

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68270; File No. SR-FINRA-2012-050)

November 20, 2012

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Adopt a Supplementary Schedule for Derivatives and Other Off-Balance Sheet Items Pursuant to FINRA Rule 4524 (Supplemental FOCUS Information)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on November 15, 2012, 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 and II 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 supplementary schedule for derivatives and other off-balance sheet items 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 rule change. The text of these statements may be examined at the places specified in Item IV

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

below. FINRA has prepared summaries, set forth in sections A, B, and 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

FINRA Rule 4524 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 reports. Pursuant to FINRA Rule 4524, FINRA is proposing the adoption of a supplemental schedule to the FOCUS reports to capture important information that is not otherwise reported on certain firms’ balance sheets. To that end, the proposal would require all carrying or clearing firms to file with FINRA the Derivatives and Other Off-Balance Sheet Items Schedule (“OBS”) within 22 business days of the end of each calendar quarter. The proposed OBS is necessary for FINRA to more effectively examine for compliance with, and enforce, its rules on capital adequacy. The proposed OBS enables FINRA to examine on an ongoing basis the potential impact off-balance sheet activities may have on carrying and clearing firms’ net capital, leverage and liquidity, and ability to fulfill their customer protection obligations.

In the aftermath of the financial crisis, FINRA began to closely monitor firms’ levels of leverage and available liquidity to meet their funding needs and began to collect certain additional information from certain carrying and clearing firms with regard to their proprietary positions, financing transactions and certain off-balance sheet transactions. FINRA believes the proposed OBS will allow FINRA to obtain more comprehensive and consistent information regarding carrying and clearing firms’ off balance sheet assets, liabilities and other commitments. The proposed OBS would require firms to report their gross exposures in

financing transactions (e.g., reverse repos, repos and other transactions that are otherwise netted under generally accepted accounting principles, reverse repos and repos to maturity and collateral swap transactions), interests in and exposure to variable interest entities, non-regular way settlement transactions (including to be announced or TBA securities and delayed delivery/settlement transactions), underwriting and other financing commitments, and gross notional amounts in centrally cleared and non-centrally cleared derivative contracts involving equities, commodities, interest rates, foreign exchange derivatives and credit default swaps. However, the proposed OBS contains a de minimis off-balance sheet activity exception for each reporting period. If the total of all off-balance sheet items is less than 10% of the firm's excess net capital on the last day of the reporting period, the firm will not be required to file the proposed OBS for the reporting period.³

The proposed rule change will be effective upon Commission approval. FINRA will announce the first quarterly reporting period (i.e., the implementation date for purposes of the proposed off-balance sheet schedule) in a regulatory notice to be published no later than 60 days following Commission approval of the proposed rule change. The due date for the first proposed schedule will be no later than 210 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,⁴ which requires, among other things, that FINRA rules must be designed to

³ For purposes of the proposed OBS, the term "excess net capital" means net capital reduced by the greater of the minimum dollar net capital requirement or two percent of combined aggregate debit items as shown in the Formula for Reserve Requirements pursuant to 17 CFR 240.15c3-3.

⁴ 15 U.S.C. 78o-3(b)(6).

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 OBS will permit FINRA to assess more effectively on an ongoing basis the potential impact off-balance sheet activities may have on carrying and clearing firms' net capital, leverage and liquidity, and ability to fulfill their customer protection obligations. FINRA also believes the rule change is consistent with Section 712(b)(3)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act in that it is necessary to enable FINRA to more effectively examine for compliance with, and enforce, its rules on capital adequacy.⁵

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 the proposed OBS will allow it to better understand the potential impact off-balance sheet activity may have on carrying and clearing firms' net capital, leverage and liquidity, and ability to fulfill their customer protection obligations. FINRA has carefully crafted the proposed OBS to achieve its intended and necessary regulatory purpose while minimizing the burden on firms. Ready access to the information is important for FINRA to efficiently monitor on an ongoing basis the financial condition of firms. In the absence of this reporting requirement, FINRA would need to request this information repeatedly on a firm-by-firm basis, resulting in similar costs for the firms.

