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February 25, 2013

RE: RN 13-05: Supplemental FOCUS  
Information - Inventory Positions

Integrated Management Solutions USA LLC (“IMS”) is pleased to comment on RN 13-05, Supplemental FOCUS Information for Inventory Positions (the “Proposed Schedule”), to detail the inventory positions held by firms, as authorized under FINRA Rule 4524 (Supplemental FOCUS Information). The Proposed Schedule is intended to provide FINRA “...with greater insights into the market risk associated with firms’ inventory positions[, enabling it]...to assess the related impact on firms’ liquidity and funding needs.”<sup>1</sup> FINRA correctly notes that firms currently compile this information as it is needed to compute haircut deductions when calculating net capital.<sup>2</sup>

IMS is one of the largest providers of financial accounting and compliance consulting services to the securities industry, providing such services to about 100 FINRA members.<sup>3</sup> We prepare and/or file FOCUS Reports routinely on behalf of our clients and have been doing so for

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<sup>1</sup> RN 13-05, p. 3.

<sup>2</sup> FINRA also notes that the information to be provided on the Proposed Schedule is “identical” to the Aggregate Securities and OTC Derivative Positions schedule from the FOCUS Report Part II CSE. FINRA proposes to exempt firms that already file this particular FOCUS Report from also filing the Proposed Schedule. RN 13-05, p. 2.

<sup>3</sup> The statements in this comment letter incorporate the views of IMS, not those of our clients.

many years. In addition, we interface with FINRA examiners and coordinators whose efforts to gain adequate knowledge about firms that they regulate are frustrated by the relative lack of significant data reported in the FOCUS Report, which is essentially a format that is, at least theoretically, the design of the SEC<sup>4</sup>. We previously commented to FINRA with respect to RN 10-33 when Rule 4524 was first being proposed along with the Supplemental Statement of Income (“SSOI”). We also sent comments to the SEC regarding the issues that were posed earlier. We believe that our regular daily experience with the FINRA reporting scheme and how it is used by FINRA itself provides a perspective that enables us to assess the impact of the Proposed Schedule on FINRA member firms from both a regulatory and business perspective.

### **Overall Concerns**

#### A. Failure to Provide Instructions

The Proposed Schedule states, at the top center, the instructions should be read before completing the form. However, no sample instructions are provided by FINRA in RN 13-05 or elsewhere and we are unable to comment on whether FINRA’s instructions are helpful, accurate or complete. As it happens, we commented similarly in the past regarding the SSOI.

#### B. Failure to Define Key Terms

Although the reporting of “Arbitrage” is provided, and the term is used in items 9 and 10 of the Proposed Schedule, it is not defined. We note that combining financial instruments of different types as “arbitrage” is somewhat useful but would tend to cause a good deal of the information that FINRA would probably wish to know to be buried within large numbers thus, necessarily, limiting their usefulness. For example, how might a firm report a portfolio of

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<sup>4</sup> The FOCUS Report itself is largely unchanged over the past 35 or more years even though the markets and technological changes have metamorphasized radically. For example, today we have algorithmic trading where products that are defined on different lines on the proposed schedule are traded as offsets or in relationship to each other.

covered calls? Would they report the short calls on line 11, “Derivatives including options,” and the long stock on line 9, “Stocks and warrants”? Or would they report both the long and short positions on the same line as number 10 “Arbitrage”?

Nor are the criteria that establish that an investment has “no ready market” defined.<sup>5</sup> Perhaps those definitions are included in the “missing” instructions?

C. Request for Irrelevant Information

The Proposed Schedule requests a beginning date, information that is meaningless. A firm holds a position as of a certain date, which is the ending date.

**Specific Recommendations**

A. Proposed Exemption for Firms whose Inventory Consists Only of U.S. Treasury Securities or Money Market Mutual Funds

FINRA proposes to exempt those firms whose inventory positions are solely in U.S. Treasury securities from filing the Proposed Schedule. This knee-jerk distinction is senseless if the regulators truly want to assess not only market risk, but also a firm’s liquidity and funding positions. There are corporates that carry a AAA rating, while our government currently has a AA rating. In fact, FINRA itself recognizes that bonds can be very risky investments in general. See <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P204318> for an article in the Investors section of the FINRA website entitled “Duration-What an Interest Rate Hike Could Do to Your Bond Portfolio,” which explains the risk of owning bonds in the current low interest rate environment. We do not understand 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.

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<sup>5</sup> Investment positions with “no ready market” raise additional concerns, discussed below.

An exemption for firms that simply invest their excess cash in short term instruments is, in our view, appropriate. Money market funds, short-term funds and high-grade debt instruments maturing within the short term are demonstrably non-risky and should be exempt from the filing requirement.

