Securities Industry Association

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April 6, 1998

Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
Mail Stop 6-9
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposal Regarding OTC Derivatives Dealers (File No. S7-30-97)

Dear Mr. Katz:

The OTC Derivative Products Committee (the "Committee") of the Securities Industry Association (the "SIA")[1] is writing in response to the release issued by the Securities and Exchange Commission (the " Commission" or "SEC") on December 17, 1997 (the "Release")[2] regarding the proposed adoption of rules and rule amendments under the Securities Exchange Act of 1934 (the "Exchange Act") that would be applicable to qualifying entities who engage in certain over-the-counter ("OTC") derivatives activities (such entities, "OTC Derivatives Dealers"), but who do not engage in the full range of securities activities typically associated with "brokers" or "dealers" (as such terms are defined under the Exchange Act). This new regulatory scheme for OTC Derivatives Dealers would be an alternative to full broker-dealer registration and is intended to permit securities firms to establish OTC Derivatives Dealer affiliates that are able to compete more effectively with banks and foreign dealers in global OTC markets.

The Committee strongly endorses the Commission's initiative to develop an alternative regulatory framework for OTC Derivatives Dealers and welcomes the opportunity to provide its comments and suggestions to the Commission and its staff in connection with this important rulemaking. This initiative by the Commission has the potential to contribute significantly to the removal of regulatory obstacles that currently inhibit U.S. broker-dealers from engaging in a broad range of OTC derivative securities activities and that place U.S. broker-dealers at a competitive disadvantage in the relevant markets vis-à-vis U.S. and non-U.S. banks and other dealers.

In the Committee's view, the success of the Commission's proposed rulemaking ultimately will

depend upon two principal considerations. The first of these is whether the proposed regulatory framework establishes a practical commercial framework for the conduct of the relevant business. Competitive considerations and considerations of capital efficiency will be central to this analysis. The second is whether the proposed regulatory framework is sufficiently flexible to be attractive to a broad spectrum of firms. Minimization of unnecessary constraints on the scope of permitted activity will be central to this analysis.

The Committee is aware that certain questions have been raised as to whether the Commission has exceeded its jurisdictional authority in proposing this regulatory alternative for OTC Derivatives Dealers. In the Committee's view, the Commission has effectively restricted the scope of its proposal to fall within the Commission's statutory jurisdiction. The Committee believes that the comments set forth in this letter, if adopted by the Commission, will help to clarify the limited jurisdictional scope of the Commission's proposal.

I. CAPITAL-RELATED MATTERS

The Committee endorses, subject to the comments noted below, the substance of the Commission's proposed amendments to Exchange Act Rule 15c3-1. Proposed Rule 15c3-1 would update the existing regulatory capital framework by incorporating important concepts of modern finance theory. In particular, the Commission's proposal would permit OTC Derivatives Dealers to use value-at-risk ("VAR") models to compute capital charges on proprietary positions as an alternative to Rule 15c3-1's current "haircut" approach. In so doing, Proposed Rule 15c3-1 represents the single most important element of the Commission's proposed rulemaking.

The Committee notes that the Commission has separately published for comment proposals to update the net capital framework applicable to broker-dealers generally.[3] The Committee urges the Commission to use the experience it gains with risk-based capital oversight from this initiative to expedite the integration of similar concepts (and, particularly, the use of VAR modelling techniques for estimating market risk) into the capital framework applicable to fully regulated broker-dealers.

A. Credit Charges.

1. **Credit concentration charge**. Proposed Rule 15c3-1f ("Appendix F") provides that "[w]here the aggregate of the net replacement values of all counterparties exceeds 300% of an OTC derivatives dealer's tentative net capital, it must deduct from net worth 100% of the amount of such excess."

Although described as a "concentration" charge, the Committee notes that the proposed charge is not in any manner based on credit concentration. Instead, the proposed charge would penalize an otherwise adequately capitalized firm based on the success of its trading book, without regard to the extent of, or lack of, credit diversification.

To the extent that receivables in the form of the net replacement value of derivatives transactions give rise to credit or liquidity risk, that risk is adequately captured by the individual counterparty credit charges imposed under Proposed Rule 15c3-1f(c)(1). The proposed credit surcharge would, in effect, re-count (at a significantly greater scaling factor) a dealer's incremental credit risk beyond the specified threshold. Such a surcharge would be prohibitive

and would significantly offset the benefits sought to be achieved by the proposal vis-à-vis the current net capital rules applicable to fully regulated broker-dealers. Moreover, the Committee is unable to identify any incremental risk not already captured by the Commission's other proposed counterparty credit charges that is systematically captured by the proposed surcharge.

The proposed surcharge also has no analogue in the capital framework applicable to U.S. banks or under the capital accord adopted by the Basle Committee on Banking Supervision. As a result, the imposition of the surcharge would place OTC Derivatives Dealers at a competitive disadvantage to U.S. and non-U.S. banks and other dealers.

The Committee therefore believes that the proposed capital surcharge is excessive and unnecessary and would significantly undermine the objectives of Proposed Rule 15c3-1 to promote capital efficiency and competitive parity. For those reasons, the Committee regards elimination of the proposed credit surcharge as critical to the efficacy of the proposed capital framework.

2. **Model-based risk charges**. The Committee believes that the Commission should also permit OTC Derivatives Dealers to use a model-based approach to credit risk as an alternative to the prescribed percentage-based charges for credit risk set forth in the Proposed Rules. Any such model would, of course, be subject to Commission approval.

