believed that there should be an exemption for firms that invest their excess cash in short-term instruments such as money market mutual funds, short-term funds and high-grade debt instruments maturing in the short term.<sup>21</sup>

FINRA has considered these comments and agrees that a firm that has inventory positions consisting only of U.S. Treasury securities should be required to file the proposed SIS. FINRA, however, proposes to exempt from the filing requirement those firms that: (1) have a minimum net capital or liquid capital requirement of less than \$100,000; or (2) have inventory positions consisting only of money market mutual funds. In response to the comment for a short-term instrument exemption, FINRA notes that the proposal exempts firms with inventory positions consisting only of money market mutual funds. However, FINRA believes that firms with inventory positions in short-term funds or high-grade debt instruments maturing in the short term should not be exempted from the proposed SIS as those positions are subject to greater market risk. For example, the credit crisis showed that short-term debt instruments (e.g., auction rate securities) can suffer material losses, irrespective of their investment grade ratings.

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<sup>18</sup> Nelson.

<sup>19</sup> Wachtel.

<sup>20</sup> IMS.

<sup>21</sup> IMS.



## 2. Exemption for Firms Based on Net Capital or Liquid Capital Requirement

In the Notice, FINRA specifically requested comment on whether there is a category of firms that should not be required to file the proposed SIS based upon a de minimis amount of inventory positions. One commenter believed there should be a de minimis cutoff and stated that FINRA should “not place undue burdens on the small broker dealer community.”<sup>22</sup> The commenter suggested that “reporting should only be required by firms that pose a systemic risk to the financial markets.”<sup>23</sup> One commenter believed that an exemption should be focused on a firm’s level of excess capital and leverage.<sup>24</sup> FINRA has considered these comments and proposes that firms with inventory positions that have a net capital or liquid capital requirement of less than \$100,000 would not need to file the proposed SIS. These firms are prohibited from engaging in dealer activities, self-clearing or carrying customer accounts and, as such pose less risk to the financial markets than firms with higher net capital or liquid capital requirements. FINRA disagrees with the commenters that reporting should only be required by firms that pose systemic risk or that an exemption should be focused on a firm’s level of excess capital and leverage. Systemic risk is not the focus of the proposed SIS; rather, the proposal is intended to protect customers and other market participants who could be at risk if the firm’s financial condition deteriorates. As such, requiring only firms that pose systemic risk to report to FINRA would hinder the staff’s ability to identify and monitor the market, funding and liquidity risk of other firms whose inventory positions and dealer activities could result in harm to customers and other market participants. In addition, an exemption based on a firm’s high excess net capital or

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<sup>22</sup> Jim Nelson and Nelson.

<sup>23</sup> Nelson.

<sup>24</sup> Wachtel.

liquid capital without regard to the type of inventory positions held would exempt a number of firms that hold significant levels of complex securities in inventory and self-clear, carry customer accounts or engage in dealer activities. Further, an exemption based on leverage would exempt those firms that have a low leverage ratio without regard to other risk factors, such as a high concentration in a particular category of less liquid securities (e.g., high yield debt, private label collateralized mortgage obligations).

### 3. Economic Impact

In the Notice, FINRA specifically requested comment on the economic impact of the proposed SIS. Two commenters believed that the proposed SIS would place an unjustified burden on firms.<sup>25</sup> One of these commenters stated that even though firms already have the requested inventory information, the data will have to be put in the required format.<sup>26</sup> The commenter suggested that FINRA should ask a firm for a copy of its inventory and then input the data.<sup>27</sup> One commenter believed that there would be significant cost with no benefit and the proposed SIS would increase the effort of monthly filing by 15%.<sup>28</sup> Further, the commenter requested that any new requirements be incorporated into the original FOCUS form rather than requiring separate schedules that entail burdensome duplication and reconciliations.<sup>29</sup> However, one commenter agreed that firms currently compile inventory information as it is needed to compute haircut deductions when calculating net capital and stated that the proposed SIS is not

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<sup>25</sup> Jim Nelson and Nelson.

<sup>26</sup> Nelson.

<sup>27</sup> Nelson.

<sup>28</sup> Wachtel.

