

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-77098; File No. SR-FINRA-2015-059)

February 9, 2016

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change to Amend the Derivatives and Other Off-Balance Sheet Items Schedule Pursuant to FINRA Rule 4524 (Supplemental FOCUS Information)

I. Introduction

On December 23, 2015, 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 amend the instructions to the Derivatives and Other Off-Balance Sheet Items Schedule (“OBS”) pursuant to FINRA Rule 4524 (Supplemental FOCUS Information) to expand the application of the OBS to certain non-carrying/non-clearing firms that have a certain amount of off-balance sheet obligations. The proposed rule change was published for comment in the Federal Register on January 7, 2016.³ The Commission did not receive written comments in response to the proposed rule change. This order approves the proposed rule change.

II. Description of Proposed Rule Change

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

¹ See 15 U.S.C. 78s(b)(1).

² See 17 CFR 240.19b-4.

³ See Exchange Act Release No. 76813 (Dec. 31, 2015), 81 FR 844 (Jan. 7, 2016).

the protection of investors or in the public interest as a supplement to the FOCUS Report.⁴ In February 2013, the SEC approved FINRA's adoption, pursuant to FINRA Rule 4524, of the OBS as a supplement to the FOCUS report.⁵ The OBS captures important information that is not otherwise reported on firms' balance sheets and requires all firms that carry customer accounts or self-clear or clear transactions for others (referred to, collectively, as "carrying or clearing firms") to file with FINRA the OBS within 22 business days of the end of each calendar quarter, unless a carrying or clearing firm meets the de minimis exception set forth in the instructions to the OBS.⁶

Pursuant to FINRA Rule 4524, FINRA proposed to amend the instructions to the OBS to expand its application beyond carrying or clearing firms to include firms that neither carry customer accounts nor clear transactions (referred to, collectively, as "non-clearing firms") that

⁴ See Securities Exchange Act Release No. 66364 (Feb. 9, 2012), 77 FR 8938 (Feb. 15, 2012) (Order Approving File No. SR-FINRA-2011-064). FINRA Rule 4524 also provides that FINRA will specify the content of additional schedules or reports, their format, and the timing and the frequency of such supplemental filings in a Regulatory Notice (or similar communication), the content of which FINRA will file with the Commission pursuant to Section 19(b) of the Exchange Act.

⁵ See Securities Exchange Act Release No. 68832 (Feb. 5, 2013), 78 FR 9754 (Feb. 11, 2013) (Order Approving File No. SR-FINRA-2012-050). Carrying or clearing firms were required to file with FINRA their initial OBS on or before July 31, 2013, to disclose off-balance sheet information as of June 30, 2013. See Regulatory Notice 13-10 (March 2013) (Supplemental FOCUS Information).

⁶ The de minimis exception relieves a carrying or clearing firm from filing the OBS for the reporting period if the aggregate of all gross amounts of off-balance sheet items is less than 10 percent of the firm's excess net capital on the last day of the reporting period. For purposes of the OBS, as well as the proposed amendments to the 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 Exchange Act Rule 15c3-3. See Securities Exchange Act Release No. 68832 (Feb. 5, 2013), 78 FR 9754, 9755 (Feb. 11, 2013) (Order Approving File No. SR-FINRA-2012-050).

have, pursuant to Exchange Act Rule 15c3-1,⁷ a minimum dollar net capital requirement equal to or greater than \$100,000, and at least \$10 million in reportable items pursuant to the OBS. The proposed rule change does not otherwise change the OBS or its instructions, including the de minimis exception. Accordingly, consistent with the current OBS, any firm (i.e., either a carrying or clearing firm or a non-clearing firm) that meets the de minimis exception need not file the OBS for the reporting period.⁸ Further, under the proposed rule change, as well as under the current OBS, any firm that is required to file the OBS must do so as of the last day of a reporting period within 22 business days of the end of each calendar quarter.

When FINRA proposed the OBS, FINRA noted the need, in the aftermath of the financial crisis, to obtain more comprehensive and consistent information regarding carrying or clearing firms' off-balance sheet assets, liabilities and other commitments.⁹ By requiring carrying or clearing 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 TBA¹⁰ securities and delayed delivery/settlement transactions), underwriting and other financing

⁷ See 17 CFR 240.15c3-1 (Net Capital Requirements for Brokers or Dealers). Exchange Act Rule 15c3-1(a)(2)(iii) requires a "dealer" (as defined in Exchange Act Rule 15c3-1(a)(2)(iii)) to maintain net capital of not less than \$100,000.

⁸ However, a firm that claims the de minimis exception must affirmatively indicate through the eFOCUS system that no filing is required for the reporting period. See Regulatory Notice 13-10 (March 2013) (Supplemental FOCUS Information).

⁹ See Securities Exchange Act Release No. 68270 (Nov. 20, 2012), 77 FR 70860 (Nov. 27, 2012) (Notice of Filing File No. SR-FINRA-2012-050).

¹⁰ FINRA Rule 6710(u) defines "TBA" to mean a transaction in an Agency Pass-Through Mortgage-Backed Security ("MBS") or a Small Business Administration ("SBA")-Backed Asset-Backed Security ("ABS") where the parties agree that the seller will

commitments, and gross notional amounts in centrally cleared and non-centrally cleared derivative transactions on the OBS, FINRA states that it has been able to more effectively monitor on an ongoing basis the potential impact that such off-balance sheet activities may have on carrying or clearing firms' net capital, leverage and liquidity, and their ability to fulfill their customer protection obligations.