As the Commission is aware, many initiatives are currently underway to develop a model-based approach to the analysis of credit risk. A model-based approach to the analysis of credit risk would introduce efficiencies to the calculation of credit risk-based capital charges comparable to those proposed by the Commission for calculating market risk-based capital charges. This is a dynamic area and the Committee believes that one or more model-based frameworks for the analysis of credit risk will likely be developed in the near future and could gain general acceptance as a reasonable and prudent methodology for calculating credit risk-based capital charges.

The Committee therefore recommends that Proposed Rule 15c3-1 be supplemented by authorizing the Commission, through designated senior staff, to approve the use of proprietary model-based methodologies for calculating credit risk-based capital charges, based on compliance with specified minimum standards, applied on an equitable basis, and consistent with the framework proposed by the Commission for market risk-based capital charges. Firms would be permitted to calculate credit charges using either the proposed formula-based approach, as adopted by the Commission, or a model-based approach conforming to prescribed minimum standards and approved by the Commission's designated senior staff. Methodologies approved by the designated senior staff should be published, subject to confidential treatment of the proprietary elements of any such methodologies or related models.

Credit charges constitute a significant component of a firm's capital requirement. It is therefore extremely important, both from the perspective of the competitive position of OTC Derivatives Dealers generally and from the perspective of fostering prudent credit risk management, that the Commission avoid adopting a framework that would inhibit firms from pursuing and implementing advances in this area. One of the major innovations and benefits of the Commission's proposed capital framework is that, for the first time, it will integrate the manner

in which firms actually analyze and manage market risk with the regulatory capital framework for market risk. It is equally, if not more, important to accomplish the same objective with respect to credit risk management. The Committee believes that its proposed approach would foster innovation and the implementation of advances in this area and would enable OTC Derivatives Dealers to derive the benefits of modelling techniques in this area as these techniques attract general recognition as prudent.

B. External Audit.

The Committee agrees with the Commission that a robust external audit function is important. The Committee nonetheless believes that the scope of the auditor's role described in paragraph (m) of Proposed Rule 17a-12 and the scope of the auditor's opinion regarding VAR in paragraph (j) of Proposed Rule 17a-12 are somewhat unclear. In this regard, the Committee recommends that the Commission clarify that the purpose of the auditor's review of the OTC Derivative Dealer's inventory pricing and modelling procedures is to confirm that they conform to the descriptions submitted by the firm to the Commission in connection with the Commission's approval of the firm's internal VAR model and comply with the qualitative and quantitative standards set forth in Proposed Rule 15c3-1f. Consistent with that approach, the auditor's opinion regarding VAR would entail confirmation that the OTC Derivatives Dealer's VAR and inventory pricing models in fact produce VAR estimates consistent with those reported by the OTC Derivatives Dealer for the relevant portfolio. This clarification would be consistent with the approach to external audits adopted in connection with the Derivatives Policy Group Framework for Voluntary Oversight (the "DPG Framework").

C. Unrated Counterparties.

Proposed Rule 15c3-1f(c)(4) provides that counterparties that are not rated by a nationally recognized statistical rating organization (an "NRSRO") may be rated by the OTC Derivatives Dealer upon demonstrating to the Commission that the dealer "uses ratings criteria equivalent to those used by NRSROs and that such ratings are current." In this connection, the Committee requests that the Commission confirm that this would not necessitate an entity-by-entity demonstration, but rather a validation of the dealer's overall approach to the rating of specific categories of unrated counterparties.

II. NON-CAPITAL RELATED MATTERS.

A. OTC Derivatives Dealers -- Scope Of Permitted Activities.

1. Non-securities activities. The Commission notes in the Release that OTC Derivatives Dealers would be "permitted to engage in any non-securities activity, subject to appropriate capital treatment under Exchange Act Rule 15c3-1".[4] The Committee agrees that, subject only to assurance that the capital framework adequately captures the market and credit risks associated with any non-securities activities, OTC Derivatives Dealers should not be limited in the type or amount of non-securities activities in which they engage. This is consistent with the current treatment of broker-dealers and is of even greater importance in the context of OTC Derivatives Dealers in light of the potential scope of their derivatives activities involving asset classes other than securities.

The Release summary also states, however, that registration as an OTC Derivatives Dealer

would be available only to entities "acting primarily as counterparties in privately negotiated over-the-counter derivatives transactions." The Committee believes that this potential inconsistency between the ability to engage in any non-securities activity and the requirement to be primarily engaged in privately negotiated OTC derivatives transactions is confusing and potentially imposes an unnecessary constraint on the scope of an OTC Derivatives Dealer's permitted activities. The Committee urges the Commission to clarify that the non-securities activities in which OTC Derivatives Dealers are permitted to engage are not limited either in scope or volume (subject only to capital considerations). [5]

***2.* Securities activities** . Through the definition of "OTC Derivative Dealer", the Commission has proposed substantial limitations on the scope of securities activities in which an OTC Derivative Dealer may engage. The Committee believes that, so long as an OTC Derivatives Dealer limits its securities dealing activities to transactions in eligible OTC derivative instruments with permissible derivatives counterparties, it is neither necessary nor desirable to limit the non-dealing securities activities of an OTC Derivatives Dealer.

