Proposed Rules

Federal Register
Vol. 70, No. 195
Tuesday, October 11, 2005

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 145 and 147

RIN 3038–AC19

Alternative Market Risk and Credit Risk Capital Charges for Futures Commission Merchants and Specified Foreign Currency Forward and Inventory Capital Charges

AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed rules.

SUMMARY: The Commodity Futures Trading Commission (''Commission'' or ''CFTC'') is issuing this release to propose amendments to Commission rules that impose minimum financial and related reporting requirements upon each person registered as a futures commission merchant (''FCM''). Pursuant to rule amendments that became effective in August of 2004, the Securities and Exchange Commission (''SEC'') has established a method for securities brokers or dealers (''BDs'') that voluntarily elect SEC consolidated supervision for their ultimate holding companies and affiliates, and that also meet specified minimum capital and other requirements, to request approval to use internal mathematical models to determine their capital deductions for market risk and credit risk associated with their proprietary trading assets. Under the rule amendments that are proposed in this release, FCMs that are also BDs (''FCM/BDs'') would have the option, subject to the reporting and other requirements that are specified in the proposed rulemaking, of electing to compute their adjusted net capital using their SEC-approved alternative market risk and credit risk capital deductions in lieu of CFTC requirements. The Commission is also proposing other rule amendments that address confidential treatment for the reports and statements that would be required to be filed under the proposed amendments, and also to address the confidential treatment of certain other information that all FCM/BDs must file with both the Commission and the SEC.

Finally, the Commission is also proposing rule amendments in this release that would amend the minimum financial requirements of FCMs and introducing brokers (''IBs'') by reducing the capital deductions for their uncovered inventory or forward contracts in specified foreign currencies. The proposed reduction is consistent with guidance currently provided by the Commission to FCMs and IBs.

DATES: Comments must be received on or before November 10, 2005.

ADDRESSES: You may submit comments, identified by RIN 3038–AC19, by any of the following methods:

- Federal eRulemaking Portal: *http://www.regulations.gov.* Follow the instructions for submitting comments.
- E-mail: *secretary@cftc.gov.* Include ''Proposed Amendment to Rule 1.17'' in the subject line of the message.
- Fax: (202) 418–5521.
- Mail: Send to Jean A. Webb, Secretary of the Commission, Commodity Futures Trading Commission, 1155 21st Street, NW., Washington DC 20581.
- Courier: Same as Mail above.

All comments received will be posted without change to *http://www.cftc.gov*, including any personal information provided.

FOR FURTHER INFORMATION CONTACT: Thomas J. Smith, Associate Deputy Director and Chief Accountant, at (202) 418–5430, or Thelma Diaz, Special Counsel, at (202) 418–5137, Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, D.C. 20581. Electronic mail: (*tsmith@cftc.gov*) or (*tdiaz@cftc.gov*).

SUPPLEMENTARY INFORMATION:

I. Background

A. Capital Charges for Proprietary Trading Assets

Commission Rule 1.17(a) requires each FCM to maintain a minimum amount of ''adjusted net capital'', which is defined as the FCM's net capital less the deductions, or ''haircuts'', that are specified in Rule 1.17(c)(5) and (8).[1] For purposes of the required haircuts on the FCM's proprietary positions in securities, Rule 1.17(c)(5) incorporates by reference percentage deductions that are set forth in SEC regulations 17 CFR 240.15c3–1(c)(2)(vi) and (vii).[2] Also, Commission Rule 1.17(c)(2)(ii), in a manner similar to the SEC's requirements for BDs under 17 CFR 240.15c3–1(c)(2)(iv), requires unsecured receivables arising from an FCM's transactions in over-the-counter (''OTC'') derivatives to be excluded from the FCM's current assets for purposes of determining the firm's regulatory capital. The deductions required for other proprietary assets of the FCM are set forth in other parts of Commission Rule 1.17(c).

The Commission and SEC have, to the extent practical, harmonized their respective capital rules in order to avoid creating inconsistent regulatory obligations for firms that are dually-registered FCMs and BDs. This harmonization of capital rules extends to the computation of net capital and adjusted net capital, and to the qualifications that subordinated debt must meet in order to qualify as regulatory capital. Furthermore, if an FCM is also registered as a BD, it may file an SEC Form X–17a–5, ''Financial and Operational Combined Uniform Single Report'' (''FOCUS Report'') to satisfy its requirement to file with the Commission a Form 1–FR–FCM financial report. In particular, Commission Rule 1.10(h) treats Part II and Part IIA of the FOCUS report as acceptable substitutes for the Form 1–FR–FCM, provided that the FOCUS report includes all information required to be furnished on and submitted with Form 1–FR–FCM. Also, for those portions of the Form 1–FR–FCM that the Commission has designated as either publicly available or as exempt from mandatory public disclosure for purposes of the Freedom of Information Act and the Government in the Sunshine Act, the Commission extends

[1] The rules of the Commission cited in this release may be found at 17 CFR Ch. I (2005). SEC rules cited in this release may be found at 17 CFR Ch. II (2005).

[2] Commission Rule 1.17(c)(5)(v) provides that the haircuts for an FCM's proprietary securities are ''the percentages specified in Rule 240.15c3–1(c)(2)(vi) of the Securities and Exchange Commission (17 CFR 240.15c3–1(c)(2)(vi)) ('securities haircuts') and 100 percent of the value of 'nonmarketable securities' as specified in Rule 240.15c3–1(c)(2)(vii) of the Securities and Exchange Commission (17 CFR 240.15c3–1(c)(2)(vii)).''

the same treatment to those portions of the FOCUS Report that are equivalent to the Form 1–FR–FCM. The uniform capital computations, and related single-form filing requirements, harmonize the regulatory requirements imposed upon dual registrants while providing the Commission and SEC with the necessary financial information to assess whether firms maintain a minimum level of regulatory capital while engaging in futures and securities businesses.

B. SEC Amendments To Establish Alternative Capital Deductions

On June 21, 2004, the SEC adopted final rule amendments to its capital rules to provide an ''alternative net capital computation for broker-dealers that voluntarily elect to be supervised on a consolidated basis,'' (the ''Alternative Capital Computation'').[3] As amended, SEC Rule 15c3–1(a)(7), (17 CFR 240.15c3–1(a)(7)), provides that the SEC may approve a BD's application, if submitted in accordance with the provisions of a new Appendix E (17 CFR 240.15c3–1e), for approval to use the Alternative Capital Computation when calculating its net capital. To the extent approved by the SEC, the BD using the Alternative Capital Computation would compute a total ''deduction for market risk'' for positions in the proprietary accounts of the BD, in accordance with the specific standards set forth in Appendix E (the standards are discussed in Part II of this release). The BD would calculate its regulatory capital using this deduction in lieu of the haircuts that SEC Rules 15c3–1(c)(2)(vi) and (c)(2)(vii) require for the BD's positions in securities.[4] The SEC may also approve alternative market risk deductions for the BD's proprietary positions in forward contracts and commodity futures contracts. Also, Appendix E provides that where the alternative market risk deduction has been used to compute the deduction on the underlying instrument for OTC derivatives of the BD, the BD would compute a ''deduction for credit risk,'' using the standards set forth in Appendix E, and it would use this deduction in lieu of the capital charges that SEC Rule 15c3–1(c)(2)(iv) requires for the BD's credit exposures arising from OTC transactions in derivatives.

The amended SEC rules limit the availability of the Alternative Capital Computation to BDs that comply with enhanced net capital, notification, recordkeeping, and reporting requirements. SEC Rule 15c3–1(a)(7) requires the BD to maintain at all times ''tentative net capital'' [5] of not less than $1 billion and net capital of not less than $500 million, and to provide same day notice if the BD's tentative net capital is less than $5 billion, or some other ''early warning'' amount specified by the SEC.[6] The amended rules specify that the SEC's response to an early warning notice may include imposing additional conditions on the use of the Alternative Capital Computation.[7]

The Alternative Capital Computation is also limited to those BDs who: (i) Have in place an internal risk management system that complies with 17 CFR 240.15c3–4 (previously applicable only to OTC derivatives dealers registered with the SEC), which addresses not only their market risk and credit risk, but also liquidity, legal and operational risks at the firm; and (ii) whose ultimate holding company and affiliates have consented to SEC consolidated supervision, *i.e.*, they become a ''consolidated supervised entity'' (''CSE''). For purposes of such consolidated supervision, the BD's ultimate holding company and affiliated entities must consent to direct examination by the SEC, unless the holding company is subject to supervision by the Federal Reserve or foreign banking regulators because it is a U.S. holding company or foreign bank that has elected financial holding company status under the Bank Holding Company Act of 1956.[8] The SEC has added a new Appendix G to Rule 15c3–1 (17 CFR 240.15c3–1g), which establishes the minimum reporting, recordkeeping, and notification requirements for all holding companies of BDs that apply for, or have received approval for the use of, the Alternative Capital Computation.[9]

In adopting the Alternative Capital Computation, the SEC has also responded to concerns expressed by several U.S. BDs that are required, pursuant to a directive issued by the European Union (''EU'') at the end of 2002 (the ''Financial Groups Directive''), to demonstrate holding company supervision that is equivalent to EU consolidated supervision.[10] Absent a demonstration of comparable group-wide supervision, the EU may restrict or otherwise place conditions upon the operations of the European-based affiliates of these BDs. The consolidated supervision requirements in the SEC's amended rules provide a regulatory structure that is intended to satisfy the requirements of the Financial Groups Directive.