The information required to complete the proposed OBS should be readily available to firms due to firms' obligations to maintain books and records and take applicable capital charges

⁵ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

in relation to off-balance sheet activity. Further, firms that are owned by a publicly held company provide much of the information required by the proposed OBS to the SEC on the quarterly Form 10-Q or on the annual Form 10-K. Finally, for those firms that conduct limited off-balance sheet activity, the proposed OBS contains a de minimis exception for each reporting period.

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

The proposed OBS was published for comment in Regulatory Notice 12-23 (May 2012) (the “Notice”). FINRA received two comment letters in response to the Notice.⁶ Below is a summary of the comments and FINRA’s responses.

In the Notice, FINRA specifically requested comment on whether there is a category of carrying or clearing firms that should not be required to file the proposed OBS based upon de minimis off-balance sheet activity. One commenter believed that a de minimis threshold for the proposed OBS would benefit both firms and FINRA.⁷ The commenter stated that it would be reasonable to set a threshold for the reporting of off-balance sheet items of 5% or 10% of net capital.⁸ The commenter suggested that the proposed OBS should not be required if no items exceed a threshold.⁹ Another commenter stated “that a de minimis standard alone may not result in identifying the firms that pose off-balance sheet risk to such a degree that regulatory attention

⁶ See Letter from Chris Charles, President, Wulff, Hansen & Co., to Marcia E. Asquith, Senior Vice President and Corporate Secretary, dated May 31, 2012 (“Wulff”); and letter from Holly H. Smith, Sutherland Asbill & Brennan LLP, to Marcia E. Asquith, Senior Vice President and Corporate Secretary, dated June 4, 2012 (“Sutherland”).

⁷ Wulff.

⁸ Wulff.

⁹ Wulff.

is warranted.”¹⁰ The commenter assumed that the term “carrying or clearing firm” includes all broker-dealers that are not exempt from 17 CFR 240.15c3-3 and had concerns about the proposed OBS applying to firms that distribute variable insurance products and shares of investment companies, and firms that introduce their business to clearing firms.¹¹ The commenter requested “that FINRA try to more closely identify the nature of the firms for whom off-balance sheet activity reporting is appropriate, and limit the application of the OBS to those firms, rather than assuming that all firms that are not exempt from Rule 15c3-3 are engaging in off-balance sheet activity as a regular course of business.”¹²

FINRA has considered these comments and believes a de minimis exception for the proposed OBS is appropriate. As stated above, if the total of all off-balance sheet items is less than 10% of the firm’s excess net capital on the last day of the reporting period, the firm will not be required to file the proposed OBS for the reporting period. Basing a de minimis exception on the aggregate of all off-balance sheet items instead of each individual item will allow FINRA to capture those firms that may not meet the threshold for any one particular item, but still would be viewed as having in the aggregate a material amount of off-balance sheet activity for the reporting period. Further, FINRA does not agree with the commenter’s characterization of a “carrying or clearing” firm for purposes of the proposed OBS. The proposal would require all carrying or clearing firms, subject to the de minimis exception, to file the proposed OBS with FINRA within 22 business days of the end of each calendar quarter. For purposes of the

¹⁰ Sutherland.

¹¹ Sutherland.

¹² Sutherland.

proposed OBS, FINRA identifies carrying or clearing firms as those firms that self-clear or clear transactions for others or firms that carry customer accounts.

One commenter believes that reporting underwriting commitments for securities that have already been sold is not useful.¹³ The commenter suggested that FINRA “[e]liminate the need to separately report an entire unsettled underwriting commitment, where all (or all but a non-material amount) of the securities have been sold as of the balance sheet date.”¹⁴ FINRA agrees with the commenter’s suggestion and has clarified the instructions to state that a firm would only need to report the market value of open contractual commitments at month-end, net of confirmed sales.

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

¹³ Wulff.

¹⁴ Wulff.

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. Please include File Number SR-FINRA-2012-050 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-FINRA-2012-050. 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-2012-050 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.¹⁵

Kevin M. O'Neill
Deputy Secretary

¹⁵ 17 CFR 200.30-3(a)(12).