The Committee notes that entities that are "investors" or "traders", rather than "dealers", may currently engage in non-dealer securities transactions without registration under the Exchange Act [6] and that fully regulated broker-dealers are permitted to engage in such securities activities as well. There appears to be no policy reasons to support imposing restrictions on the ability of OTC Derivatives Dealers to engage in such activities. The Committee therefore believes that OTC Derivatives Dealers should be permitted to engage freely in non-dealing securities transactions.

In addition, the imposition of the limitations proposed by the Commission would unnecessarily constrain appropriate securities activities, create potentially significant interpretative difficulties for firms and result in unnecessarily complex oversight and policing issues for Commission staff. The Committee strongly believes that, on balance, any perceived benefits to the Commission from the proposed limitation would be significantly outweighed by the burdens and costs of the limitation both for the Commission and registrants.

The Committee acknowledges the Commission's concern that OTC Derivatives Dealers not be permitted to engage in restricted securities dealing activities. The Committee believes, however, that so long as an OTC Derivatives Dealer complies with the prohibitions in footnote 24 to the Release (prohibiting purchases and sales as principal from or to customers, carrying a dealer inventory, quoting two-way markets, etc.), restricted securities dealing activities would be effectively prohibited. The explicit prohibitions in footnote 24 are adequate to prevent potential abuses such as inventorying an affiliated fully regulated broker-dealer's equity book or "shadow" dealing through an affiliated fully regulated broker-dealer.

The Committee appreciates that the Commission may have concerns regarding its ability to police effectively restrictions in securities dealing activities. However, this is a problem that the Commission currently confronts daily in the context of professional trading firms that are not subject to Commission oversight and whose activities are, as a result, more opaque to the Commission than the activities of an OTC Derivatives Dealer would be. The Committee believes that by imposing the proposed limitations on non-dealing activities in securities, the Commission is merely exchanging one set of administrative concerns for another, at the same time introducing unnecessary compliance and administrative burdens and unnecessarily

diminishing the scope of potential interest in the proposed new regulatory category.[7]

While Proposed Rule 15a-1(a)(1)(iii), enabling the Commission to authorize OTC Derivatives Dealers to engage in additional securities activities, is a constructive proposal and will mitigate somewhat the inhibitory impact of the proposed limitations, the Committee believes that this provision will not be entirely effective, especially given the policy objectives established by implication under the explicit limitations proposed by the Commission, and will introduce an unnecessary administrative burden on Commission and registrant resources.

Accordingly, the Committee urges the Commission to consider simplifying its proposal by (1) making the proposed regulatory category available to "dealers who are not engaged in the business of buying and selling securities other than securities that are eligible OTC derivative instruments" and (2) deleting the proposed restrictions on non-dealing activities in securities contained in Proposed Rule 15a-1 (see also Proposed Rule 3b-12).[8] The Committee believes that this approach will help clarify the Commission's jurisdiction in connection with this initiative.

B. **Permissible Risk Management, Arbitrage and Trading Transactions*.***

As noted in the preceding discussion, the Committee regards the Commission's proposed limitation on non-derivatives securities activities as too restrictive and as establishing parameters that will be potentially complex to interpret and burdensome to police. The Committee's principal specific concerns with the proposed limitations are summarized immediately below.[9]

1. **Documentation of the purpose of individual transactions*.*** The Release states that an OTC Derivatives Dealer would be required to document the purpose of each transaction in a security that is not an eligible OTC derivative instrument. If adopted, this is a requirement with which OTC Derivatives Dealers could not practically comply, and for which dealers could not implement effective internal control mechanisms.

As a threshold matter, the proposed requirement would necessitate a recordkeeping system that would be onerous and impracticable to implement, with potentially significant systems development implications. Additionally, as the Commission is aware, dealers do not structure their risk management and related trading activities on an individual transactional basis. To the maximum extent practicable and subject to systems constraints, dealers formulate and implement these decisions on a dynamic, real-time basis and on a portfolio-wide basis, based on risk management objectives that may also be established on a dynamic, real-time basis. Accordingly, the Committee believes that it would not be practicable to create, for each individual order executed, a permanent documentary record of the precise prevailing portfolio characteristics, risk management objectives and the role performed therein by the individual transaction. Instead, consistent with the Commission's underlying objectives, OTC Derivatives Dealers could reasonably be expected to demonstrate that, on a portfolio-wide basis, their cash market securities transactions are consistent with any limitations on those activities ultimately adopted by the Commission.

2. **Definition of "permissible risk management, arbitrage and trading transactions".** In several respects, Proposed Rule 3b-15 unduly restricts the scope of permitted securities activities by OTC Derivatives Dealers.[10] These are summarized immediately below.

a. Collateral. Under Proposed Rule 3b-15(a), an OTC Derivatives Dealer would be permitted to take possession of and sell counterparty collateral. The Committee believes that an OTC Derivatives Dealer must be permitted to engage in (1) any disposition (not just a "sale") of collateral provided by a counterparty, as well as (2) the acquisition of, and any subsequent sale or disposition of, collateral to be provided to a counterparty.

b. Risk management. Under Proposed Rule 3b-15(c), an OTC Derivatives Dealer would be permitted to engage in "risk management" transactions solely to "hedge" an element of market or credit risk associated with an eligible OTC derivative instrument or the issuance of a warrant, hybrid security or structured note. The Committee regards the limitation of this activity to "hedging" as unduly restrictive. Instead, OTC Derivatives Dealers should be permitted to engage in any risk management transaction (subject to appropriate capital charges) that is designed to implement management's decision as to the market risk profile the firm wishes to obtain. In addition, the Committee believes that OTC Derivatives Dealers should be permitted to manage the risks associated with cash management, financing and other permitted securities positions, in addition to the risks arising from permitted derivative and hybrid positions.