As the SEC noted when first proposing rules for the Alternate Capital Computation, the required market risk and credit risk deductions are expected to be substantially smaller in amount than the standardized deductions.[11] As the SEC rule amendments were being discussed and proposed, Commission staff identified that continued harmonization of the capital rules of the two agencies would require amendment of Rule 1.17, and communicated this to various market participants potentially affected by the difference between the SEC's proposed rules and Rule 1.17. After the SEC adopted rule amendments allowing BDs to apply for approval to use the Alternative Capital Computation, several FCM/BDs, along with representatives of the Securities Industry Association and the Futures Industry Association, contacted staff of the Commission's Division of Clearing and Intermediary Oversight (the ''Division'') to express their support for Commission rulemaking that would allow dually-registered FCM/BDs to use their SEC-approved alternative market risk and credit risk deductions when computing their adjusted net capital under Rule 1.17.[12] In addition, two

[3] The SEC's new rule was published at 69 FR 34428 (June 21, 2004). The effective date of the rule was August 20, 2004.

[4] As an example of the haircuts required by SEC Rule 15c3–1(c)(2)(vi), the haircut for equity securities is equal to 15 percent of the market value of the greater of the long or short equity position plus 15 percent of the market value of the lesser position, but only to the extent this position exceeds 25 percent of the greater position. The deduction for securities with no ready market is 100 percent under SEC Rule 15c3–1(c)(2)(vii).

[5] The BD's ''tentative net capital'' consists of its net capital before the approved deductions for market and credit risk under the SEC's amended rule, and also increased by the balance sheet value (including counterparty net exposure) resulting from transactions in derivative instruments that would otherwise be deducted by virtue of paragraph (c)(2)(iv) of Rule 15c3–1.

[6] Upon written application by a BD, the SEC may lower the threshold for the early warning requirement, either unconditionally or subject to specified terms and conditions. The SEC will consider various factors to determine whether the requirement is unnecessary. 69 FR at 34461.

[7] The additional conditions that may be imposed on the BD include restricting the BD's business on a product-specific, category-specific or general basis; requiring submission of a plan to increase its net capital or tentative net capital; requiring more frequent reporting; requiring modifications to the BD's internal risk management control procedures; or requiring capital deductions using the SEC's standardized haircuts. *See* 17 CFR 240.15c3–1e(e).

[8] The CSE rule specifically exempts FCM affiliates of BDs, and other functionally regulated BD affiliates, from the SEC's direct examination.

[9] To minimize duplicative regulation, Appendix G imposes fewer requirements on holding companies that have elected financial holding company status.

[10] *See* ''Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002.''

[11] The SEC's proposed rules for the Alternative Capital Computation were published in the **Federal Register** in 2003. 68 FR 62872 (November 6, 2003).

[12] The Securities Industry Association and the Futures Industry Association are industry trade

dually-registered FCM/BDs that had received SEC approval for the Alternative Capital Computation requested no-action positions from Division staff, without which the Alternative Capital Computation could not be used for purposes of their capital computation and reporting requirements to the Commission. The Division granted such relief on an interim basis, to be superseded by such final rules as the Commission might eventually adopt in connection with the Alternative Capital Computation.

II. SEC Requirements for BDs Using Alternative Capital Computation

A. SEC Appendix E Requirements for Computation of Alternative Deductions for Market Risk and Credit Risk.

1. Deduction for Market Risk.

The computation for the alternative market risk deduction is set forth in paragraph (b) of the new Appendix E (17 CFR 240.15c3–1e(b)), and is the sum of the following:

• For proprietary positions for which the SEC has approved the BD's use of ''value at risk'' (''VaR'') models, ''the VaR of the positions multiplied by the appropriate multiplication factor,'' which is initially set at three.[13] VaR models are mathematical models that are used to generate a summary measure of market risk for a portfolio of assets, and the VaR of a portfolio can be expressed in terms of the estimated loss in value, over a given time period, that is expected to be equaled or exceeded with a given, small probability. Under Appendix E, the loss estimates under the BD's VaR models must use price changes equivalent to a ten business-day period movement in rates and prices, and a confidence level of 99 percent, *i.e.*, the VaR of the BD's positions can be expressed as the ten business-day loss that is expected to be equaled or exceeded 1 percent of the time.[14] Appendix E also requires that the BD monitor whether the ''multiplication factor'' should be increased, by requiring the BD to conduct backtesting of the model beginning three months after the BD begins using the VaR model to calculate market risk. Backtesting ''exceptions'' will be determined by comparing the actual daily net trading profit or loss of the BD with the corresponding VaR measure generated by its model. As further specified in Appendix E, on the last business day of each quarter, the BD must identify the number of business days, for each of the past 250 business days, for which the actual net trading loss exceeded the corresponding VaR measure. The BD will then use, until it obtains the next quarter's backtesting results, the multiplication factor indicated in the table included in Appendix E, which increases the required multiplication factor based on the number of backtesting exceptions.

• For any positions for which the VaR model does not incorporate ''specific risk,'' which is the risk that any position, particularly one with no ready market, does not have price moves that correlate to broad market moves, an additional deduction must be included in the BD's computation of its alternative market risk deduction. As part of the review of the BD's application, the SEC will review the BD's methodology for determining specific risk deductions.

• For proprietary positions for which the SEC has approved the use of ''scenario analysis,'' the required deduction is the greatest loss, as indicated by the analysis, resulting from a range of adverse movements in relevant risk factors, prices, or spreads for the positions,[15] or is some multiple of the greatest loss based on the liquidity of the positions subject to scenario analysis.[16] This deduction is subject to a ''floor,'' so that irrespective of the deduction otherwise indicated under scenario analysis, the resulting deduction for market risk must be at least $25 per 100 share equivalent contract for equity positions, or one-half of one percent of the face value of the contract for all other types of contracts.

• For all remaining proprietary positions for which the SEC has not approved the BD's use of VaR models or scenario analysis, the standard deductions specified in SEC rules 17 CFR 240.15c3–1(c)(2)(vi), (c)(2)(vii), and applicable appendices to § 240.15c3–1.

When first proposing the Alternative Capital Computation, the SEC noted that it had been modeled on rule amendments previously adopted by the SEC for OTC derivatives dealers in 1998.[17] In turn, the rules for OTC derivatives dealers parallel those that U.S. banking agencies had adopted in 1996 to require banks to compute a market risk charge, and to establish standards for the internally-generated market risk estimates that banks could use to compute the charge.[18] The rules adopted by the banking agencies implemented recommendations of the Basel Committee on Banking Supervision (''Basel Committee''),[19] which recognized the growing use of VaR models as part of the risk management procedures of internationally active banks with large trading portfolios.[20] The rules adopted by the banking agencies implemented capital charges for the market risks incurred by such banks, and approved the use of proprietary VaR models as part of the calculation of the required market risk charges, subject to the models satisfying certain ''qualitative'' and ''quantitative'' conditions.[21] These

groups whose members include broker-dealers, futures commission merchants, and representatives of other segments of the securities and futures industries.

[13] The multiplication factor may be increased based upon the number of exceptions observed during model backtesting, which the BD is required to perform, but may not be less than three.

[14] Incorporating VaR models into the firm's capital calculations offers the firm the advantage of increasing its ability to recognize the correlations and hedges in its trading portfolio, and reducing its capital charge for market risk as a consequence. For example, as the SEC has noted, its fixed-percentage securities haircuts recognize only limited hedging activities, and do not account for historical correlations between foreign securities and U.S. securities or between equity securities and debt securities. According to the SEC, by ''failing to recognize offsets from these correlations between and within asset classes, the fixed percentage haircut method may cause firms with large, diverse portfolios to reserve capital that actually overcompensates for market risk.'' 62 FR 68011, 68014 (December 30, 1997) (SEC concept release regarding the extent to which statistical models might be considered for use in setting the capital requirements for a BD's proprietary positions).

[15] The relevant risk factors, prices, or spreads are designed to represent a negative movement greater than, or equal to, the worst ten-day movement over the four years preceding the calculation of the greatest loss.

[16] If historical data is insufficient, the SEC requires the deduction for positions for which scenario analysis is used to be the largest loss within a three standard deviation movement in those risk factors, prices, or spreads over a ten-day period, multiplied by an appropriate liquidity adjustment factor.

[17] 68 FR at 62872.

[18] The SEC first proposed rules for OTC derivatives dealers in 1997, and stated that they were consistent with the market risk capital requirements adopted by the U.S. banking agencies. 62 FR 67940, 67947 (December 30, 1997).

[19] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities established in 1974 by the central-bank Governors of the Group of Ten countries. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

[20] In 1988, the Basel Committee published a document titled the ''International Convergence of Capital Measurement and Capital Standards'' (the ''Basel Capital Accord''), which set forth an agreed framework for measuring capital adequacy and the minimum requirements for capital for banking institutions. There have been several amendments to the Basel Capital Accord in the intervening years, including, in January of 1996, the ''Amendment to the Capital Accord to Incorporate Market Risks.'' Most recently, the Basel Committee issued a revised framework in June of 2004 (''Basel II'') that amends provisions related to credit risk and adds provisions to address operational risk.

[21] *See, generally*, 61 FR 47358 (September 6, 1996) (final rules adopted by federal banking

Continued

conditions included the requirement of an appropriate multiplication factor, initially set at three and increased as indicated by backtesting results.[22]

The amended SEC rules similarly specify several qualitative and quantitative requirements for the VaR models used by those BDs that are approved to use the Alternative Capital Computation. The qualitative requirements set forth in Appendix E include certain requirements already described above, *i.e.*, those related to the multiplication factors applied to VaR based on backtesting results, and also include the following: (i) VaR models used to calculate market risk or credit risk must be integrated into the daily internal risk management system of the BD; (ii) VaR models must be reviewed both periodically (by either the BD's internal audit staff or an outside auditor) and annually (by a registered public accounting firm, as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq.*); and (iii) the BD must have, for purposes of incorporating specific risk into its VaR model, methodologies in place to capture liquidity, event, and default risk adequately for each position. Other requirements for the models used to calculate deductions for specific risk include that they explain the historical price variation in the portfolio; capture concentration in terms of magnitude and changes in composition; be robust to an adverse environment; and be validated through backtesting.

