

**Securities Industry Association**

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October 16, 1998

Catherine McGuire, Esq.
Chief Counsel
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: OTC Derivatives Dealers (Release No. 34-39454)

Dear Ms. McGuire:

The SIA OTC Derivative Products Committee appreciates this opportunity to supplement its earlier letter dated April 6, 1998 with respect to several aspects of the captioned proposed rulemaking. These include: (1) the permissible scope of an OTC derivatives dealer's securities trading activities; (2) the definition of "OTC derivative instrument"; (3) the requirement that all securities transactions be executed through a fully regulated U.S. broker-dealer; (4) the application of Securities Exchange Act of 1934 ("Exchange Act") Section 11(a)(1) to transactions executed by exchange members on behalf of their affiliated OTC derivatives dealers; (5) compliance with Rule 17a-5; (6) disclosure requirements under Rule 15c2-5; and (7) the definition of "customer" under Rules 8c-1, 15c2-1, 15c3-2 and 15c3-3.

With respect to item (1), the Committee recommends the following: so long as an OTC derivatives dealer's securities activities consist primarily of conducting an OTC derivatives dealing business, an OTC derivatives dealer would be permitted to engage in cash market securities trading activities for portfolio management purposes, subject to the limitation that these trading activities do not give rise to portfolio risk exposures that, on an aggregate basis, exceed the risk management parameters established for the OTC derivatives dealer's business pursuant to proposed Rule 15c3-4.

This approach would have several salutary effects. First, it would permit OTC derivatives dealers to engage in portfolio management activities consistent with the manner in which such firms currently manage their OTC derivatives businesses. Second, it would eliminate the need for onerous and unrealistic policing activities by the Commission and individual firms. Finally, it is consistent with the Commission's current intention of precluding firms from establishing OTC derivatives dealers for the purpose of conducting a proprietary trading business in cash market

securities.

With respect to item (2), we have set forth immediately below a proposed definition of the term "OTC derivative instrument":

(A) The term "OTC derivative instrument" means 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 or nonoccurrence 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 derivative transaction commonly entered into by participants in the financial markets.

(B) Notwithstanding the foregoing, the term "OTC derivative instrument" does not include:

- (i) a contract providing for the purchase or sale of a security, on a firm basis, unless (1) the settlement date for such purchase or sale occurs more than nine months, in the case of a government security, or more than two months, in the case of any other security, following the trade date¹ or (2) such contract has other material features of a type described in Clause (A) above; 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 either (1) listed on a national securities exchange or (2) one of a class of fungible instruments that are standardized as to their material economic terms.

We believe the foregoing definition encompasses the broad range of instruments that comprise OTC derivatives. At the same time, the proposed definition would exclude those instruments that the Commission staff has expressed the desire to exclude from any definition of OTC derivative instrument.²

With respect to item (3), proposed Rule 15a-1 would require each security transaction by an OTC derivative dealer to be effected through a fully regulated broker-dealer. All persons having contact with counterparties to securities transactions would be required to be properly qualified registered representatives.

The Committee continues to believe that it is inappropriate to impose the foregoing requirements in the context of transactions in which the OTC derivatives dealer is engaged in permissible non-dealing transactions through or with a counterparty who is a regulated broker-dealer or bank. These requirements are particularly troublesome in the context of offshore transactions involving foreign securities. In this context, the proposed requirements could create significant burdens on registrants, without meaningful corresponding benefits. Firms might be required to register their non-U.S. offices as branch offices of their fully regulated U.S. broker-dealer with potentially adverse tax, licensing or other regulatory

consequences, or confront prohibitive logistical obstacles to compliance with the proposed requirements. Within the United States, these requirements afford no meaningful customer protection benefit.

Similar considerations apply in the context of an OTC derivatives transaction that is arranged and effected by employees resident in a foreign office of an OTC derivatives dealer with a counterparty that is also resident in a foreign jurisdiction. In this situation, local law may also require that the transaction be effected through a local registrant, thus requiring a transaction intermediated by two separate entities.

The Committee notes that the exceptions to the requirements of proposed Rule 15a-1 proposed herein are not exceptions to the requirement that transactions in securities with customers be effected through a registered broker-dealer. Instead, the Committee's proposal implements this requirement while recognizing two principles: first, that hedging and other incidental (*i.e.*, non-dealing) transactions entered into by an OTC derivatives dealer with banks and broker-dealers are not transactions with "customers"; and, second, that transactions executed outside the United States with foreign counterparties are appropriately executed through entities that are registered or licensed in accordance with applicable local laws in the jurisdiction(s) in which the transaction is executed or the parties are located.