c. Financing. Under Proposed Rule 3b-15(d), an OTC Derivatives Dealer would be permitted to engage in eligible financing transactions only for the purpose of financing a securities position that is acquired by the Dealer in connection with a permitted securities transaction. The Committee similarly regards this limitation as unduly restrictive. An OTC Derivatives Dealer should be permitted to finance any aspect of its permitted activities, subject (unless exempted as discussed in Part II. I. below) to compliance with Exchange Act Section 7(c) or (d), as applicable.

d. Arbitrage. Under Proposed Rule 3b-15(e), permitted arbitrage would not include arbitrage of: (1) eligible OTC derivative instruments; (2) arbitrage of short securities positions; or (3) arbitrage of prospective securities purchases or sales under permitted forward arrangements. The Committee believes that these excluded activities should also be permissible for an OTC Derivatives Dealer.

e. Trading. As drafted, Proposed Rule 3b-15(f) would require that securities trading: (1) relate to a securities position acquired in connection with a transaction involving collateral, cash management or hedging; and (2) not exceed 150 transaction per year.

The Committee believes that, as proposed, the limitation on trading activities might inadvertently also exclude the purchase or disposition of securities delivered or received, or to be delivered or received, by the OTC Derivatives Dealer pursuant to the terms of an eligible OTC derivative instrument.

The Committee also understands that the proposed 150 transaction basket is intended to provide a "safe harbor" for securities positions that, while entered into in connection with a permissible activity, cannot, through documentary evidence be shown to "relate to" such activity. The Committee recommends that this definition be clarified to indicate that the basket is not intended to place a limit on the number of securities transactions that may be entered into by an OTC Derivatives Dealer if such transactions can be demonstrated to relate to permitted activities. In addition, the Committee believes that the proposed basket is both potentially too small and would not adequately reflect the character and scope of a particular firm's activities.

The Committee therefore recommends that the size of any such basket be related to the scope of the OTC Derivatives Dealer's activities rather than a specified number of transactions.

C. Eligible OTC Derivative Instrument.

Proposed Rule 3b-13 includes a broad definition of the term "eligible OTC derivative instrument". Nonetheless, the Committee believes that the proposed definition fails to include certain important categories of transaction and is unclear as to certain others.

For example, by its terms, the definition would exclude all forward transactions other than forward transactions for the delivery of securities at least one year following the transaction date. The Committee does not see any need to impose any limit in the definition, however, on forward contracts involving non-securities. The Committee also believes that the minimum duration of one year for securities forwards is unnecessarily long and that a period in excess of one month would be adequate to avert use of OTC derivative instruments to circumvent restrictions on an OTC Derivative Dealer's securities dealing activities. The Commission could, in any event, promptly curtail any observed pattern of abuse prospectively.

The Committee also believes that the proposed definition fails to encompass potentially significant categories of transactions that are based on the occurrence or nonoccurrence of specified events, but that do not technically relate to one or more securities, commodities, etc., although they are associated with financial consequences. Examples, among others, include credit derivatives and other contingency-related events that are not linked to specific liabilities but rather to the insolvency or default of a specified entity.

Finally, the Committee notes that the proposed definition adopts concepts from Commodity Exchange Act regulations in excluding transactions that are standardized or traded on "an exchange, an electronic marketplace, or similar facility supervised or regulated by the Commission, or any other multilateral transaction execution facility." The Committee is concerned by this approach for two reasons. First, the proposed text could potentially exclude from the definition a broad range of transactions involving exempt securities, as well as transactions that do not involve securities at all, which should not be excluded from the proposed definition. Perhaps even more significant, the language proposed in the Release will inevitably spawn significant uncertainty over its scope.

For these reasons, the Committee recommends that the Commission define the term "eligible OTC derivative instrument" to include:

> any contract, agreement or transaction that provides, in whole or in part, on a fixed or contingent basis, for the purchase or sale of, or is based on the value of, or any interest in, one or more commodities, securities, currencies, interest or other rates, indices, quantitative measures, or other financial or economic interests or property of any kind, or that involves any payment or delivery that is dependent on the occurrence of any event associated with a potential financial, economic or commercial consequence, or any combination or permutation of any of the foregoing, or any similar transaction commonly entered into by participants in the financial markets, but does not include: (i) a contract providing exclusively for the purchase or sale of a security, on a firm basis, within one month following the transaction date; or (ii) any contract, agreement or transaction providing for the purchase or sale of any security (or group or index of securities) or any

interest therein or based on the value thereof that is listed on a national securities exchange or an electronic trading system expressly designated by the Commission as subject to the restriction set forth in this definition.

The Committee believes that its suggested definition encompasses the range of OTC derivatives currently conducted and accommodates the evolving character of the market. The Committee further recommends that the Commission clarify that, by this proposed definition of "eligible OTC derivative instrument", the Commission is not intending to construe or expand the definition of "security" under Exchange Act Section 3(a)(10).[11]

D. Permissible Derivatives Counterparty.

1. Additional classes of counterparties. The Committee would endorse the expansion of the class of eligible natural persons to include those who have $5 million in total assets.[12] The Committee believes that such persons are appropriate counterparties and would benefit from having access to risk mitigation products that can be tailored to their individual circumstances and objectives. The Committee would also endorse a broader class of eligible counterparties including those entities and individuals that are "qualified purchasers" as defined by the Commission in Section 2(a)(51) of the Investment Company Act of 1940 (the "Investment Company Act ").