The quantitative requirements for the VaR models are also set forth in Appendix E, and in addition to the requirement, described above, for market risk VaR models to be based on a 99 percent confidence level and ten-day holding period, also include the following: (i) The VaR model must use an effective historical observation period of at least one year; (ii) the BD must consider the effects of market stress in its construction of the model; (iii) the historical data sets used for the models must be updated at least monthly and reassessed whenever market prices or volatilities change significantly; and (iv) the VaR model must take into account and incorporate all significant, identifiable market risk factors applicable to positions in the accounts of the BD.[23] An additional quantitative requirement, related to the VaR models used for the BD's deduction for credit risk, is discussed below.

2. Deduction for Credit Risk

To determine its alternative deduction ''for credit risk on transactions in derivative instruments (if [Appendix E] is used to calculate a deduction for market risk on those instruments),'' Appendix E requires the BD to compute three separate capital charges and add them together. As set forth in 17 CFR 240.15c3–1e(c), the alternative deduction for credit risk is an amount equal to the sum of the following three charges:

(1) A ''counterparty exposure charge'' in an amount equal to the sum of the following: (i) The net replacement value in the account of each counterparty that is insolvent, or in bankruptcy, or that has senior unsecured long-term debt in default; and (ii) For each of the BD's other counterparties, a ''credit equivalent amount'' (generally speaking, the extent to which, after taking into account available collateral and enforceable netting agreements, the BD is exposed to the creditworthiness of the counterparty, both in terms of the current cost of replacing the positive cash flow under the OTC agreement if the counterparty were to default, and in terms of the potential for the replacement cost to increase over the length of the contract, due to movements in the rates or prices underlying the contract (the firm's ''maximum potential exposure'')), multiplied by the ''credit risk weight'' of the counterparty (counterparties with lower credit ratings have higher credit risk weights),[24] multiplied by 8 percent.[25] ''Maximum potential exposure'' will be determined using a VaR model, which, like the market risk VaR model, must use a 99 percent confidence level, but the price changes will be equivalent to a one-year movement in rates and prices.[26] The VaR for maximum potential exposure must also be multiplied by a multiplication factor, which will be initially set at one, but is also subject to increases based on backtesting exceptions, in accordance with a schedule of multiplication factors that has been proposed by the BD and approved by the SEC.

(2) A ''concentration charge by counterparty,'' which is the total determined by adding together, for each counterparty of a given credit risk weight, a specified percentage of the amount of the BD's current exposure to the counterparty that is in excess of 5 percent of the BD's tentative net capital.[27]

(3) A ''portfolio concentration charge'' of 100 percent of the amount of the BD's aggregate current exposure for all counterparties in excess of 50 percent of the tentative net capital of the BD.

The SEC has stated that the provisions related to OTC derivatives in the amended rules are based on its experience with the reporting provided by the Derivatives Policy Group,[28] and

---

agencies to require market risk capital charge and adopting standards for the ''internal models'' approach for calculation of the charge).

[22] The table in Appendix E that provides the required VaR multiplication factor is consistent with the recommendations made by the Basel Committee in 1996. *See* ''Supervisory Framework for the Use of Backtesting in Conjunction with the Internal Models Approach to Market Risk Capital Requirements'' (January 1996).

[23] The required market risk factors under the SEC's rule include not only specific risk for individual positions, but also the following general market risks: (i) Risks arising from the non-linear price characteristics of derivatives and the sensitivity of the market value of those positions to changes in the volatility of the derivatives' underlying rates and prices; (ii) empirical correlations with and across risk factors or, alternatively, risk factors sufficient to cover all the market risk inherent in the positions in the proprietary or other trading accounts of the BD, including interest rate risk, equity price risk, foreign exchange risk, and commodity price risk; and (iii) where applicable, spread risk, and segments of the yield curve sufficient to capture differences in volatility and imperfect correlation of rates along the yield curve for securities and derivatives that are sensitive to different interest rates.

[24] Appendix E assigns specific credit weights, ranging from 20 percent to 150 percent, based either on the ratings made by a nationally recognized statistical rating organization or internally by the firm. A BD may request approval to determine credit risk weights based on internal calculations. The BD must make and keep current a record of the basis for the credit rating, and credit risk weight, for each counterparty.

[25] The SEC stated that the 8 percent multiplier is consistent with the calculation of credit risk in the OTC derivatives dealer rules and applicable requirements in Basel Committee publications, and is designed to dampen leverage to help ensure that the firm maintains a safe level of capital.

[26] The SEC may approve a shorter time horizon (but not less than ten business days), based on a review of the BD's procedures for managing collateral, the daily mark-to-market of the collateral, and the BD's ability to call for additional collateral daily.

[27] Appendix E requires that for each counterparty with a credit risk weight of 20 percent or less, the concentration charge is 5 percent of the amount of the current exposure to the counterparty that is in excess of 5 percent of the BD's tentative net capital; for each counterparty with a credit risk weight of greater than 20 percent but less than 50 percent, the charge is 20 percent of the current exposure to the counterparty that is in excess of 5 percent of the BD's tentative net capital; and for each counterparty with a credit risk weight of greater than 50 percent, the charge is 50 percent of the current exposure to the counterparty that is in excess of 5 percent of the BD's tentative net capital.

[28] The Derivatives Policy Group (''DPG'') consists of several U.S. firms that are most active in the OTC derivatives market. The DPG was formed at the request of the SEC to address the public policy issues arising from the activities of unregistered affiliates of BDs. In March of 1995 the DPG published its ''Framework for Voluntary Oversight, a Framework for Voluntary Oversight of the OTC Derivatives Activities of Securities Firm Affiliates to Promote Confidence and Stability in Financial Markets,'' under which the members of the DPG agreed to report voluntarily to the SEC on their activities in the OTC derivatives market.

also with the SEC's regulation of OTC derivatives dealers.[29] The provisions for OTC derivatives also reflect the reporting recommendations made by the Basel Committee and the Technical Committee of the International Organization of Securities Commissions (''IOSCO'') in a joint report issued in 1995 and revised in 1998, which included recommendations for the reporting by banks and securities firms related to the credit risk of their OTC derivatives, particularly their current and potential credit exposures to their counterparties, the credit quality of their counterparties, and the concentration of credit risk with these counterparties.[30]

B. SEC Application Process

The approval process under Appendix E of SEC Rule 15c3–1 is initiated by the filing of an application by the BD, which is required to: (i) Describe the mathematical models used to price positions and to compute market risk and credit risk capital deductions, and explain how the models meet the required quantitative and qualitative standards set forth in SEC regulations; (ii) describe the BD's internal risk management control system and how that system satisfies the requirements set forth in SEC regulations; (iii) include corrected or updated information going forward as appropriate; and (iv) provide a written undertaking and certain information from the BD's holding company. Furthermore, the BD must amend or resubmit an application to obtain SEC approval of any material change to its approved mathematical models. The SEC may approve the application in whole or in part, and the SEC may revoke its approval upon certain conditions. The SEC delegates to the Director of the SEC's Division of Market Regulation the authority to undertake specific activities and determinations under the rule, including the authority to approve any amendments to the BD's application. If a BD decides it no longer wishes to continue using its approved alternative market risk and credit risk charges, it must give notice to the SEC 45 days (or a shorter or longer period as approved by SEC) prior to the BD ceasing use of the approved models and reverting to the standard haircuts. The SEC has also specified in Appendix E, at paragraph (a)(11), that the BD's approval to use the Alternative Capital Computation may be revoked by SEC order, upon a finding that the exemption is no longer necessary or appropriate in the public interest or for the protection of investors. The rule further states that in making its finding, the SEC will consider the compliance history of the BD related to its use of models, the financial and operational strength of the BD and its ultimate holding company, the BD's compliance with its internal risk management controls, and the holding company's compliance with its written undertaking with the SEC.

C. Reporting Required by SEC for the Alternative Capital Computation

To implement other conditions for the use of the Alternative Capital Computation, the SEC also amended its Rule 17a–5 (17 CFR 240.17a–5), which sets forth financial reporting requirements applicable to all BDs. In addition to the information otherwise required under SEC Rule 17a–5(a), a BD that uses the Alternative Capital Computation must, on a monthly basis, file reports that include: (i) Regular risk reports supplied to the BD's senior management in the format described in the application; (ii) for each product for which the BD calculates a deduction for market risk in accordance with Appendix E, the product category and the amount of the deduction for market risk; (iii) a graph reflecting, for each business line, the daily intra-month VaR; (iv) the aggregate value at risk for the BD; (v) for each product for which the BD uses scenario analysis, the product category and the deduction for market risk; and (vi) credit risk information on derivatives exposures. More specifically, the credit risk information to be filed for OTC derivatives exposures includes: (i) The BD's overall current exposure; (ii) its current exposure (including commitments) listed by counterparty for the 15 largest exposures; (iii) the 10 largest commitments listed by counterparty; (iv) the BD's maximum potential exposure listed by counterparty for the 15 largest exposures; (v) the BD's aggregate maximum potential exposure; (vi) a summary report reflecting the BD's current and maximum potential exposures by credit rating category; and (vii) a summary report reflecting the BD's current exposure for each of the top ten countries to which the BD is exposed (by residence of the main operating group of the counterparty).

The amended SEC Rule 17a–5(a) also requires quarterly reports that include: (i) the number of business days for which the actual daily net trading loss exceeded the corresponding daily VaR; and (ii) the results of backtesting of all internal models used to compute allowable capital, including VaR and credit risk models, indicating the number of backtesting exceptions. BDs approved to use the Alternative Capital Computation must also file supplements to their annual financial statements, which under amended SEC Rule 17a–5(k) are to consist of: (i) An accountant's report on management controls (indicating the results of the review made by a registered public accounting firm of the BD's internal risk management control system); and (ii) a related statement, made prior to commencement of the accountant's review, that describes the review procedures agreed to by the BD and the accountant.

