

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-76813; File No. SR-FINRA-2015-059)

December 31, 2015

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “SEA”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on December 23, 2015, 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 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 significant amounts of off-balance sheet obligations. The proposed rule change does not propose amendments to existing rule text.

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.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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 below. FINRA has prepared summaries, set forth in sections IIA, IIB, and IIC 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 Report.³ In February 2013, the SEC approved FINRA's adoption, pursuant to FINRA Rule 4524, of the OBS as a supplement to the FOCUS report.⁴ 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,

³ See Securities Exchange Act Release No. 66364 (February 9, 2012), 77 FR 8938 (February 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 Act.

⁴ See Securities Exchange Act Release No. 68832 (February 5, 2013), 78 FR 9754 (February 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).

unless a carrying or clearing firm meets the de minimis exception set forth in the instructions to the OBS.⁵

Pursuant to FINRA Rule 4524, the proposed rule change would 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 have, pursuant to SEA Rule 15c3-1,⁶ 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. As discussed in more detail below, FINRA believes this proposed expansion is necessary to effectively examine for compliance with, and enforce, its rules on capital adequacy. 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.⁷ Further, under the proposed rule change, as under the

⁵ 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 SEA Rule 15c3-3. See Securities Exchange Act Release No. 68832 (February 5, 2013), 78 FR 9754, 9755 (February 11, 2013) (Order Approving File No. SR-FINRA-2012-050).

⁶ See 17 CFR 240.15c3-1 (Net Capital Requirements for Brokers or Dealers). SEA Rule 15c3-1(a)(2)(iii) requires a “dealer” (as defined in SEA Rule 15c3-1(a)(2)(iii)) to maintain net capital of not less than \$100,000.

⁷ 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).

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.⁸ 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 TBA⁹ securities and delayed delivery/settlement transactions), underwriting and other financing commitments, and gross notional amounts in centrally cleared and non-centrally cleared derivative transactions on the OBS, FINRA 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

⁸ See Securities Exchange Act Release No. 68270 (November 20, 2012), 77 FR 70860 (November 27, 2012) (Notice of Filing File No. SR-FINRA-2012-050).

⁹ 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 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).

requirements for the TBA market¹⁰ 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")¹¹ 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 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. FINRA is concerned about firms appropriately monitoring their financial exposure and applying capital charges for these transactions as required for compliance with SEA Rule 15c3-1.¹² 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 is proposing to expand the reporting requirements of the OBS to non-clearing firms that

¹⁰ See Securities Exchange Act Release No. 76148 (October 14, 2015), 80 FR 63603 (October 20, 2015) (Notice of Filing File No. SR-FINRA-2015-036).

¹¹ 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/>.

¹² 17 CFR 240.15c3-1.

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.¹³

If the Commission approves the proposed rule change, FINRA will announce the implementation date (i.e., the first quarterly reporting period for newly affected firms¹⁴) in a Regulatory Notice to be published no later than 60 days following Commission approval of the proposed rule change. The implementation date 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,¹⁵ 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 Act because expanding the reporting requirements of the OBS to the proposed non-clearing firms would 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. FINRA also expects that impacted non-clearing firms, as well as their correspondent clearing firms, would benefit from increased awareness of their open trade

¹³ See supra note 5.

¹⁴ 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.

¹⁵ 15 U.S.C. 78o-3(b)(6).

exposures, which may reduce their potential for losses, encourage better counterparty risk management and promote firms' financial stability. The proposed rule change is also 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.¹⁶

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 has carefully crafted the proposed rule change to achieve its intended and necessary regulatory purpose while minimizing the burden on firms.

Economic Impact Assessment

The purpose of the proposal is to ensure that all firms with significant derivative and off-balance sheet positions report these positions to FINRA on a consistent and regular basis. Specifically, the proposal extends the reporting requirement 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 primary anticipated net benefit of the proposal is better insights into the size and nature of firms' open exposures in TBA and other extended settlement transactions or other off-balance sheet exposures. This information would enable FINRA to more efficiently monitor on an ongoing basis the financial condition of member firms, including firms' compliance with capital adequacy rules. FINRA also expects that impacted non-clearing firms, as well as their correspondent clearing firms, would benefit from increased awareness of their open trade exposures, which may reduce their potential for

¹⁶ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

losses. Accordingly, FINRA's experience suggests that firms may apply better counterparty risk management practices as a result of extending the OBS to the additional firms.