2. Suggested clarifications. By way of technical clarification, the Committee recommends that the Commission clarify that the exclusion of corporations, partnerships, proprietorships, organizations, trusts or other entities that are formed solely for the specific purpose of constituting a permissible derivatives counterparty does not apply when the entity is formed for the benefit of persons that are themselves permissible counterparties.

The Committee also recommends that the reference to "insurance companies" in Proposed Rule 3b-14 should be clarified so that the term explicitly includes insurance company separate accounts.

Finally, the Committee recommends that the reference to employee benefit plans in clause (g) of Proposed Rule 3b-14 be expanded to include governmental plans.

E. Effecting Transactions Through a Fully Regulated Broker-Dealer .

1. Intermediation of securities transactions by a fully regulated broker-dealer. Proposed Rule 15a-1 would require that OTC Derivatives Dealers effect securities transactions through a fully regulated broker-dealer. We understand that the primary reason for this requirement is to ensure that SRO sales practice rules and suitability requirements would apply to such transactions. The Committee, however, does not believe that the interpositioning of an additional intermediary is necessary and, particularly given the sophisticated character of the permissible derivatives counterparties, the active participation by such counterparties in structuring products to fulfill their particular needs, and the consensual negotiation of the terms of individual transactions, does not believe that the imposition of sales practice and suitability requirements is warranted.[13] Notably, in the case of qualified purchasers, Congress has expressly recognized the ability of such persons to fend for themselves, permitting such persons to invest in hedge funds that engage in unrestricted investment activities (including OTC derivatives) and that are managed by persons that are not subject to registration under the

Investment Company Act or the Investment Advisers Act of 1940.

At a minimum, the Committee believes that there should be no requirement that an OTC Derivatives Dealer effect securities transactions through a fully regulated broker-dealer (i) where the counterparty to the transaction is a bank, broker-dealer, government securities broker, government securities dealer, or supranational organization, or (ii) in connection with risk management, financing, arbitrage or other trading transactions in which the OTC Derivatives Dealer is not acting in its capacity as a dealer, but rather as an investor or end-user.

2. Confirmations of securities transactions. In connection with securities transactions effected through a fully regulated broker-dealer, the Release states that the OTC Derivatives Dealer's counterparty would be considered the "customer" of the fully regulated broker-dealer and that all applicable SRO sales practice requirements would apply to such transaction. However, footnote 28 to the Release states that both the OTC Derivatives Dealer and the fully regulated broker-dealer would be required, in accordance with Rule 10b-10 under the Exchange Act, to send a confirmation to such counterparty (unless the counterparty specifically instructs both the OTC Derivatives Dealer and the fully regulated broker-dealer to send a joint confirmation), [14] thus implying that the counterparty would be considered a customer of both the OTC Derivatives Dealer and the fully regulated broker-dealer.

The Committee agrees that the counterparty to any such securities transaction would be a "customer" of the fully regulated broker-dealer and that the fully regulated broker-dealer would therefore have an obligation under Rule 10b-10 to deliver a confirmation to such counterparty. However, under such circumstances, the Committee does not believe that the counterparty would be a "customer" of the OTC Derivatives Dealer with respect to such securities transaction and, accordingly, does not believe that the OTC Derivatives Dealer should be required to deliver a dual (or joint) Rule 10b-10 confirmation to the counterparty. The Committee therefore recommends that appropriate amendments to Rule 10b-10 be adopted in order to clarify that the counterparty to a securities transaction effected through a fully regulated broker-dealer would be the "customer" of such fully regulated broker-dealer, and not the OTC Derivatives Dealer, and that the OTC Derivatives Dealer would not be obligated to deliver a Rule 10b-10 confirmation with respect to such transaction.

Additionally, if, as proposed, each dealer would be jointly and severally liable for a joint confirmation, the Committee believes that the requirement to obtain customer consent to the sending of a joint confirmation is unnecessary, burdensome and should be eliminated.

3. Dual employee requirement. In connection with securities transactions effected through a fully regulated broker-dealer, the Release states that "all persons having contact with counterparties would need to be properly qualified registered representatives of the fully regulated broker-dealer."[15] The Release notes, however, that such persons could be "dual employees" of both the fully regulated broker-dealer and the OTC Derivatives Dealer.

While there may indeed be certain individuals who would be employees of both the fully regulated broker-dealer and the OTC Derivatives Dealer, the Committee does not believe that it is appropriate or necessary to require that all employees of the OTC Derivatives Dealer having contact with counterparties to OTC derivatives transactions effected through a fully regulated broker-dealer become employees, and be licensed as registered representatives, of the fully regulated broker-dealer.

F. Definition of "Customer".

1. Proposed amendments. The proposed amendments to Rules 8c-1, 15c2-1 and 15c3-3 would exclude from the definition of "customer" therein only consenting permissible derivatives counterparties to transactions in eligible OTC derivative instruments. These amendments would not exclude counterparties to permissible cash management, risk management and financing transactions. The Committee believes that the proposed exclusion should be expanded to clarify that these additional counterparties also are not "customers" of the OTC Derivatives Dealer.

In addition, the proposed exclusion from "customer" status is conditioned on the requirement that counterparties consent thereto after receiving "disclosure of the unrestricted use of the collateral." The scope of this disclosure requirement is unclear. The Committee requests clarification that this requirement would be deemed satisfied in any instance in which the counterparty has entered into an agreement explicitly authorizing the repledging, rehypothecation, substitution or other disposition of collateral provided by the counterparty to the dealer.