III. Proposed Rules for FCMs Registered as BDs To Use Their SEC-Approved Capital Charges

The SEC, in adopting its rules permitting alternative capital charges incorporating VaR measurements for qualifying BDs subject to consolidated supervision, commented that ''the alternative method of computing net capital responds to [broker and dealer] requests to align their supervisory risk management practices and regulatory capital requirements more closely.'' [31] Absent the changes that are being proposed in this release to Commission Rule 1.17, the potential for reduced capital charges that is available to dual registrants under the Alternative Capital Computation would not be available under the Commission's rules. As a result, FCM/BDs would be faced with potentially complex capital computations and compliance burdens. Given the commonality of purpose between the capital charges required by the SEC for BD registrants and by the Commission for FCM registrants, the Commission is therefore proposing to permit dual registrants that have qualified for the exemption under the SEC's net capital rule to use the same alternative charges with respect to their calculation of minimum CFTC net capital, subject to the general requirement that the Commission receive the same notices and the monthly, quarterly and annual reporting information, as described above, that the SEC's amended rules require FCM/BDs to provide to the SEC. As for holding company information that is provided to the SEC under the new Appendix G to SEC Rule 15c3–1, or as part of the

[29] 68 FR at 62879.

[30] *See* ''Framework for Supervisory Information about Derivatives and Trading Activities,'' published in September of 1998 by the Basel Committee and IOSCO. IOSCO provides an international cooperative forum for securities regulatory agencies, and its member securities agencies regulate more than 90 percent of the world's securities markets.

[31] 69 FR at 34428.

application that the BD files with the SEC to request approval to use the Alternative Capital Computation, the proposed rules in the release do not require the Commission's receipt of such holding company information, because such information is being provided to the SEC for purposes of the SEC's consolidated supervision of the holding company.

In formulating the proposed amendments, the Commission has taken into consideration that the Alternative Capital Computation, unlike the current standardized charges, is determined by an ongoing oversight process that results in individualized capital charges that require considerable firm-specific information. Pursuant to Commission Rule 1.17(a)(3), FCMs must be able to demonstrate to the satisfaction of the Commission their compliance with their minimum financial requirements under the Commodity Exchange Act and implementing regulations of the Commission. The proposed amendments to Rule 1.17 would enable FCM/BDs to elect to use their SEC approved capital charges in satisfaction of their requirements under Rule 1.17, subject to compliance with FCM notification and filing requirements that would promote the Commission's risk oversight of FCMs, given their critically important role as risk intermediaries in the futures and options markets.

The Commission is not proposing any amendments in this release to Rules 1.14 and 1.15, pursuant to which FCMs are required to maintain and report ''risk assessment'' information to the Commission concerning the FCM's material affiliates. The SEC imposes similar requirements on BDs, through SEC Rules 17h–1T and 17h–2T, for recordkeeping and reporting on the material affiliates of the BD. A firm that is dually registered as a BD and an FCM must comply with the risk assessment regulations of the SEC and the Commission, but Commission Rule 1.15(d)(1) permits FCM/BDs to meet their filing requirements by providing copies to the Commission of the risk assessment documents that are filed with the SEC.[32]

Given the overlap between information that the SEC requires under the newly adopted Appendix G and under SEC Rules 17h–1T and 17h–2T, the SEC amended its rules so that BDs whose holding companies are directly examined by the SEC are relieved of having to also meet the filing obligations required by SEC Rules 17h–1T and 17h–2T. Because the Commission does not require holding company information under the amendments to Rule 1.17 proposed in this release, the proposed rule amendments do not duplicate the filing requirements of Commission Rules 1.14 and 1.15. FCM/BDs that elect to use the Alternative Capital Computation will therefore continue to be required to comply with the provisions of Rules 1.14 and 1.15.

A. Proposal to Permit FCMs To Elect To Use Their SEC-Approved Capital Charges

The Commission proposes to amend paragraph (c)(6) of Rule 1.17 by providing that an FCM/BD may elect, if it satisfies the requirements of proposed paragraph (c)(6), to compute its adjusted net capital using alternative capital deductions that the SEC has approved by written order under 17 CFR 240.15c3–1(a)(7). To the extent that the SEC has approved alternative capital deductions for the FCM/BD's unsecured receivables from OTC transactions in derivatives, or for its proprietary positions in securities, forward contracts, or futures contracts, the FCM/BD may use these same alternative capital deductions when computing its adjusted net capital. These alternative deductions would be used in lieu of the amounts that otherwise would be required by the following regulations: Rule 1.17(c)(2)(ii) for unsecured receivables from OTC derivatives transactions; Rule 1.17(c)(5)(ii) for proprietary positions in forward contracts; Rule 1.17(c)(5)(v) for proprietary positions in securities; and Rule 1.17(c)(5)(x) for proprietary positions in futures contracts. The proposed rulemaking would not alter or affect the haircuts that Rule 1.17(c)(5)(v) and Rule 1.32(b) require for securities that are held in segregation under Section 4d of the Commodity Exchange Act, because the alternative deductions apply solely to an FCM/BD's proprietary positions.[33]

B. Proposed Requirements for FCMs Electing the Alternative Capital Computation

1. Notice of Election or of Changes to Election

Proposed paragraph (c)(6)(ii) of Rule 1.17 would specify that an FCM's election to use the Alternative Capital Computation would not be effective unless and until it has filed with the Commission a notice, addressed to the Director of the Division of Clearing and Intermediary Oversight, that is to include: (i) A copy of the SEC order approving its alternative market risk and credit risk capital charges; and (ii) a statement that identifies the amount of tentative net capital below which the FCM is required to provide notice to the SEC, and that also includes portions of the information made available to the SEC for purposes of its request for approval to use the Alternative Capital Computation, as follows:[34]

(1) A list of the categories of positions that the firm holds in its proprietary accounts, and, for each such category, a description of the methods that the firm will use to calculate its deductions for market risk and credit risk, and, if calculated separately, its deductions for specific risk;

(2) A description of the VaR models to be used for its market risk and credit risk deductions, and an overview of the integration of the models into the internal risk management control system of the firm;

(3) A description of how the firm will calculate current exposure and maximum potential exposure for its deductions for credit risk;

(4) A description of how the firm will determine internal credit ratings of counterparties and internal credit risk weights of counterparties, if applicable; and

(5) A description of the estimated effect of the alternative market risk and credit risk deductions on the amounts reported by the firm as net capital and adjusted net capital.

Proposed Rule 1.17(c)(6)(ii) would also require the FCM to supplement its statement, upon the request of the Commission made at any time, with any other explanatory information for the firm's computation of its alternative market risk and credit risk deductions as the Commission may require at its

[32] To comply with SEC Rule 17h–2T, BDs file SEC Form 17–H, and Commission Rule 1.15(d)(1) allows FCM/BDs to comply with the requirements in Rules 1.15(a)(1)(i) and (a)(2) by filing copies with the Commission of their Forms 17–H, if these are additionally supplemented to ensure that the Commission receives all of the information required under Rule 1.15.

[33] FCM/BDs using the Alternative Capital Computation would continue to be required, under Rule 1.17(c)(5)(v), to deduct the securities haircuts specified in SEC Rules 15c3–1(c)(2)(vi) and (vii) from the value of securities that are held in segregated accounts under Section 4d and the Commission's implementing regulations and which were not deposited by customers. Such FCM/BDs would also continue to be required, when computing the amount of funds required to be in segregated accounts, to use the standard SEC securities haircut expressly referenced in Rule 1.32(b), *i.e.*, SEC Rule 15c3–1(c)(2)(vi). Rule 1.32 applies this haircut for purposes of the permissible offset of any net deficit in a customer's account against the current market value of readily marketable securities, less the SEC standard haircut, that are held for the same customer's account.

[34] As noted earlier, SEC Rule 15c3–1(a)(7)(ii) requires same-day notice to the SEC if the BD's tentative net capital is less than $5 billion, or a lower amount that has been agreed to by the SEC.

discretion. The requests for explanatory information under proposed Rule 1.17(c)(6)(ii) may be made by the Director of the Division of Clearing and Intermediary Oversight, to whom, as set forth in Commission Rule 140.91(a)(6), the Commission has delegated authority for the functions reserved for the Commission under Rule 1.17.

Proposed Rule 1.17(c)(6)(ii) would further provide that the FCM must file, as a supplemental notice with the Director of the Division of Clearing and Intermediary Oversight, a notice advising that the SEC has imposed additional or revised conditions after the date of the SEC order filed with the FCM's original notice to the Director of the Division of Clearing and Intermediary Oversight. The FCM must also file as a supplemental notice a copy of any approval by the SEC of amendments that the firm has requested for its application to use the Alternative Capital Computation.

An FCM would also be permitted under the proposed rule to voluntarily change its election, by filing with the Director of the Division of Clearing and Intermediary Oversight a written notice that specifies a future date as of which its market risk and credit risk capital charges will no longer be determined by the Alternative Capital Computation, but will instead be computed as otherwise required under the Commission's rules.

2. Conditions UNDER Which FCM May No Longer Elect Alternative Capital Charges

Proposed paragraph (c)(6)(iii) of Rule 1.17 would provide that an FCM may no longer elect to use its SEC-approved alternative market risk and credit risk deductions, and shall instead compute the charges otherwise required under Rules 1.17(c)(5) or 1.17(c)(2), upon the occurrence of any of the following: (i) The SEC revokes its approval of the firm's market risk and credit risk deductions; (ii) the firm fails to come into compliance with its filing requirements under the proposed rule, after having received from the Director of the Division of Clearing and Intermediary Oversight written notification that the firm is not in compliance with its filing requirements, and must cease using the Alternative Capital Computation if it has not come into compliance by a date specified in the notice; or (iii) the Commission by written order finds that permitting the firm to continue to use such alternative market risk and credit risk deductions is no longer appropriate for the protection of customers of the FCM or the financial integrity of the futures or options markets.[35]

3. Additional Filing Requirements

In addition to the notice and supplemental notices described above, proposed paragraph (c)(6)(iv) of Rule 1.17 would also provide that any firm that elects to use the Alternative Capital Computation must file with the Commission copies of all additional monthly, quarterly, and annual reporting items that BDs who are approved to use the Alternative Capital Computation must file with SEC, as discussed above. The FCM would also be required to file with the Commission a copy of the notice that it must file with the SEC whenever its tentative net capital falls below the amount required by the SEC, or of the notice filed with the SEC or the firm's designated examining authority in regard to planned withdrawals of excess net capital.