Since the OBS became effective, however, FINRA has observed considerable principal trading activities of some non-clearing firms. In particular, through its efforts to establish margin requirements for the TBA market¹¹ and subsequent examinations of firms' margining practices related to all securities transactions with extended settlement dates, FINRA has become aware of non-clearing firms with both material TBA transactions as well as other types of securities transactions with extended settlement dates. In the case of TBA transactions, non-clearing firms may have entered into a Master Securities Forward Transaction Agreement ("MSFTA")¹² with their clients and are principal to the TBA transactions. In the case of other transactions with extended settlement dates cleared through a clearing firm, non-clearing firms are principal to the

deliver to the buyer a pool or pools of a specified face amount and meeting certain other criteria but the specific pool or pools to be delivered at settlement is not specified at the Time of Execution, and includes TBA transactions for good delivery and TBA transactions not for good delivery. Agency Pass-Through MBS and SBA-Backed ABS are defined under FINRA Rule 6710(v) and FINRA Rule 6710(bb), respectively. The term "Time of Execution" is defined under FINRA Rule 6710(d).

¹¹ See Securities Exchange Act Release No. 76148 (Oct. 14, 2015), 80 FR 63603 (Oct. 20, 2015) (Notice of Filing File No. SR-FINRA-2015-036).

¹² The Securities Industry and Financial Markets Association ("SIFMA") developed, and subsequently updated, in coordination with the Treasury Market Practices Group ("TMPG"), the MSFTA as a standard industry template for forward and other delayed delivery transactions involving mortgage-backed and asset-backed securities. See, e.g., SIFMA Guidance Notes to the Master Securities Forward Transaction Agreement (December 2012), available at: <http://www.sifma.org/services/standard-forms-and-documentation/mra,-gmra,-msla-and-msftas/>.

trades and financially responsible to the clearing firms for any losses that may result from clients' failures to complete the transactions on the date of settlement. Therefore, these transactions may present significant financial exposure for non-clearing firms, and FINRA is concerned about firms appropriately monitoring their financial exposure and applying capital charges for these transactions as required for compliance with Exchange Act Rule 15c3-1.¹³ Further, such transactions are not reported on non-clearing firms' balance sheets, making it difficult to monitor their compliance with capital requirements.

As a result of these concerns, and to ensure that all firms with significant derivative and off-balance sheet positions report these positions to FINRA on a consistent and regular basis, FINRA proposed to expand the reporting requirements of the OBS to non-clearing firms that have a minimum dollar net capital requirement equal to or greater than \$100,000, and at least \$10 million in reportable items pursuant to the OBS. The current de minimis exception would remain available to any firm that conducts limited off-balance sheet activity.¹⁴

FINRA stated that it will announce the proposed rule change's implementation date (i.e., the first quarterly reporting period for newly affected firms¹⁵) in a Regulatory Notice to be published no later than 60 days following Commission approval of the rule change, and that the implementation date will be no later than 210 days following Commission approval of the rule change.

¹³ See 17 CFR 240.15c3-1.

¹⁴ See supra note 5.

¹⁵ Carrying or clearing firms that are currently subject to the OBS's reporting requirements would not be impacted by the proposed rule change and shall continue to file on a quarterly basis, as required, without interruption.

III. Discussion and Commission Findings

After careful consideration of the proposed rule change, the Commission finds that the proposed rule change is consistent with the requirements of the Exchange Act, and the rules and regulations thereunder that are applicable to a national securities association.¹⁶ In particular, the Commission finds that the proposal is consistent with the provisions of Section 15A(b)(6) of the Exchange Act,¹⁷ which requires, among other things, that 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 the proposed rule change is consistent with the Exchange Act because expanding the reporting requirements of the OBS to the proposed non-clearing firms should permit FINRA to assess effectively on an ongoing basis the potential impact off-balance sheet activities may have on these firms' net capital, leverage and liquidity, and ability to fulfill obligations to other members and counterparties. In addition, impacted non-clearing firms, as well as their correspondent clearing firms, may benefit from increased awareness of their open trade exposures, which may reduce their potential for losses, encourage better counterparty risk management and promote firms' financial stability.

The Commission does not believe that the proposed rule change will result in burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission believes FINRA has carefully crafted the proposed rule change to achieve

¹⁶ 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).

¹⁷ See 15 U.S.C. 78o-3(b)(6).

its intended and necessary regulatory purpose while minimizing the burden on firms. Although the proposed rule change expands the number of firms required to file the OBS, the expansion is limited to non-clearing firms that have a minimum dollar net capital requirement equal to or greater than \$100,000, and at least \$10 million in reportable items pursuant to the OBS. In addition, the current de minimis exception continues to remain available to any firm that conducts off-balance sheet activity that is limited relative to its excess net capital.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,¹⁸ that the proposed rule change (SR-FINRA-2015-059) be and hereby is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁹

Brent J. Fields
Secretary

¹⁸ See 15 U.S.C. 78s(b)(2).

¹⁹ See 17 CFR 200.30-3(a)(12).