

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73192; File No. SR-FINRA-2014-025)

September 23, 2014

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1, and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Adopt a Supplementary Schedule for Inventory Positions Pursuant to FINRA Rule 4524 (Supplemental FOCUS Information)

I. Introduction

On June 16, 2014, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt a supplementary schedule for inventory positions pursuant to FINRA Rule 4524 (Supplemental FOCUS Information). The proposed rule change was published for comment in the Federal Register on June 26, 2014.³ The Commission received three comment letters on the proposed rule change.⁴ On September 22, 2014, FINRA filed Amendment No. 1 with the Commission to respond to the comment letters and to add clarifying instructions.⁵ The Commission is publishing this notice and order to solicit comments on

¹ See 15 U.S.C. 78s(b)(1).

² See 17 CFR 240.19b-4.

³ See Exchange Act Release No. 72444 (June 20, 2014), 79 FR 36357 (June 26, 2014).

⁴ See Letter from Holly H. Smith, Sutherland Asbill & Brennan LLP, to Elizabeth M. Murphy, Secretary, SEC, dated July 17, 2014 (“Sutherland”); Letter from Howard Spindel, Senior Managing Director, and Cassondra E. Joseph, Managing Director, Integrated Management Solutions USA LLC, to Elizabeth M. Murphy, Secretary, SEC, dated July 17, 2014 (“IMS”); Letter from Suzanne Shatto, dated September 7, 2014 (“Shatto”).

⁵ See SEC File No. SR-FINRA-2014-025 Amendment No. 1, dated September 22, 2014 (“Amendment No. 1”). Amendment No. 1 is described below in Section III and the text

Amendment No. 1 and to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

II. Description of Proposal

Pursuant to Exchange Act Rule 17a-5,⁶ 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.⁷ In general, firms with a FOCUS filing requirement must either file a FOCUS Report Part II if they clear transactions or carry customer accounts⁸ or file a FOCUS Report Part IIA if they do not.⁹ Firms that are government securities broker-dealers registered under Section 15C of the Exchange Act¹⁰ 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”).¹¹ 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.¹²

of Amendment No. 1 is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA, and on the Commission’s website at <http://www.sec.gov/rules/sro.shtml>.

⁶ See 17 CFR 240.17a-5.

⁷ See SEC Form X-17A-5.

⁸ Firms that calculate net capital using Appendix E to Exchange Act Rule 15c3-1 file FOCUS Report Part II CSE, rather than FOCUS Report Part II.

⁹ See 17 CFR 240.17a-5.

¹⁰ See 15 U.S.C. 78o-5.

¹¹ See Department of the Treasury Form G-405.

¹² See 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.¹³ 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 about 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.¹⁴

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 dollar net capital or liquid capital requirement¹⁵ 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

¹³ 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 Exchange Act in lieu of FOCUS Reports.

¹⁴ 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.

¹⁵ Firms that file the FOCUS Report must comply with a minimum dollar 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.¹⁶ 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 would not only minimize the burden on firms, but also would 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

¹⁶ 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.

III. Summary of Comment Letters, FINRA's Response, and Amendment No. 1

As stated above, the Commission received three comment letters in response to the proposed rule change.¹⁷ One commenter opposed the definition of "arbitrage" in the instructions for the SIS and questioned why the definition was limited to firms that have a separate arbitrage trading desk.¹⁸ The commenter stated that the SIS should take into account arbitrage strategies and recommended amending the SIS to allow firms "to indicate how much of the gross market value reported in the long or short columns represented positions that were offsets or related to other positions, directly or indirectly."¹⁹ In addition, the commenter recommended eliminating line 10 (Arbitrage) and the parenthetical description on line 9 (Stocks and Warrants (other than arbitrage positions)) on the SIS on the grounds that they would become redundant if the columns for offsets were added.²⁰ Finally, the commenter suggested the definition of "arbitrage" in the

¹⁷ See supra note 4.

¹⁸ See IMS.

¹⁹ See IMS.

²⁰ See IMS.

instructions “be changed to indicate something to the effect that arbitrage is whatever the reporting firm thinks it is.”²¹

In response to the commenter’s concern regarding the definition of “arbitrage,” FINRA agrees that the definition should not be limited to firms that have a separate arbitrage trading desk and is proposing to amend the instructions to provide that firms would report the market value of all securities that are part of a “bona fide arbitrage.” For purposes of the SIS, a security would be considered part of a “bona fide arbitrage” if a security is convertible into or exchangeable for another security within a period of 90 days, subject to no conditions other than the payment of money, and the other securities into which such security is convertible or for which it is exchangeable, are short in the accounts of such broker or dealer. The definition of “bona fide arbitrage” is substantially similar to the provision in Exchange Act Rule 15c3-1(c)(2)(vi)(J)(I). With respect to the additional changes requested by the commenter, FINRA believes, at this time, that the proposed SIS captures the information 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.

Another commenter had concerns “with FINRA’s piecemeal approach to requesting supplemental financial and operational information” and recommended “that FINRA coordinate with the SEC to propose an amended FOCUS report that requests all of the information FINRA is collecting or plans to collect from firms via supplementary schedules or reports.”²² In addition, the commenter requested that FINRA: (1) “define the term ‘inventory’ by reference to specific reporting lines of the FOCUS report, so that member firms know exactly what FOCUS

²¹ See IMS.