The Committee further recommends that the Commission clarify that counterparties to transactions effected through a fully regulated broker-dealer (see discussion in Part II.E. above) are not "customers" of the OTC Derivatives Dealer for purposes of Rules 8c-1, 15c2-1 and 15c3-3 (in addition to Rule 10b-10).

Finally, in order to avoid the potential application of provisions rendered inapplicable to OTC Derivatives Dealers by the proposal, such as the customer reserve formula requirement, the Committee recommends that any OTC Derivatives Dealer having no "customers" within the meaning of Rules 8c-1, 15c2-1 and 15c3-3 (as such rules are proposed to be amended by the Commission) be exempted entirely from the requirements of such provisions.

2. Government securities. The Committee notes that an OTC Derivatives Dealer registered as such with the Commission who engages in transactions in eligible OTC derivative instruments that are government securities would be exempt from registration as a government securities dealer under Exchange Act Section 15C, subject to compliance with the notice requirements under Exchange Act Section 15C(a)(1)(B). In connection with transactions in eligible OTC derivative instruments that are government securities, it would be desirable to obtain confirmation from the Department of the Treasury that such entities may comply with the

Commission's net capital, customer protection, recordkeeping and reporting rules, as amended by the Commission in connection with the proposed rulemaking.

G. Oversight function.

The Release states that OTC Derivatives Dealers would be exempt from the self-regulatory organization ("SRO") membership requirement. The Committee agrees with the Commission that OTC Derivatives Dealers should not be required to become members of any SRO. However, the proposed exemption from SRO membership would be conditioned on the requirement that the dealer enter into an agreement with the examining authority designated for one or more of its affiliates providing that the examining authority will conduct a review of the OTC Derivatives Dealer, report any potential violations of applicable SEC rules and evaluate the adequacy of the dealer's procedures and controls. The Committee believes that this delegation of the oversight function to existing SROs is inappropriate at this time and, at least in the near term, will prove unworkable. It is also not clear that existing SROs (essentially, the NYSE and NASD) would be willing to assume the proposed responsibilities absent a membership affiliation with the SRO. The Committee is also concerned that the absence of relevant SRO experience and expertise will give rise to inefficiencies and difficulties in implementation of the oversight responsibility.

Instead, in light of the fact that a relatively small number of firms are expected (at least initially) to register as OTC Derivatives Dealers, the Committee believes that, in the first instance, the proposed oversight function should be performed by Commission staff. Although the Commission does not generally engage in direct audits of registrants, the novelty of the proposed scheme, the desirability of providing an opportunity for Commission staff to develop relevant experience and expertise, and the very limited initial number of expected registrants, together justify an exception to the Commission's general reluctance to engage in direct oversight of registrants. If the OTC Derivatives Dealer registration category becomes more widely used over time, the Commission could then delegate an appropriate portion of its oversight role to an SRO. Depending on the circumstances then prevailing, the Committee believes it may well be appropriate for that SRO to be a new SRO specifically established for the purpose of overseeing the activities of OTC Derivatives Dealers.

H. SIPA Exemption.

Under Proposed Rule 36a1-2, OTC Derivatives Dealers would be exempt from the provisions of the Securities Investor Protection Act of 1970 ("SIPA") and from membership in the Securities Investor Protection Corporation ("SIPC"). The Committee notes that the Commission's exemptive authority under Section 36 of the Exchange Act extends to any provision "under this title" and strongly endorses this use of the Commission's exemptive authority under Section 36. The Committee regards exemptive relief from SIPA and SIPC membership as critical to the commercial viability of the OTC Derivatives Dealer category.

I. Margin Treatment -- Exemption From Exchange Act Section 7.

In the Release, the Commission has proposed that extensions of credit by an OTC Derivatives Dealer would be exempt from Regulation T ("Regulation T") of the Board of Governors of the Federal Reserve System (the "FRB"), but subject to FRB Regulation U ("Regulation U "), and that extensions of credit to an OTC Derivatives Dealer would be eligible for exemptions under

Section 7 of the Exchange Act to the same extent as extensions of credit to a fully regulated broker-dealer. The Committee fully supports this proposal. Certain technical issues, however, are raised by the codification of these provisions.

For example, Proposed Rule 36a1-1 would exempt the OTC Derivatives Dealer from Section 7 of the Exchange Act, subject to compliance with "other federal margin requirements applicable to non-broker-dealer lenders" (*i.e.*, Regulation U). However, Regulation U is itself promulgated pursuant to Section 7. The Committee therefore suggests that Proposed Rule 36a1-1 be modified by exempting credit extended by OTC Derivatives Dealers from Section 7(c) of the Exchange Act, subject to compliance with Section 7(d) thereof.

The Committee also notes that Sections 7(c)(2) and 7(d)(2) provide exemptions from the prohibitions contained in Sections 7(c) and 7(d), respectively, in the context of credit extended to a broker or dealer "[a] substantial portion of whose business consists of transactions with persons other than brokers or dealers" or where the broker-dealer is borrowing to finance its activities as a market maker or underwriter. The Committee understands that the intent of the Commission's proposal is to enable OTC Derivatives Dealers to obtain financing on the same terms as fully regulated broker-dealers. Accordingly, the Committee recommends that the Commission, together with the FRB, clarify that, in the case of an OTC Derivatives Dealer, (i) all transactions in eligible OTC derivative instruments, other than transactions in which the principal counterparty is itself a securities broker or dealer, qualify as "transactions with persons other than brokers or dealers" within the meaning of Sections 7(c) and (d), and (ii) all borrowings by OTC Derivatives Dealers to finance their activities as market makers in OTC derivative instruments are exempt under Sections 7(c) and (d). Further, the Committee requests confirmation from the Commission or, if appropriate, from the FRB, that those OTC Derivatives Dealers that qualify as "exempted borrowers" under Regulations T and U will continue to be treated as such under the Commission's proposal.