Specifically, the proposed rule would require the following to be filed with the Commission, at the same time that originals are filed with the SEC:

(1) All information that the firm files on a monthly basis with its designated examining authority or the SEC in satisfaction of SEC Rule 17a–5(a)(5)(i), whether by way of schedules to the firm's FOCUS reports or by other filings;

(2) The quarterly reports required by SEC Rule 17a–5(a)(5)(ii);

(3) The supplemental annual filings as required by SEC Rule 17a–5(k), which consist of a report on management controls that is prepared by a registered public accounting firm and is filed by the firm concurrently with its annual audit report, and also a related statement, filed prior to the commencement of the accountant's review but no later than December 10 of each year, that includes a description of the procedures agreed to by the firm and the accountant and a notice describing changes to the agreed-upon procedures, if any, or stating that there are no changes; and

(4) Any notification to the SEC or the firm's designated examining authority of planned withdrawals of excess net capital, and any notification that the firm is required to file with the SEC when its tentative net capital is below an amount specified by the SEC.

BDs that use the Alternative Capital Computation also file a revised Part II to the FOCUS report, designated ''Part II CSE''. This revised FOCUS report includes financial information that BDs previously reported in Part II of the FOCUS Report, and also includes new schedules that provide much of the additional information that BDs who use the Alternative Capital Computation must report on a monthly basis. In order to facilitate the firm's reporting requirements and reduce administrative burden, the Commission proposes to amend Rule 1.10(h) to specify that a dual registrant may file, in lieu of its Form 1–FR–FCM report, a copy of the FOCUS Report, Part II CSE that the firm files with the SEC.[36]

C. Treatment of Information Received From FCMs Electing the Alternative Capital Computation

1. The Freedom of Information and Sunshine Acts

The Freedom of Information Act, 5 U.S.C. 552 *et seq.* (''FOIA''), provides generally that the public has a right of access to federal agency records except to the extent such records, or portions of them, are protected from disclosure by one (or more) of nine narrow exemptions. The Government in the Sunshine Act, 5 U.S.C. 552b (''Sunshine Act''), enacted to ensure that agency action is open to public scrutiny, contains identical exceptions. Accordingly, the Commission is required by the FOIA and the Sunshine Act to make public its records and actions unless a specific exemption is available.

Historically, portions of the Form 1–FR and FOCUS reports that are filed with the Commission under Rule 1.10 have been available to the public.[37]

[35] Because the proposed rule would permit only dual registrants to use the Alternative Capital Computation, an FCM's election to use the Alternative Capital Computation would automatically terminate immediately, without further action by the Commission, if it ceases to be dually-registered as a BD.

[36] Several other Commission rules include references to Parts II and Part IIA of the FOCUS report, in order to facilitate the filing of the FOCUS report in lieu of the Form 1–FR–FCM. The Commission also proposes be amend these rules to add a reference to Part II CSE. In particular, the Commission proposes to amend the following rules: Rule 1.10(d)(4)(ii), which sets forth the requirements for ''authorized signers'' of the FOCUS report; Rule 1.10(f)(1), which sets forth the procedures required to obtain extensions of time for filing the FOCUS report; Rule 1.16(c)(5), which requires the accountant's supplemental report on material inadequacies to be filed as of the same date as the Form 1–FR or FOCUS report; Rules 1.18(a) and (b)(2), which permit FOCUS filings to satisfy certain recordkeeping requirements of the FCM; and Rule 1.52(a), which permits the designated self-regulatory organization of a dual registrant to accept a FOCUS report in lieu of a Form 1–FR–FCM.

[37] The statement of financial condition, which consists of a balance sheet showing assets, liabilities and ownership equity; the computations for net capital and minimum capital requirements; and the statements related to the segregation of customer funds under Section 4d of the Commodity Exchange Act. See 17 CFR 1.10g. Since 1995, the Commission routinely has published on its Web site

Continued

Other portions of these reports currently are exempt from disclosure [38] as confidential commercial or financial information pursuant to Commission regulation 145.5(d), which tracks the language of its FOIA counterpart, exemption (b)(4).[39] Similarly, Commission meetings (or portions of meetings) may be ''closed'' under the Sunshine Act where the Commission determines that open meetings will likely reveal information protected by an exemption.[40]

The Commission believes that the filings required by the proposed amendments, as well as certain portions of the Form 1–FR and FOCUS reports presently filed with the Commission pursuant to Rule 1.10, also are protected from disclosure by FOIA and Sunshine Act exemption (8), pursuant to which the Commission is authorized to withhold from the public matters ''contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.'' 5 U.S.C. 552(b)(8) and 5 U.S.C. 552b(c)(8). Commission Rules 145.5(h) and 147.3(b)(8) similarly provide that the Commission generally will not make public matters that are ''contained in or related to examinations, operating, or condition reports prepared by, on behalf of, or for the use of the Commission or any other agency responsible for the regulation or supervision of financial institutions.''

Because the term ''financial institution'' is not defined either in the FOIA or its legislative history, courts have relied on the legislative history of the Government in the Sunshine Act,[41] a statute in *pari materia* with the FOIA, to take an inclusionary and expansive view of the term.[42] The Commission is aware that no court directly has considered whether Commission registrants are financial institutions for purposes of either exemption 8; the Commission believes, however, that the language of the Sunshine Act's legislative history contemplates the inclusion of commodities professionals, including futures commission merchants, designated contract markets, derivatives transaction execution facilities, commodity pool operators and commodity trading advisors. Recent legislation bolsters this view. The USA PATRIOT Act [43] defines FCMs, CPOs and CTAs as financial institutions for purposes of the anti-money laundering requirements of the Bank Secrecy Act, 31 U.S.C. 5311 *et seq.*; 31 U.S.C. 5312(c), and identifies the Commission as a ''federal functional regulator.'' [44]

Similarly, Section 5g(a) of the Commodity Exchange Act provides that any FCM, CTA, CPO or IB that is subject to the Commission's jurisdiction with respect to any financial activity shall be treated as a financial institutions for purposes of the privacy requirements in Title V of the Gramm-Leach-Bliley Act. 7 U.S.C. 7b–2(a).[45]

The primary purposes of FOIA exemption 8 have been described as ''protecting the integrity of financial institutions and facilitating cooperation between [agencies] and the entities regulated by [them].'' [46] In light of the expanded activities and growing impact of FCMs as financial institutions,[47] and the delineation in the Commodity Futures Modernization Act of 2000 (''CFMA'') [48] of the Commission's oversight role with respect to all Commission registrants, these goals are especially desirable.

2. Proposed Amendments to Parts 1, 145, and 147

In light of these considerations, the Commission proposes to treat as nonpublic certain financial information filed with it by FCMs and BDs. Under the proposed amendments to Rule 1.10(g), statements of financial condition in monthly FOCUS reports, the full computations of net capital, and the minimum capital requirements in monthly FOCUS reports would no longer be publicly available. The express mandates of the Commodity Exchange Act, however, support the Commission's determination that certain information that is filed in Form 1–FR and FOCUS reports remain

selected financial information for every FCM from the publicly available statements and schedules listed in rule 1.10(g): (1) Total adjusted net capital; (2) minimum capital requirement; (3) adjusted net capital in excess of the minimum requirement; (4) customer funds that the Commission requires to be held in segregated accounts in accordance with Section 4d of the Act; and (5) customer funds that the Commission requires to be held in secured accounts in accordance with Part 30 of the Commission's regulations.

[38] See 17 CFR 145.5 and 147.3. Those portions are: the Statement of Income (Loss); the Statement of Cash Flows; the Statement of Changes in Ownership Equity; the Statement of Changes in Liabilities Subordinated to the Claims of General Creditors Pursuant to a Satisfactory Subordination Agreement; the Statement of Changes in Financial Position; the Computation for Determination of Reserve Requirements for Broker-Dealers under (SEC) Rule 15c3–3; the Statement denoted ''Exemptive Provision Under (SEC) Rule 15c3–3;'' the Statement of Ownership Equity and Subordinated Liabilities maturing or proposed to be withdrawn within the next six months and accruals, which have not been deducted in the computation of net capital, and the Recap thereof; the Statement of Financial and Operational Data; and the accountant's report on material inadequacies filed under Rule 1.16(c)(5). The foregoing include items that all FCMs and IBs are required to file, and also include items that are filed only by BDs that file FOCUS reports in lieu of Form 1–FR.

[39] Both the FOIA exemption (b)(4) and Commission rule 145.5(d) exempt from disclosure matters that are ''trade secrets and commercial or financial information obtained from a person and privileged or confidential.''

[40] As noted, the Sunshine Act exemptions are identical to their FOIA counterparts. The Commission's Sunshine Act obligations are codified in its Part 147 rules, 17 CFR 147.

[41] The Senate Report accompanying the Sunshine Act states that: [The term is] intended to include banks, savings and loan associations, credit unions, *brokers and dealers in securities or commodities, exchanges dealing in securities or commodities,* such as the New York Stock Exchange, investment companies, investment advisors, self-regulatory organizations subject to 15 U.S.C. 78s, and institutional managers as defined in 15 U.S.C. 78m. S. Rep. No. 354, 94th Cong., 1st Sess. 24 (1975). (emphasis supplied).