<sup>29</sup> Wachtel.

nearly as burdensome as receiving questions from FINRA examiners or coordinators seeking to drill down into figures that are provided by the FOCUS Report.<sup>30</sup>

Consistent with the discussion above, FINRA believes that the economic impact associated with completion of the proposed SIS would be minimal because the required information should be readily available to firms, as it is necessary for purposes of computing the haircut deductions required under SEA Rule 15c3-1.<sup>31</sup> Moreover, FINRA believes the proposed SIS is an effective and timely way to obtain detail of the inventory positions held by firms. FINRA notes it consulted with its advisory committees to help inform this view. In regard to the comment that the proposed SIS would increase the effort of monthly filing by 15%, FINRA notes that the commenter did not provide any evidence, basis or context to support the assertion, and therefore FINRA is uncertain as to its reliability. With respect to incorporating new requirements into the original FOCUS form, Form X-17A-5, FINRA notes that it is an SEC form, and any changes to it must be proposed and adopted by the SEC. However, FINRA would support updates to Form X-17A-5 by the SEC that would incorporate this more detailed reporting, and, if such updates were made, FINRA staff would seek to reduce accordingly the requirement for firms to file the proposed SIS.

#### 4. Instructions and Recommended Changes

One commenter was concerned that there were no instructions provided for the proposed SIS and that key definitions such as “arbitrage” and “no ready market” are not defined.<sup>32</sup> In addition, the commenter believed that the term “Investments” is particularly confusing in the

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<sup>30</sup> IMS.

<sup>31</sup> 17 CFR 240.15c3-1.

<sup>32</sup> IMS.

category for “Investments with no ready market” and suggested that “Securities” should be used.<sup>33</sup> In addition, the commenter believed that asking for a beginning date on the proposed SIS is meaningless information.<sup>34</sup> Furthermore, the commenter stated that the proposed SIS ignores financings such as repurchase agreements and loans, does not contain a line for securities lending, does not itemize derivatives by market bias and does not request a breakdown of the types of commodities actually being held.<sup>35</sup>

In response to the commenter, FINRA has developed instructions for the proposed SIS. The instructions include guidance, clarifications and definitions with respect to specific line items that FINRA believes should ameliorate the commenter’s concern. In addition, FINRA has amended the proposed SIS to state “[s]ecurities with no ready market” on line 13, instead of “[i]nvestments with no ready market,” to alleviate confusion and has removed the line item for a beginning period date. With regard to capturing information about repurchase agreements and securities lending, FINRA notes that the proposed SIS is an inventory schedule and, as such, is not intended to capture financing transactions. In response to the comment about itemizing derivatives exposures by market bias, FINRA has expanded the “Derivatives including Options” on line 11 to distinguish between centrally cleared derivatives and other derivatives and to require a limited breakdown of information for the two categories. In addition, FINRA notes that additional derivatives information is captured on the Derivatives and Other Off-Balance Sheet Schedule. Finally, in response to the request for a breakdown of the types of commodities actually being held, FINRA believes, at this time, that the proposed SIS captures the information

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<sup>33</sup> IMS.

<sup>34</sup> IMS.

<sup>35</sup> IMS.

that is needed to enable FINRA staff to assess the related market risk and impact on firms' liquidity and funding needs arising from inventory holdings.

#### 5. Alternatives to Proposed SIS

One commenter offered an alternative to the proposed SIS.<sup>36</sup> The commenter suggested that "FINRA should offer firms the ability to report the dollar amounts to which each haircut category applies."<sup>37</sup> The commenter believed that "[t]he haircut category is so much more relevant than the issuer type or even whether the haircut is on a long or short position."<sup>38</sup> FINRA disagrees with the commenter and believes that for purposes of understanding market risk associated with firms' inventory positions, issuer type is more appropriate than haircut category. For example, an equity security has different market risk than certain high-yield bonds; however, both types of securities can be in the same haircut category. Therefore, FINRA believes that obtaining information regarding the actual makeup of a firm's inventory positions is best achieved through the proposed SIS.

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change; or

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<sup>36</sup> IMS.

<sup>37</sup> IMS.

<sup>38</sup> IMS.

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2014-025 on the subject line.

##### Paper Comments:

- Send paper comments to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2014-025. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>).

Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F

Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m.

Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2014-025 and should be submitted on or before **[insert date 21 days from publication in the Federal Register]**.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>39</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>39</sup> 17 CFR 200.30-3(a)(12).