J. Enhanced Reporting Requirements.

1. Confidentiality. In light of the sensitive content of the enhanced credit reports and other capital compliance data to be filed with the Commission by OTC Derivatives Dealers, the Committee requests that the Commission clarify the confidential status of such information (including all information that would be provided to the Commission pursuant to Rule 15c3-1 and Proposed Rule 17a-12 and related provisions).

2. Credit concentration information--technical comments. Proposed Rule 17a-12 would require OTC Derivatives Dealers to include certain additional information in their quarterly FOCUS report filings. The additional information required would include credit concentration information, with breakdowns along geographic and counterparty lines as described in the DPG Framework. Certain technical corrections and conforming changes should be made to the enhanced credit reports. For example, references to "potential future credit exposure" are retained in part and deleted in part. Additionally, the scope of covered OTC products do not incorporate all of the relevant sources of (or offsets to) market risk in a firm's portfolio.

K. Suggested Additional Amendments, Exemptions And Clarifications.

In the Release, the Commission requests comment as to whether any additional amendments or exemptions are required with respect to the proposed new class of OTC Derivatives Dealers.

The Committee's suggestions are set forth immediately below.

1. SRO position and exercise limits. In order to make the Commission's proposal viable and to place OTC Derivatives Dealers on a competitive footing with banks and non-U.S. broker-dealers, it is essential that OTC Derivatives Dealers either be subject to a more realistic SRO position and exercise limit regime than is currently applicable under NASD rules or be expressly exempted from the application of SRO position and exercise limits with respect to OTC securities options booked through a fully regulated broker-dealer affiliate.

2. Transaction fees. The Committee requests that the Commission adopt an exemption for OTC Derivatives Dealers from the imposition of transaction fees under Exchange Act Section 31 in connection with transactions in eligible OTC derivatives instruments that are securities. The imposition of any such fee would create a competitive disadvantage for OTC Derivatives Dealers vis-à-vis banks and non-U.S. broker-dealers.

3. Amendments to the Investment Company Act Rules. The Committee recommends that the Commission adopt amendments to Investment Company Act Rule 12d3-1 in order to clarify its scope in the context of OTC Derivatives Dealers and eligible OTC derivative instruments and to assure that it would not unduly restrict the ability of OTC Derivatives Dealers to enter into OTC derivatives transactions with and offer structured securities to registered investment companies.

4. Proxy materials. The Committee recommends that the Commission expressly exempt OTC Derivatives Dealers from compliance with the provisions of Exchange Act Rule 14(b) governing the transmission of proxy communications with respect to securities in its custody as counterparty collateral. OTC Derivatives Dealers are not in the business of carrying equity securities in customer accounts or in providing custodial services for customers. Accordingly, application of these provisions is inappropriate and unnecessary.

5. Quarterly securities counts. For the reasons described in the immediately preceding comment, the Committee recommends that the Commission similarly exempt OTC Derivatives Dealers from the requirement that a broker-dealer conduct a quarterly securities count under Exchange Act Rule 17a-13.

6. FOCUS reports. The Committee recommends that the Commission clarify that the provisions of Exchange Act Rule 17a-5(a)(2) (requiring the monthly filing of Form X-17A-5) do not apply in the context of the permitted activities of an OTC Derivatives Dealer.

The Committee also questions the requirement that VAR data be broken out by asset class, since aggregate VAR will not equal the sum of these amounts. To the extent that the Commission nonetheless requires asset class VAR data to be separately reported, each firm should be permitted to define the relevant asset classes in a manner consistent with the organization of that firm's trading operations and internal accounting.

7. Books and records. The Commission states that OTC Derivatives Dealers would be required to comply with the books and records requirements set forth in Rules 17a-3 and 17a-4 under the Exchange Act. The proposal would amend such Rules to more properly reflect the nature of the business engaged in by OTC Derivatives Dealers and the different types of records that would be required to be maintained by such entities in connection therewith. In order to

promote back-office efficiency on a group-wide basis and to reduce incremental systems costs, the Committee requests that the Commission clarify that such books and records could be maintained on behalf of an OTC Derivatives Dealer by its fully regulated broker-dealer affiliate.

L. Costs and Benefits; Effects on Competition.

In the Release, the Commission also solicits comments on, among other matters, (1) whether the proposed rulemaking would address competitive inequalities confronting U.S. dealers in the OTC derivatives market, and (2) the costs and benefits associated with the proposed rulemaking.

The Committee acknowledges that the Commission's proposal entails potentially significant attendant costs and recognizes that the proposal would (because of the substantial minimum capital requirements applicable to OTC Derivatives Dealers) be available only to large, well-capitalized firms. The Committee notes, however, that participation as an intermediary in the OTC derivatives market is already limited to highly capitalized firms as a result of commercial credit considerations. Moreover, subject to the comments noted above, the Committee agrees with the Commission that the proposal's potential costs and limitations are far outweighed by the proposal's potential benefits.