FINRA estimates that approximately 100 additional firms will be required to file the OBS under the proposal, though the actual number will fluctuate as off-balance sheet items and excess net capital vary depending on firms' reporting figures. However, the filing of the OBS is not expected to have significant compliance costs for the newly affected firms and will not impact member firms currently required to file the OBS.¹⁷ The information required for proposed newly affected firms to complete the OBS should be accessible to firms due to firms' obligations to maintain books and records and to take applicable capital charges in relation to off-balance sheet transactions. Further, FINRA understands that correspondent clearing firms typically provide non-clearing firms with information on all open trades or provide non-clearing firms with ready access to such information, either of which could serve as a potential source for the required information for non-clearing firms. Finally, as discussed above, for those firms that conduct limited off-balance sheet activity, the proposed amended OBS retains the de minimis exception for each reporting period.¹⁸

The proposal will ensure that all firms with significant off-balance sheet obligations are required to report them in a consistent manner. Further, the reporting requirement is expected to create positive externalities as firms that currently do not report this information will be able to better monitor and manage their counterparty exposures, better manage their participation in off-balance sheet activities and maintain sufficient net capital to support such transactions. To the

¹⁷ For example, in discussions with non-clearing firms regarding the proposal, several firms estimated that it would take no more than a few hours per quarter and cost \$5,000 to \$10,000 per year to file the OBS.

¹⁸ See supra note 5.

extent that member firms reduce their off-balance sheet activities as a result of this rule, impacted customers may incur search costs as they replace their broker counterparties.

A potential significant benefit of the proposal may arise from enhanced monitoring of systemic risk that is caused by the interconnectedness of firms through significant counterparty exposure and likelihood of correlated defaults in the financial industry. This enhanced monitoring of systemic risk should also benefit clearing firms as counterparty risk is partially mitigated for these firms as a result of better monitoring of financial exposures created by these transactions. There is academic evidence that banking systems may be less prone to crises if more comprehensive financial reporting regimes are in effect, even when the reporting is only to the regulator.¹⁹

FINRA considered alternative thresholds, such as extending the OBS reporting requirements to non-clearing firms with less than \$10 million in reportable items, when developing the proposed rule change. In connection with this proposal, FINRA identified 334 firms that currently do not file the OBS with open exposure in TBA and other extended settlement transactions totaling approximately \$93.3 billion.²⁰ FINRA reviewed their aggregate exposures in TBA and other extended settlement transactions and found that the majority of these firms (227 firms) had open exposures of less than \$10 million, totaling approximately \$363 million, and that the level of firms' exposures dropped off significantly below the \$10 million

¹⁹ Solomon A. Tadesse, The Economic Value of Regulated Disclosure: Evidence from the Banking Sector, 25 J. ACCT. & PUB. POL'Y 32-70 (2006).

²⁰ To assess the potential size of TBA and other extended settlement transactions of non-clearing firms, FINRA conducted a survey of some of the largest correspondent clearing firms. The figures represented are only approximate and represent identified non-clearing firms' exposures as of a specific date. As exposures in TBA and other extended settlement trades vary from month to month, the actual number of firms falling into these categories will change, as will the number of firms required to file the OBS on any given month.

threshold. In this regard, of the non-clearing firms identified to have less than \$10 million in TBA and other extended settlement exposure, the vast majority of those (204 firms) had exposure of less than \$5 million, totaling approximately \$206 million. Accordingly, the firms with open TBA and other extended settlement transactions of less than \$10 million collectively account for less than 1% of the total aggregate open TBA and other extended settlement transactions of the non-clearing firms identified. FINRA does not believe that the purpose of the proposed rule change is furthered by requiring firms with relatively immaterial levels of this type of exposure to file the OBS. Therefore, FINRA believes that extending the reporting requirements to non-clearing firms meeting the chosen criteria – that is, those with a minimum dollar net capital requirement equal to or greater than \$100,000 (the required minimum dollar net capital for dealers under SEA Rule 15c3-1(a)(2)(iii)²¹) and at least \$10 million in reportable items – will capture those non-clearing firms with the most significant amounts of off-balance sheet exposure and possible risk to other members and counterparties.

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

Written comments were neither solicited nor received.

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

²¹ See supra note 6.

(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. Please include File Number SR-FINRA-2015-059 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-2015-059. 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-2015-059 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.²²

Jill M. Peterson
Assistant Secretary

²² 17 CFR 200.30-3(a)(12).