²² See Sutherland.

line items are required to be dis-aggregated for the SIS”; (2) confirm that “investments held by member firms for the purpose of funding employee benefit plans for a member firm’s associated persons” would not be considered inventory under the SIS; and (3) publish general directions for firms with nothing to report because they have no inventory.²³

In response to the commenter’s recommendation that FINRA coordinate with the SEC to propose an amended FOCUS Report, FINRA proposed the SIS pursuant to FINRA Rule 4524, which, subject to FINRA meeting the requirements of Section 19(b)(1) of the Exchange Act²⁴ and Rule 19b-4 thereunder,²⁵ provides an independent basis for FINRA to supplement information provided on FOCUS and FOGS Reports filed pursuant to Exchange Act Rule 17a-5 and FINRA Rule 2010.²⁶ In response to this commenter, FINRA further notes that Form X-17A-5 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 more detailed reporting, and, if such updates were made, FINRA staff would seek to reduce accordingly the requirement for firms to file supplemental information. With respect to the term “inventory,” for purposes of the SIS, FINRA is proposing to define the term “inventory positions” to mean securities or commodities positions (long, short or both) which are required to be reported on the balance sheet pursuant to GAAP. Consequently, if “investments held by member firms for the purpose of funding employee benefit plans for a member firm’s associated persons” fall within the term “inventory positions,” as defined in the proposed SIS, then such

²³ See Sutherland.

²⁴ See 15 U.S.C. 78s(b)(1).

²⁵ See 17 CFR 240.19b-4.

²⁶ See Securities Exchange Act Release No. 66364 (Feb. 9, 2012), 77 FR 8938 (Feb. 15, 2012) (Order Granting Accelerated Approval of SR-FINRA-2011-064).

investments would be required to be reported. Finally, in regard to firms with nothing to report, the eFOCUS system would not require an affirmative indication from the firm that no filing is required for the reporting period.

A third commenter raised a number of issues that are outside the scope of the proposal.²⁷ This commenter, however, also suggested daily reporting for the proposed SIS.²⁸ FINRA believes daily reporting for the proposed SIS would be overly burdensome on firms without a concomitant benefit to FINRA regarding its understanding of a firm's market risk.

In addition to the changes proposed in response to some of the comments the SEC received, discussed above, FINRA is proposing to clarify that the capital exception for filing the proposed SIS is based on the minimum dollar net capital requirement or liquid capital requirement. Firms that have a minimum dollar net capital or liquid capital requirement, as applicable, of less than \$100,000 would not have to file the proposed SIS.

IV. Commission's Findings

After careful consideration of the proposed rule change, as modified by Amendment No. 1, the comment letters received, and FINRA's response to the comment letters, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Exchange Act, and the rules and regulations thereunder that are applicable to a national securities association.²⁹ In particular, the Commission finds that the proposal, as modified by Amendment No. 1, is consistent with Section 15A(b)(6) of the

²⁷ See Shatto.

²⁸ See Shatto.

²⁹ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

Exchange Act,³⁰ which requires, among other things, that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. The Commission believes that FINRA adequately addressed the comments raised in response to FINRA's notice.

The proposed SIS should provide FINRA with the ability to obtain more specific information about the inventory of a member broker-dealer. Thus, the Commission believes that the proposed rule change, as modified by Amendment No. 1, is consistent with the provisions of the Exchange Act noted above in that the proposed SIS could 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 review inventory trends and 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 Commission believes that the proposed rule change, as modified by Amendment No. 1, works in conjunction with the existing Commission broker-dealer financial responsibility rules and will further FINRA's ability to oversee its members by, among other things, capturing trends in the securities held in broker-dealers' inventory.

The Commission does not believe that the proposed rule change, as modified by Amendment No. 1, will result in burden on competition that is not necessary or appropriate in

³⁰ See 15 U.S.C. 78o-3(b)(6).

furtherance of the purposes of the Exchange Act. As stated above, the Commission believes the proposed SIS will allow FINRA to better understand the potential impact of broker-dealers' inventory on net capital, leverage and liquidity, and ability to fulfill customer protection obligations. Ready access to the information in the proposed SIS is important for FINRA to efficiently monitor on an ongoing basis the financial condition of firms.

The Commission also believes FINRA has carefully crafted the proposed SIS to achieve its intended and necessary regulatory purpose while being cognizant of the burden on firms. The information required to complete the proposed SIS should be readily available to firms due to firms' obligations to maintain books and records and apply applicable capital charges to their inventory. Further, for smaller firms, the proposed SIS contains exceptions for firms that (1) have a minimum dollar net capital or liquid capital requirement, as applicable, of less than \$100,000, or (2) have inventory positions consisting only of money market mutual funds.

V. Accelerated Approval

The Commission finds good cause, pursuant to Section 19(b)(2) of the Exchange Act³¹ for approving the proposal, as modified by Amendment No. 1, prior to the 30th day after publication of Amendment No. 1 in the Federal Register. The changes proposed in Amendment No. 1 are technical or clarifying changes and do not raise regulatory concerns.

Accordingly, the Commission finds that good cause exists to approve the proposal, as modified by Amendment No. 1, on an accelerated basis.

³¹ See 15 U.S.C. 78s(b)(2).

VI. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether Amendment No. 1 to the proposed rule change is consistent with the Exchange 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-2014-025 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Brent J. Fields, 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].

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,³² that the proposed rule change (SR-FINRA-2014-025), as modified by Amendment No. 1, be and hereby is approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³³

Brent Fields
Secretary

³² See 15 U.S.C. 78s(b)(2).

³³ See 17 CFR 200.30-3(a)(12).