B. Inventory with “No Ready Market”

Aside from definitional concern, noted above, the Proposed Schedule provides a category for “Investments with no ready market” (Item 13, with 3 sub-categories for “equity,” “debt” and “other (include limited partnership interests)”), but nothing for trading positions with no ready market. We believe that that the term “Investments” is particularly confusing. Perhaps FINRA could use a simple term like “Securities” to indicate the data it wishes to capture?

C. Derivatives

Derivatives, including options, are to be reported at their market value as of the reporting date. There is no differentiation among types of derivatives or their duration. For example, wouldn't itemizing derivatives by market bias; e.g., a long put is really a short position, provide valuable information as to market risk and firm liquidity?

D. Repos and Loans

The Proposed Schedule ignores financings such as repurchase agreements and loans. For a Schedule that purports to provide FINRA with better tools to assess a firm's liquidity and financing needs, that omission is startling. This information can be quite relevant especially to the extent that repurchase agreements are part of the trading strategy of firms.

Have the lessons of the over-leveraging of firms that were supposedly too big to fail but failed anyway been so quickly forgotten?

Securities lending is another business line that affects a firm's inventory positions, as well as its bottom line. Wouldn't such disclosure assist FINRA in assessing a firm's liquidity status?

E. Spot Commodities

The Proposed Schedule requests no breakdown of the types of commodities actually being held. Isn't that information relevant? Is gold the same as pork bellies?

F. Short Positions

Currently, "shorts" merit one line on the FOCUS report, hardly commensurate with the degree of risk they possibly pose. In addition, a FOCUS Report does not clearly reflect the fact that, in many instances, derivatives serve as hedges to the risks posed by long positions, especially when they are directly related to specific long positions. The fact that FINRA will now receive the same information for short positions as for long positions is a major improvement.

**Some Good News**

A, Tax considerations are ignored

When FINRA initially proposed the SSOI Schedules, in November of 2011, categories were based on taxability considerations even though, we believe, such considerations do not reflect the business realities of the business lines firms use in their books and records, how firms record transactions or always comport with GAAP. Regrettably, the tax code classifications remain in FINRA Rule 4524. Laudably, the Proposed Schedule makes no attempt to separate positions by their taxability considerations, nor should it since it is irrelevant.

B. Important granular information can be provided consistently

There are many naysayers who regard reporting as burdensome. It is not nearly as burdensome as receiving questions from FINRA examiners or coordinators seeking to drill down into the figures that are provided by the FOCUS Report. At best, the FOCUS Report is a slight hint as to what firms are doing. There is a benefit to the entire FINRA community when FINRA is able to know what is transpiring at each firm without separately generating an inquiry phone call or email. There's no reason to keep FINRA guessing. FINRA will derive the information in a less consistent manner if the status quo persists. Our hope is that FINRA won't bother obtaining the information from firms where there is clearly no risk, such as those holding low duration, high-grade debt instruments<sup>6</sup> or money market funds.

### **Our Alternative Recommendation**

As a simple optional alternative to providing the information in the format of the SIS, we believe that FINRA should offer firms the ability to report the dollar amounts to which each haircut category applies. Generally, the haircuts on riskier positions are much higher than those on less risky positions. Thus, for example, a firm with an entire portfolio subject to, say, a 3% haircut would not need to consider whether the asset is a municipal bond, a U.S. Government bond or a corporate bond subject to that kind of haircut or whether it part of an arbitrage position. All 3% haircut category financial instruments are somewhat similar from a regulatory concern standpoint. All 15% haircut securities are considerably more volatile and risky.

This alternative is not so far-fetched because most firms that have portfolios of any significant size use computer programs that can sort data in many different ways. The haircut category is so much more relevant than the issuer type or even whether the haircut is on a long or short position. The proposed form does not discriminate at all in terms of risk. The categories

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<sup>6</sup> Commercial paper, bonds maturing in less than two years, etc. are all good examples.

don't make that much sense to us. We truly question the form's usefulness as a regulatory tool when there is a better method available.

We realize that there may be some merit to categorizing by sub-category certain items. For example, we see merit in separating a 15% stock from a 15% bond because they tend to fluctuate very differently.

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Thank you for the opportunity to comment on the Proposed Schedule. Should you have any further questions, please feel free to call Howard Spindel at 212-897-1688 or Cassandra Joseph at 212-897-1687, or contact us by e-mail at [hspindel@intman.com](mailto:hspindel@intman.com) or [cjoseph@intman.com](mailto:cjoseph@intman.com), respectively.

Very truly yours,

A handwritten signature in black ink, appearing to be 'H Spindel', with a stylized, somewhat abstract form.

Howard Spindel  
Senior Managing Director

A handwritten signature in blue ink, appearing to be 'Cassandra E. Joseph', with a fluid, cursive style.

Cassandra E. Joseph  
Managing Director