[42] Accordingly, several district courts have interpreted the term ''financial institutions'' broadly for purposes of FOIA exemption 8. *See Mermelstein* v. *SEC*, 629 F.Supp.672, 673–75 (D.D.C. 1986) (Congress did not take a restrictive view of ''financial institutions'' and intended to include securities exchanges); *Berliner, Zisser, Walter & Gallegos, P.C.* v. *SEC*, 962 F.Supp. 1348, 1352–53 (D. Colo. 1997) (including investment advisors, as fiduciaries who direct and make important investment decisions, in the definition ''furthers Exemption 8's dual purposes of protecting the integrity of financial institutions and facilitating cooperation between the SEC and the entities regulated by it''); *Feshbach* v. *SEC*, 5 F.Supp. 2d 774, 781 (N.D. Cal. 1997) (the term financial institution encompasses self-regulatory organizations such as the NASD).

[43] The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. 107–56, 115 Stat. 272 (2001).

[44] Section 509(2) of the Gramm-Leach-Bliley Act includes as federal functional regulators the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Board of Directors of the Federal Deposit Insurance Corporation; the Director of the Office of Thrift Supervision; the National Credit Union Administration Board; and the Securities and Exchange Commission.

As a separate matter, the Chairman of the Commission is a member of the President's Working Group on Financial Markets, along with the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Securities and Exchange Commission. The Working Group was formed with the goal of enhancing the integrity, efficiency, orderliness, and competitiveness of the U.S. financial markets and maintaining investor confidence. *See* Executive Order 12631 (March 18, 1988).

[45] Generally, Title V of the Gramm-Leach-Bliley Act limits the instances in which a financial institution may disclose nonpublic personal information about a consumer to nonaffiliated third parties, and requires a financial institution to disclose to all of its customers the institution's privacy policies and practices with respect to information sharing with both affiliates and nonaffiliated third parties.

[46] *Berliner, Zisser, Walter & Gallegos, supra.*

[47] The Commission noted the increased significance of FCMs in global financial markets when proposing, and subsequently adopting, amendments to Rule 1.10 to require that Form 1–FR—FCM reports and equivalent FOCUS reports be filed on a monthly rather than quarterly basis. 69 FR 49874 (August 12, 2004).

[48] Pub. L. 106–554, App. E, 114 Stat. 2763 (2000).

publicly available. As proposed to be amended, Rule 1.10(g) would provide that the following information in Forms 1–FR and FOCUS reports would be publicly available: (i) The amounts for a registrant's adjusted net capital, its minimum capital requirement under Rule 1.17, and its adjusted net capital in excess of its minimum capital requirement; (ii) the statement of financial condition in the certified annual financial report, and footnote disclosures thereof; and (iii) the statements related to customer funds that the Commission requires to be held in segregated accounts in accordance with Section 4d of the Commodity Exchange Act, or in secured accounts in accordance with Part 30 of the Commission's regulations.[49] Such information provides insight into the financial resources of an FCM relative to its aggregate obligations and assures that market users may assess the financial integrity of the intermediaries they employ in their trading activities.

Accordingly, the Commission proposes to amend Rules 145.5 and 147.3 to exempt from mandatory public disclosure, pursuant to FOIA exemption 8,[50] the following specific categories of information, except as provided for in Rules 1.10(g) and 31.13:

(1) Forms 1–FR required to be filed pursuant to Rule 1.10;

(2) FOCUS reports that are filed in lieu of Forms 1–FR pursuant to Rule 1.10(h);

(3) Forms 2–FR[51] required to be filed pursuant to Rule 31.13; and

(4) All reports and statements required to be filed pursuant to Rule 1.17(c)(6).[52]

[49] Rule 1.10(g) currently provides, and will continue to provide, that all information on Forms 1–FR and FOCUS reports that is nonpublic will be available for official use by any official or employee of the United States or any State, by any self-regulatory organization of which the person filing such report is a member, by the National Futures Association in the case of an applicant, and by any other person to whom the Commission believes disclosure of such information is in the public interest. Rule 1.10(g) also specifies that the rule does not limit the authority of any self-regulatory organization to request or receive any information relative to its members' financial condition.

[50] Certain of this information would continue to be exempt from disclosure under FOIA exemption 4 as well.

[51] Rule 31.13 requires leverage transaction merchants (''LTMs'') to file with the Commission financial condition information using ''Forms 2–FR,'' and provides that certain information in such reports shall be deemed public. For a number of years there have been no registered LTMs, and the Commission is not proposing any amendments to Rule 31.13 in this release.

[52] The accountant's report on material inadequacies filed in accordance with Rule 1.16(c)(5), which is already included in Rules 145 and 147 as exempt from disclosure under FOIA Exemption 4, would also be included as exempt from disclosure under FOIA Exemption 8.

IV. Proposed Amendment To Reduce Capital Charges for Foreign Currency Forwards and Inventory in Specified Currencies

The Commission is further proposing to amend Commission Rule 1.17(c)(5)(ii), pursuant to which an FCM or IB, in computing its adjusted net capital, must deduct from its net capital specified percentages of the market value of its inventory, fixed price commitments and forward contracts. Such capital charges, which are imposed in percentages of up to twenty percent of market value, are reduced if the FCM's or IB's inventory, fixed price commitments or forward contracts are covered (*i.e.*, hedged) by an open futures contract or commodity option.[53] For example, the capital charge for a forward contract that is covered by an open futures contract is ten percent, which is less than the twenty percent capital charge applied to an uncovered forward contract. Rule 1.17(c)(5)(ii) also includes a proviso that eliminates any capital charge for inventory and forward contracts that are in a foreign currency purchased or sold for future delivery on or subject to the rules of a contract market, and which are covered by an open futures contract.

The Commission provides written instructions to assist FCMs in the preparation of their Form 1–FR reports (''Form 1–FR–FCM Instructions Manual'').[54] As described in the Form 1–FR–FCM Instructions Manual, those assets, liabilities, forward contracts, and fixed price commitments of an FCM or IB that are denominated in the same foreign currency are to be factored together, and any net balance that is not covered is subject to a capital charge. The Form 1–FR–FCM Instructions Manual further provides that the applicable capital charge is twenty percent unless such uncovered net foreign currency balances are in euros, British pounds, Japanese yen, Canadian dollars, and Swiss francs, in which case the capital charge is six percent. This reduced capital charge is less than that strictly called for by Commission Rule 1.17(c)(5)(ii), which would require an FCM to take a twenty percent charge, but is consistent with similar capital charges that BDs are required to deduct from their net capital under SEC regulations. The New York Stock Exchange Interpretation Handbook (''NYSE Handbook''), which provides general guidance for the financial reports prepared by BDs, instructs them to treat uncovered balances in foreign currencies as ''inventory,'' and to take a six percent capital charge for balances held in seven identified foreign currencies, and a twenty percent capital charge for other foreign currencies.[55] In support of this instruction, the NYSE Handbook cites a 1986 SEC no-action letter that lists certain ''major'' non-U.S. currencies, and further equates the haircut for unhedged forward positions in such currencies with the haircut applicable to the unhedged underlying currency, which ''is set at 6 [percent].'' [56] The foreign currencies in the SEC letter include the same national currencies specified in the Commission's Form 1–FR–FCM Instructions Manual.[57]

As noted in the earlier summary of Rule 1.17(c)(5)(ii), there is no capital charge for the covered inventory and forward contracts of FCMs and IBs in foreign currencies that are purchased or sold for future delivery on, or subject to the rules of, a contract market. For all inventory and forward contracts that are not covered, however, Rule 1.17(c)(5)(ii) establishes a capital charge of twenty percent, and the Commission therefore proposes to amend the rule by adding a provision that would specify a capital charge of six percent for uncovered inventory and forward contracts in euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs. Uncovered forward contracts and cash deposits in any other non-U.S. currency would remain subject to the capital charge of twenty percent currently set forth in the rule.

The Commission believes that the proposed amendment would be consistent with the reduced currency risk of these foreign currencies, given their stability relative to the U.S. dollar. The proposed amendment would also provide greater clarity and transparency to the Commission's capital rule, as currently the lower capital charge for the specified major non-U.S. currencies

[53] The term ''cover,'' as used in the Commission's capital rule, is defined in Rule 1.17(j).

[54] An electronic copy of the ''Instructions for Form 1–FR–FCM'' is available to the public on the Commission's Web site, at *http://www.cftc.gov/files/tm/tminstructionsmanualfinalseptember2004.pdf*.

[55] *See NYSE Interpretation Handbook*, Interpretation /01 to Rule 15c3–1b(a)(3)(ix) (2003).

[56] Letter from Michael A. Macchiaroli, Division of Market Regulation, Securities and Exchange Commission, to Philadelphia Stock Exchange, Inc., February 14, 1986, (SEC Staff No Action Letter) reprinted at 1986 WL 67696. An SEC Commission release issued in 1993 also includes the statement that the charge applied to uncovered forward contracts in major currencies is 6 percent, and 20 percent for other currencies. *See* 58 FR 27486, fn. 34 (May 10, 1993).

[57] As of 2002, two of the national currencies referred to in the 1986 SEC Staff No Action Letter—the Deutschemark and the French franc—have been replaced as legal tender by the euro.

is set forth only in the Commission's Form 1–FR Instructions Manual.

V. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA''), 5 U.S.C. 601 *et seq.*, requires that agencies, in proposing rules, consider the impact of those rules on small businesses. The Commission previously has established certain definitions of ''small entities'' to be used by the Commission in evaluating the impact of its rules on such entities in accordance with the RFA.[58] The Commission has determined previously that FCMs are not small entities for the purpose of the RFA.[59] With respect to IBs, the Commission has determined to evaluate within the context of a particular rule proposal whether all or some IBs would be considered ''small entities'' for purposes of the RFA and, if so, to analyze at that time the economic impact on IBs of any such rule.[60]

The Commission has previously determined, pursuant to 5 U.S.C. 605(b), that Part 145 rules relating to Commission records and information do not have a significant economic impact on a substantial number of small entities. Also, the proposed amendments to Rule 1.17(c)(6) would apply to FCMs only and therefore would have no economic impact on IBs. Because the proposed amendment to Rule 1.17(c)(5)(ii) reduces the capital charge that an IB would otherwise be required to incur under the Commission's existing regulations, the proposed amendment should have no adverse economic impact on an IB's financial operations.[61] Therefore, the Chairman, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the action proposed to be taken herein will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (''PRA'')[62] imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. Except for the proposed revision of Rule 1.17(c)(6), the other amendments being proposed would not, if approved, require a new collection of information on the part of any entities that would be subject to the proposed rule amendments. Pursuant to the PRA, the Commission has submitted a copy of this section to the Office of Management and Budget (''OMB'') for its review.