This approach is entirely consistent with the Commission's intention that an OTC derivatives dealer should effectively be a "booking" entity. This approach merely reflects the fact that firms operate globally through separately incorporated entities each of whom must comply with local regulatory and licensing requirements. As a result, in each of these jurisdictions, the OTC derivatives dealer is potentially an alternative booking vehicle for eligible transactions with local counterparties. Such an approach promotes global consolidation and its attendant efficiencies. The alternative approach initially proposed by the Commission, on the other hand, would potentially require firms to have three separate entities represented in each jurisdiction: the OTC derivatives dealer, the local broker-dealer and the U.S. fully regulated broker-dealer, with the potential adverse consequences referred to above.

Accordingly, the Committee strongly urges the Commission to adopt an exception to the requirements of proposed Rule 15a-1 in the following contexts:

- (1) any permitted securities transaction effected by an OTC derivatives dealer, other than in its capacity as a broker or dealer: (a) with a registered broker or dealer or a bank, or (b) with or through a foreign broker or dealer or a foreign bank registered with or licensed by a foreign financial regulatory authority; or
- (2) any permitted securities transaction with a counterparty resident in a jurisdiction other than the United States that is arranged and effected by employees of an OTC derivatives dealer who are not resident in the United States; provided that such transaction is effected with or through a foreign broker or dealer or a foreign bank registered or licensed by a foreign financial regulatory authority in the jurisdiction in which such counterparty is resident or such employees are resident, in accordance with applicable legal requirements, if any.

The Committee believes that these exceptions are appropriately limited in scope and are consistent with the Commission's customer protection objectives.

With respect to item (4), Section 11(a)(1) of the Exchange Act imposes limitations on the circumstances in which a member of a national securities exchange may execute transactions on the exchange for the account of an associated person. The Committee recommends that the Commission clarify that it has made a determination under Section 11(a)(1)(I) of the Exchange Act that it would be consistent with the purposes of Section 11(a)(1), the protection of investors and the maintenance of fair and orderly markets to permit an exchange member to execute transactions on a national securities exchange for the account of its affiliated OTC derivatives dealer.

The Committee believes that this clarification is consistent with the Commission's objectives in relation to this initiative.

With respect to item (5), the Committee believes it would be helpful if the Commission would clarify that compliance by an OTC derivatives dealer with the reporting requirements under proposed Rule 17a-12 would be deemed to satisfy the OTC derivatives dealer's reporting obligations under Rule 17a-5. The Committee believes this result would be consistent with the Commission's intent in promulgating proposed Rule 17a-12.

With respect to item (6), Rule 15c2-5 currently requires a broker-dealer not subject to Regulation T to make certain disclosures in connection with specified extensions of credit. Because OTC derivatives dealers, unlike broker-dealers generally, will be subject to Regulation U, the Committee believes that OTC derivatives dealers should be exempt from the requirements of Rule 15c2-5.

Finally, with respect to item (7), the Committee recommends that the Commission clarify the scope of the definition of "customer" under Rules 8c-1, 10b-10, 15c2-1, 15c3-2 and 15c3-3. In particular, the Committee recommends that, for purposes of these provisions, the term customer would not include a counterparty who posts collateral with the OTC derivatives dealer in connection with any transaction and who either waives the provisions of these rules or who consents to the repledging, rehypothecation or other use of the posted collateral by the OTC derivatives dealer in connection with such transaction.

Please do not hesitate to contact the undersigned (tel. 212 816-0821) or Edward J. Rosen, of Cleary, Gottlieb, Steen & Hamilton, counsel to the Committee (tel. 212 225-2820), if you have any questions or comments with respect to the foregoing.

Very truly yours,

Zachary Snow
Chairman

cc: Michael Macchiaroli

Footnotes:

¹ Because the duration of a forward contract will have substantive regulatory consequences, it would be helpful for the Commission to provide some guidance in the preamble to any adopting release regarding the application of these duration requirements in the context of certain

transaction structures where confusion could arise. For example, certain contracts provide that they are to be periodically marked-to-market and repriced with a settlement payment to be made on each repricing date in an amount equal to the change in the value of the underlying security. Under these contracts, the interim settlements and resets do not accelerate, reduce or eliminate the originally scheduled delivery obligation. Thus, a one year forward might be reset monthly to mitigate the credit risk associated with the transaction, with final settlement and delivery occurring at the end of one year. It would be helpful for the Commission to clarify that any such transaction would be regarded as a single one year forward transaction and not as separate one month forward transactions for purposes of this definition.

² The Committee suggests that conforming amendments to the definition of hybrid security under proposed Rule 3b-16 be made, specifically, by replacing the words "currencies, interest rates, commodities, securities, or indices" with the words: "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 or nonoccurrence of any event associated with a potential financial, economic or commercial consequence".