These benefits include most notably the potential for greater capital efficiency and market access on more competitive terms. As the Commission has noted in the Release, the proposed rulemaking is designed to tailor capital, margin and other regulatory requirements to the activities of OTC Derivatives Dealers in order to enable U.S. registered broker-dealers, with OTC Derivatives Dealer affiliates, to compete more effectively with banks and non-U.S. dealers in global derivatives markets. The Committee believes that, subject to the comments noted above, the Commission's proposal will accomplish this objective by removing significant regulatory and economic barriers under the regulatory regime currently applicable to broker-dealers that impede the ability of such U.S. firms to compete effectively in global derivatives markets. The Committee also agrees with the Commission that the Proposed Rules would, among other consequences, rationalize capital requirements and promote operational efficiency and capital formation by reducing incentives to broker-dealers to fractionalize their OTC derivatives business by conducting these activities in various entities.

In so doing, the Commission's proposal will significantly enhance the ability of affected firms to compete more effectively in the global derivatives markets and represents an important first step toward the goal of enabling U.S. broker-dealers generally to compete more effectively in global capital and financial markets.

The Committee appreciates having had this opportunity to provide the Commission with its comments and suggestions regarding this important proposal and looks forward to working with the Commission on future proposals that would eliminate other barriers to effective competition in the global marketplace.

* * *

If you have any questions or would like further information regarding this letter, please feel free to contact Gerard J. Quinn, Staff Adviser to the Committee, at 212-618-0507 or Edward J. Rosen of Cleary, Gottlieb, Steen & Hamilton, counsel to the Committee, at 212-225-2820.

Very truly yours,

Zachary Snow, Chairman
OTC Derivative Products Committee

cc: The Honorable Arthur Levitt, Chairman
The Honorable Norman S. Johnson, Commissioner
The Honorable Isaac C. Hunt, Jr., Commissioner
The Honorable Paul A. Carey, Commissioner
The Honorable Laura S. Unger, Commissioner
Richard R. Lindsey, Director, Division of Market Regulation
Robert L. D. Colby, Deputy Director, Division of Market Regulation
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Footnotes:

1 SIA is the leading proponent of capital markets, bringing together the shared interests of nearly 800 securities firms throughout North America. SIA members -- including investment banks, brokers-dealers, specialists, and mutual fund companies -- are active in all markets and in all phases of corporate and public finance. In the United States, SIA members collectively account for approximately 90%, or $100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. (More information about the SIA is available on its home page: http://www.sia.com.)

2 SEC Release No. 34-39454 (Dec. 17, 1997).

3 See SEC Release Nos. 34-39455 (Dec. 17, 1997) and 34-39456 (Dec. 17, 1997).

4 See, e.g., the Release at footnote 20.

5 Because of limitations on the scope of the proposed definition of "eligible OTC derivative instrument", clarification of this point is particularly important. For example, the proposed definition does not include a broad range of cash market and forward transactions in the physicals underlying eligible OTC derivative instruments (such as foreign exchange and commodities) and also would exclude transactions in certain other non-securities derivative instruments. (See Part II.C. below.)

The Committee believes that the suggested clarification would also help to dispel some of the confusion that has arisen regarding the jurisdictional scope of the Commission's proposal.

6 See, e.g., Fairfield Trading Corp., SEC no-action letter (avail. Jan. 10, 1988); Continental Grain

Company, SEC no-action letter (avail. Nov. 6, 1987).

[7] The Committee's specific concerns in relation to proposed limitations on securities activities are discussed in Part II.B. below.

[8] The Committee notes that, if a broader range of securities trading activity is permitted to be conducted by an OTC Derivatives Dealer, the OTC Derivatives Dealer's portfolio will represent a more robust environment in which to evaluate the use of VAR for capital adequacy purposes.

[9] As noted in Part II.A.2., implementation of the comments in this Part II.B. would not be necessary if the Commission were to implement the Committee's suggestion that non-dealing restrictions be eliminated entirely from the Commission's proposal.

[10] By way of technical clarification, the Committee also notes that the definition of "OTC Derivatives Dealer" in Proposed Rule 3b-12 (see also Proposed Rule 15a-1) is drafted in a manner which suggests that, to qualify as an OTC Derivatives Dealer, an entity (i) must engage in "permissible risk management, arbitrage and trading transactions," and (ii) may only engage in one of the three categories of transactions listed under clause (a) of the proposed definition, and not in two or all three of such categories of transactions.

[11] The Committee, of course, assumes that by its proposal the Commission also is not intending in any way to construe any term or provision of the Commodity Exchange Act or regulations thereunder.

[12] The Committee believes that natural persons with $5 million in total assets should be deemed permissible derivatives counterparties whether or not they are hedging an actual or anticipated asset or liability. However, if the Commission is unwilling to establish such an additional class of eligible counterparties, the Committee would endorse the expansion of such class to include natural persons with $5 million in total assets coupled with the hedging requirement.

[13] If the definition of "permissible derivatives counterparty" is expanded to include additional, less sophisticated classes of natural persons beyond those proposed in the Release or suggested by the Committee (see Part II.D.1.), the Committee acknowledges that such protections may be appropriate in connection with transactions involving such additional classes of persons.

[14] The Committee notes that there is no reference to this dual confirmation requirement in the Proposed Rules or Rule amendments, nor any provision regarding joint confirmation.

[15] The Committee notes that this requirement is not reflected in the Proposed Rules.