

NASD NOTICE TO MEMBERS 98-19

SEC Requests Comment On Proposed Amendments To Net Capital Rule

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Executive Summary

The Securities and Exchange Commission (SEC) is requesting comment on proposed amendments to Rule 15c3-1, the Net Capital Rule. The SEC proposes to create a new category of broker/dealer for affiliates conducting an OTC derivatives business that would have special capital, margin, and other regulatory requirements. Comments on this proposal are due by March 2, 1998. Also, comments are due by March 2, 1998, on the SEC's proposed definition for designating an organization as a "nationally recognized statistical rating organization" (NRSRO), and by March 30, 1998, on changes to the haircuts for certain interest rate instruments held in a broker/dealer's proprietary account. In addition, the SEC is soliciting comment on its Concept Release in which the SEC is considering possible alternative methods for calculating credit and market risk capital requirements for broker/dealers. Specifically, the SEC seeks comment on whether the Net Capital Rule should be amended to allow broker/dealers to use statistical models to calculate net capital requirements. Comments on the Concept Release are due by March 30, 1998.

Questions concerning this *Notice* may be directed to Samuel Luque, Jr., Associate Director, Compliance Department, NASD Regulation, Inc., at (202) 728-8472, or Anne Harpster, Regional Compliance Supervisor, Compliance Department, NASD RegulationSM, at (202) 728-8092.

Background

SEC Rule 15c3-1, the Net Capital Rule, requires broker/dealers to have sufficient liquid capital to protect the assets of customers and to meet their obligations to other broker/dealers. In calculating the amount of net capital required, broker/dealers reduce the market value of the securities they own by certain charges or

haircuts as a precaution against adverse market movements or financial and operational risks.

The SEC has proposed amendments to the Net Capital Rule and issued a related Concept Release that will affect how net capital requirements are determined. These proposals are summarized briefly below.

Proposed Amendments To Rule 15c3-1 Creation Of OTC Derivatives Dealer

The SEC proposes to create a new registration category for OTC derivatives dealers. An OTC derivatives dealer would be defined as any dealer that limits its securities activities to: 1) engaging as a counterparty in transactions in eligible OTC derivative instruments with permissive derivatives counterparties, as these terms are defined in proposed Rules 3b-13 and 3b-14; 2) issuing and reacquiring issued securities through a fully regulated broker/dealer; or 3) engaging in other securities transactions which are designated by SEC order and, with regard to these activities, engaging in permissible risk management, arbitrage, and trading transactions, as defined in proposed Rule 3b-15.

Under the SEC proposal, registration as an OTC derivatives dealer would be an alternative to full broker/dealer registration, and OTC derivatives dealers would be subject to modified capital and margin requirements. The proposed rule requires OTC derivatives dealers to maintain tentative net capital of not less than \$100 million and net capital of not less than \$20 million.

OTC derivatives dealers would be prohibited from accepting or holding customer funds or securities, or acting as a "dealer" in securities, as

defined in Section 3(a)(5) of the Securities Exchange Act of 1934. Moreover, proposed Rule 15a-1 requires an OTC derivatives dealer to effect any securities transaction through a fully regulated broker/dealer. The dealer's counterparties in such securities transactions would be considered customers of the fully regulated broker/dealer, and all persons having contact with counterparties would need to be properly qualified registered representatives of the fully regulated broker/dealer.

Under proposed amendments to Rules 17a-3, 17a-4, 17a-11, proposed Rule 17a-12, and proposed revisions to Form X-17A-5 (FOCUS report), OTC derivatives dealers would maintain certain records regarding transactions and provide certain information regarding their financial condition and operations. In addition, these dealers must maintain internal risk management controls under proposed Rule 15c3-4.

Definition Of NRSRO

The SEC is proposing amendments to the definition of NRSRO in the Net Capital Rule by including a list of attributes that will be considered by the SEC in designating rating organizations as NRSROs.

The proposed attributes are: 1) national recognition; 2) adequate staffing, financial resources, and organizational structure; 3) use of systematic rating procedures designed to ensure credible and accurate ratings; 4) extent of contacts with the management of issuers; and 5) internal procedures to prevent misuse of non-public information and compliance with these procedures.

Under the proposal, those rating organizations that have been designated as NRSROs following receipt of a no-action letter from the SEC will retain their designation and will not

have to reapply. However, current NRSROs will be subject to SEC review and any NRSRO that does not meet the requirements in the proposed definition will have its designation revoked.

Haircuts On Interest Rate Instruments

The SEC is proposing changes to the haircuts for certain interest rate instruments held in a broker/dealer's proprietary account.

Under the proposed amendments, the net capital rule would recognize various hedges among a portfolio of government securities, investment grade nonconvertible debt securities or corporate debt securities, pass-through mortgage-backed securities, repurchase and reverse repurchase agreements, money market instruments, futures and forward contracts on these debt instruments, and other types of debt-related derivatives (fixed income products).

The proposed amendments do not affect the haircuts for municipal securities or non-investment grade debt securities.

Concept Release On Statistical Models

The SEC is soliciting comment on possible alternative methods for calculating credit and market risk capital requirements for broker/dealers. Specifically, the SEC seeks comment on whether the Net Capital Rule should be amended to allow broker/dealers to use statistical models to calculate net capital requirements.

Currently, net capital is calculated by deducting fixed percentages from the market value of securities, and the Net Capital Rule only recognizes certain limited hedging activities. The SEC is concerned that, by failing to recognize offsets between and

among asset classes, the Rule may cause firms with large, diverse portfolios to reserve capital that actually overcompensates for market risk.

The SEC is requesting response to 51 specific questions on the following topics: 1) modifying the current haircut approach; 2) the potential use of statistical models; 3) abnormal market conditions; 4) qualitative and quantitative criteria for models; 5) additional risks; and 6) a two-tiered approach. Commenters are encouraged also to submit statements on any aspect of the current Net Capital Rule.

National Association of Securities Dealers, Inc. (NASD[®]) members are urged to review the SEC's proposals and the Concept Release in their entirety. They appear in the December 30, 1997, *Federal Register*, or may be accessed at the SEC's Web site at www.sec.gov. Members also may contact the Compliance Department, NASD Regulation, Inc., (202) 728-8221, to request a copy of the proposals or the Concept Release.

Members that wish to comment must do so by March 2, 1998, concerning the creation of an OTC derivatives dealer and the proposed definition for an NRSRO, and by March 30, 1998, concerning proposed haircut changes for interest rate instruments and the Concept Release on the use of statistical models for setting net capital requirements.

Comment letters should be sent in triplicate to:

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549.

Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov.

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