Collection of Information. (Regulations and Forms Pertaining to the Financial Integrity of the Marketplace, OMB Control Number 3038–0024.)

Under the proposed amendment to Rule 1.17(c)(6), an FCM that voluntarily elects to use the Alternative Capital Computation would be required to file with the Commission a statement that includes information filed with its application to the SEC made under 17 CFR 240.15c3–1e, and would also be required to file copies of the monthly, quarterly and annual filings that BDs using SEC-approved alternative capital charges are required to file with the SEC. The collection of information required by Rule 1.17(c)(6) is necessary for the Commission's oversight of the FCM's compliance with its minimum financial requirements under the Commodity Exchange Act and implementing regulations of the Commission. The Commission estimates that as of September 2005, in addition to the two FCM/BDs that have already received approval orders from the SEC to use alternative capital charges, there are eight other FCM/BDs who may elect to use the alternative capital charges that would be permitted under the proposed Rule 1.17(c)(6).[63] Assuming that a total of ten FCM/BDs elect to use the Alternative Capital Computation, the Commission estimates a minimal increase in the annual reporting burden associated with OMB Collection of Information Control No. 3038–004, as each of these registrants can satisfy the Commission's filing requirements by filing copies of documents that the FCM/BD will be required to file with the SEC. The Commission has therefore determined that the proposed amendment to Rule 1.17(c)(6) would increase by 90 hours the total annual reporting burden associated with the above-referenced collection of information, which has been approved previously by OMB. Moreover, much of the required monthly information will be provided as schedules included in the Part II CSE FOCUS reports that FCM/BDs electronically file with both the Commission and the SEC. The estimated burden of the proposed amendments to Rule 1.17 was calculated as follows:

Estimated number of respondents: 10.

Reports annually by each respondent: 18.

Total annual responses: 180.

Estimated average number of hours per response: 0.5.

Annual reporting burden: 90.

Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street, NW., Washington, DC 20581 (202) 418–5160. The Commission considers comments by the public on this proposed collection of information in—

Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have a practical use;

Evaluating the accuracy of the Commission's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;

Enhancing the quality, utility, and clarity of the information to be collected; and

Minimizing the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, *e.g.*, permitting electronic submission of responses.

Organizations and individuals desiring to submit comments on the information collection should contact the Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503, Attn: Desk Officer of the Commodity Futures Commission. OMB is required to make a decision concerning the collection of information contained in these proposed regulations between 30 and 60 days after publication of this document in the **Federal Register**. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the Commission on the proposed regulations.

[58] 47 FR 18618 (April 30, 1982).

[59] 47 FR at 18619.

[60] 47 FR at 18618, 18620.

[61] Moreover, many IBs are exempted from meeting the requirement to file financial Forms 1–FR under the provisions of Rule 1.10(b), which exempts those IBs that operate pursuant to an FCM guarantee agreement that satisfies the requirements of Rule 1.10(h). Generally, at least two-thirds of registered IBs operate pursuant to a guarantee agreement.

[62] 44 U.S.C. 3507(d).

[63] When adopting it new rules in June of 2004, the SEC's PRA analysis used an estimate of eleven BDs that would compute their net capital using the alternative market risk and credit risk deductions. 69 FR at 34451.

C. Cost-Benefit Analysis

Section 15(a) of the Act, as amended by Section 119 of the CFMA, requires the Commission to consider the costs and benefits of its action before issuing a new regulation under the Act. By its terms, Section 15(a) as amended does not require the Commission to quantify the costs and benefits of a new regulation or to determine whether the benefits of the regulation outweigh its costs. Rather, Section 15(a) simply requires the Commission to ''consider the costs and benefits'' of its action.

Section 15(a) of the Act further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations. Accordingly, the Commission could in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The proposed amendment to Rule 1.17(c)(6) would permit FCM/BDs that meet the requirements of the proposed rule to compute their adjusted net capital using the same alternative capital deductions that have been approved by the SEC.[64] The proposed amendment to Rule 1.17(c)(5)(ii) would reduce a capital charge to which FCMs and IBs are subject under the Commission's current regulations. The Commission is considering the costs and benefits of these proposed rules in light of the specific provisions of Section 15(a) of the Act, as follows:

1. *Protection of market participants and the public.* The proposed amendment to Rule 1.17(c)(6) provides the benefit of increasing the accuracy of the reflection of risks in the net capital charges for FCM/BDs approved for using the alternative net capital charges based on internal risk measurement tools, while bettering the Commission's ability to perform appropriate financial and risk oversight. Furthermore, as the proposed rule would be an option available to requesting FCM/BDs but not a requirement, the Commission considers that no FCM/BD will request to use the charges unless the costs of compliance would be outweighed by the benefits to such FCM/BD from using the alternative net capital charges.

2. *Efficiency and competition.* The Commission anticipates that the proposed amendment to Rule 1.17(c)(6) will benefit efficiency by eliminating a difference in the computation of net capital charges between the SEC and the CFTC for dually-registered FCM/BDs that have been approved by the SEC to use such charges. The proposed amendment to Rule 1.17(c)(5)(ii) will reduce the capital charges applicable to FCMs and IBs, which may therefore result in the more efficient utilization of their capital.

3. *Financial integrity of futures markets and price discovery.* The notification and reporting requirements in proposed Rule 1.17(c)(6) contribute to the benefit of ensuring that eligible FCMs can meet their financial obligations to customers and other market participants. Customers and other market participants would also benefit from the provisions in proposed Rule 1.10(g) that would continue to make publicly available certain information in Form 1–FR and FOCUS reports related to capital requirements and requirements for customer funds to be held in segregated or separate accounts. The proposed amendments should have no effect, from the standpoint of imposing costs or creating benefits, on the price discovery function of such markets.

4. *Sound risk management practices.* The alternative capital computation permitted under proposed Rule 1.17(c)(6) is limited to FCMs who have in place an internal risk management system that expressly addresses market risk, credit risk, liquidity risk, legal risk and operational risks at the firm. The proposed rule also requires that the Commission receive copies of written reviews, which are to be prepared annually by registered public accountants, of the firm's internal risk management control system. The proposed amendment may therefore contribute to the sound risk management practices of futures intermediaries.

5. *Other public interest considerations.* The Commission also believes that the proposed amendment to Rule 1.17(c)(6) is beneficial in that it minimizes what would otherwise be a conflict between the Commission and SEC rules, which conflict would otherwise make the SEC's opportunity for qualifying BDs to use alternative net capital charges unavailable to dually registered FCM/BDs, despite the commonality of interest and purpose for the CFTC and SEC minimum net capital rules. The proposed amendment to Rule 1.17(c)(5)(ii), which will incorporate agency guidance not presently included in the Commission's regulations, will enhance the transparency of the Commission's rulemaking for FCMs and IBs.

After considering these factors, the Commission has determined to propose the amendments discussed above. The Commission invites public comment on its application of the cost-benefit provision. Commenters also are invited to submit any data that they may have quantifying the costs and benefits of the proposal with their comment letters.

List of Subjects

17 CFR Part 1

Brokers, Commodity futures, Reporting and recordkeeping requirements.

17 Part 145

Freedom of information.

17 Part 147

Sunshine Act.

Accordingly, 17 CFR Chapter I is proposed to be amended as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23, and 24, as amended by the Commodity Futures Modernization Act of 2000, Appendix E of Pub.L. No. 106–554, 114 Stat. 2763 (2000).

2. Section 1.10 is proposed to be amended by revising paragraphs (d)(4)(ii), (f)(1) introductory text, (g)(1), (g)(2), (g)(4), and (h) to read as follows:

§ 1.10 Financial reports of futures commission merchants and introducing brokers.

* * * * *

(d) * * *

(4) * * *

(ii) If the registrant or applicant is registered with the Securities and Exchange Commission as a securities broker or dealer, the representative authorized under § 240.17a–5 of this title to file for the securities broker or dealer its Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, or Part II CSE. In the

[64] Section 4f(b) of the Act prohibits persons from becoming registered as FCMs or IBs if they do not meet the minimum financial requirements set forth in either the Commission's regulations or in such Commission-approved requirements as may be established by the contract markets and derivatives transaction execution facilities of which the FCM or IB is a member.

case of a Form 1–FR filed via electronic transmission in accordance with procedures established by the Commission, such transmission must be accompanied by the Commission-assigned Personal Identification Number of the authorized signer and such Personal Identification Number will constitute and become a substitute for the manual signature of the authorized signer for the purpose of making the oath or affirmation referred to in this paragraph.

* * * * *

(f) *Extension of time for filing uncertified reports.* (1) In the event a registrant finds that it cannot file its Form 1–FR, or, in accordance with paragraph (h) of this section, its Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, or Part II CSE (FOCUS report), for any period within the time specified in paragraphs (b)(1)(i) or (b)(2)(i) of this section without substantial undue hardship, it may request approval for an extension of time, as follows:

* * * * *

(g) *Public availability of reports.* (1) Forms 1–FR filed pursuant to this section, and FOCUS reports filed in lieu of Forms 1–FR pursuant to paragraph (h) of this section, will be treated as exempt from mandatory public disclosure for purposes of the Freedom of Information Act and the Government in the Sunshine Act and parts 145 and 147 of this chapter, except for the information described in paragraph (g)(2) of this section.

(2) The following information in Forms 1–FR, and the same or equivalent information in FOCUS reports filed in lieu of Forms 1–FR, will be publicly available:

(i) The amount of the applicant's or registrant's adjusted net capital; the amount of its minimum net capital requirement under § 1.17 of this chapter; and the amount of its adjusted net capital in excess of its minimum net capital requirement; and

(ii) The following statements and footnote disclosures thereof: the Statement of Financial Condition in the certified annual financial reports of futures commission merchants and introducing brokers; the Statements (to be filed by a futures commission merchant only) of Segregation Requirements and Funds in Segregation for customers trading on U.S. commodity exchanges and for customers' dealer options accounts, and the Statement (to be filed by a futures commission merchant only) of Secured Amounts and Funds held in Separate Accounts for foreign futures and foreign options customers in accordance with § 30.7 of this chapter.

(3) * * *

(4) All information that is exempt from mandatory public disclosure under paragraph (g)(1) of this section will, however, be available for official use by any official or employee of the United States or any State, by any self-regulatory organization of which the person filing such report is a member, by the National Futures Association in the case of an applicant, and by any other person to whom the Commission believes disclosure of such information is in the public interest. Nothing in this paragraph (g) will limit the authority of any self-regulatory organization to request or receive any information relative to its members' financial condition.

* * * * *

(h) *Filing option available to a futures commission merchant or an introducing broker that is also a securities broker or dealer.* Any applicant or registrant which is registered with the Securities and Exchange Commission as a securities broker or dealer may comply with the requirements of this section by filing (in accordance with paragraphs (a), (b), (c), and (j) of this section) a copy of its Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, or Part II CSE (FOCUS report), in lieu of Form 1–FR: *Provided, however,* That all information which is required to be furnished on and submitted with Form 1–FR is provided with such FOCUS report.

* * * * *

3. Section 1.16 is proposed to be amended by revising paragraph (c)(5) to read as follows:

§ 1.16 Qualifications and reports of accountants.

* * * * *

(c) * * *

(5) *Accountant's report on material inadequacies.* A registrant must file concurrently with the annual audit report a supplemental report by the accountant describing any material inadequacies found to exist or found to have existed since the date of the previous audit. An applicant must file concurrently with the audit report a supplemental report by the accountant describing any material inadequacies found to exist as of the date of the Form 1–FR being filed: *Provided, however,* That if such applicant is registered with the Securities and Exchange Commission as a securities broker or dealer, and it files (in accordance with § 1.10(h)) a copy of its Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, or Part II CSE, in lieu of Form 1–FR, the accountant's supplemental report must be made as of the date of such report. The supplemental report must indicate any corrective action taken or proposed by the applicant or registrant in regard thereto. If the audit did not disclose any material inadequacies, the supplemental report must so state.

* * * * *

4. Section 1.17 is proposed to be amended by revising paragraph (c)(5)(ii) and adding (c)(6) to read as follows:

§ 1.17 Minimum financial requirements for futures commission merchants and introducing brokers.

* * * * *

(c) * * *

(5) * * *

(ii) In the case of all inventory, fixed price commitments and forward contracts, the applicable percentage of the net position specified as follows:

(A) Inventory which is currently registered as deliverable on a contract market and covered by an open futures contract or by a commodity option on a physical.—No charge.

(B) Inventory which is covered by an open futures contract or commodity option.—5 percent of the market value.

(C) Inventory which is not covered.—20 percent of the market value.

(D) Inventory and forward contracts in those foreign currencies that are purchased or sold for future delivery on or subject to the rules of a contract market, and which are covered by an open futures contract.—No charge.

(E) Inventory and forward contracts in euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs, and which are not covered by an open futures contract or commodity option.—6 percent of the market value.

(F) Fixed price commitments (open purchases and sales) and forward contracts which are covered by an open futures contract or commodity option.—10 percent of the market value.

(G) Fixed price commitments (open purchases and sales) and forward contracts which are not covered by an open futures contract or commodity option.—20 percent of the market value.

* * * * *

(6) Election of alternative capital deductions that have received approval of Securities and Exchange Commission pursuant to section 240.15c3–1(a)(7) of this title. (i) Any futures commission merchant that is also registered with the Securities and Exchange Commission as a securities broker or dealer, and who also satisfies the other requirements of

this paragraph (c)(6), may elect to compute its adjusted net capital using the alternative capital deductions that, under section 240.15c3–1(a)(7) of this title, the Securities and Exchange Commission has approved for it by written order. To the extent that a futures commission merchant is permitted by the Securities and Exchange Commission to use alternative capital deductions for its unsecured receivables from over-the-counter transactions in derivatives, or for its proprietary positions in securities, forward contracts, or futures contracts, the futures commission merchant may use these same alternative capital deductions when computing its adjusted net capital, in lieu of the deductions that would otherwise be required by paragraph (c)(2)(ii) of this section for its unsecured receivables from over-the-counter derivatives transactions; by paragraph (c)(5)(ii) of this section for its proprietary positions in forward contracts; by paragraph (c)(5)(v) of this section for its proprietary positions in securities; and by paragraph (c)(5)(x) of this section for its proprietary positions in futures contracts.

(ii) *Notifications of election or of changes to election.* (A) No election to use the alternative market risk and credit risk deductions referenced in paragraph (c)(6)(i) of this section shall be effective unless and until the futures commission merchant has filed with the Commission, addressed to the Director of the Division of Clearing and Intermediary Oversight, a notice that is to include a copy of the approval order of the Securities and Exchange Commission referenced in paragraph (c)(6)(i) of this section, and to include also a statement that identifies the amount of tentative net capital below which the futures commission merchant is required to provide notice to the Securities and Exchange Commission, and which also provides the following information: A list of the categories of positions that the futures commission merchant holds in its proprietary accounts, and, for each such category, a description of the methods that the futures commission merchant will use to calculate its deductions for market risk and credit risk, and also, if calculated separately, deductions for specific risk; a description of the value at risk (VaR) models to be used for its market risk and credit risk deductions, and an overview of the integration of the models into the internal risk management control system of the futures commission merchant; a description of how the futures commission merchant will calculate current exposure and maximum potential exposure for its deductions for credit risk; a description of how the futures commission merchant will determine internal credit ratings of counterparties and internal credit risk weights of counterparties, if applicable; and a description of the estimated effect of the alternative market risk and credit risk deductions on the amounts reported by the futures commission merchant as net capital and adjusted net capital.

(B) A futures commission merchant must also, upon the request of the Commission at any time, supplement the statement described in paragraph (c)(6)(ii)(A) of this section, by providing any other explanatory information regarding the computation of its alternative market risk and credit risk deductions as the Commission may require at its discretion.

(C) A futures commission merchant must also file the following supplemental notices with the Director of the Division and Clearing and Intermediary Oversight:

(*1*) A notice advising that the Securities and Exchange Commission has imposed additional or revised conditions for the approval evidenced by the order referenced in paragraph (c)(6)(i) of this section, and which describes the new or revised conditions in full, and

(*2*) A notice which attaches a copy of any approval by the Securities and Exchange Commission of amendments that a futures commission merchant has requested for its application, filed under 17 CFR 240.15c3–1e, to use alternative market risk and credit risk deductions approved by the Securities and Exchange Commission.

(D) A futures commission merchant may voluntarily change its election to use the alternative market risk and credit risk deductions referenced in paragraph (c)(6)(i) of this section, by filing with the Director of the Division of Clearing and Intermediary Oversight a written notice specifying a future date as of which it will it no longer use the alternative market risk and credit risk deductions, and will instead compute such deductions in accordance with the requirements otherwise applicable under paragraph (c)(2)(ii) of this section for unsecured receivables from over-the-counter derivatives transactions; by paragraph (c)(5)(ii) of this section for proprietary positions in forward contracts; by paragraph (c)(5)(v) of this section for proprietary positions in securities; and by paragraph (c)(5)(x) of this section for proprietary positions in futures contracts.

(iii) *Conditions under which election terminated.* A futures commission merchant may no longer elect to use the alternative market risk and credit risk deductions referenced in paragraph (c)(6)(i) of this section, and shall instead compute the deductions otherwise required under paragraph (c)(2)(ii) of this section for unsecured receivables from over-the-counter derivatives transactions; by paragraph (c)(5)(ii) of this section for proprietary positions in forward contracts; by paragraph (c)(5)(v) of this section for proprietary positions in securities; and by paragraph (c)(5)(x) of this section for proprietary positions in futures contracts, upon the occurrence of any of the following:

(A) The Securities and Exchange Commission revokes its approval of the market risk and credit risk deductions for such futures commission merchant;

(B) A futures commission merchant fails to come into compliance with its filing requirements under this paragraph (c)(6), after having received from the Director of the Division of Clearing and Intermediary Oversight written notification that the futures commission merchant is not in compliance with its filing requirements, and that it must cease using the alternative capital deductions permitted under this paragraph (c)(6) if it has not come into compliance by a date specified in the notice; or

(C) The Commission by written order finds that permitting the futures commission merchant to continue to use such alternative market risk and credit risk deductions is no longer necessary or appropriate for the protection of customers of the futures commission merchant or of the integrity of the futures or options markets.

(iv) *Additional filing requirements.* Any futures commission merchant that elects to use the alternative market risk and credit risk deductions referenced in paragraph (c)(6)(i) of this section must file with the Commission, in addition to the filings required by paragraph (c)(6)(ii) of this section, copies of any and all of the following documents, at such time as the originals are filed with the Securities and Exchange Commission:

(A) Information that the futures commission merchant files on a monthly basis with its designated examining authority or the Securities and Exchange Commission, whether by way of schedules to its FOCUS reports or by other filings, in satisfaction of 17 CFR 240.17a–5(a)(5)(i);

(B) The quarterly reports required by 17 CFR 240.17a–5(a)(5)(ii);

(C) The supplemental annual filings as required by 17 CFR 240.17a–5(k);

(D) Any notification to the Securities and Exchange Commission or the futures commission merchant's designated examining authority of planned withdrawals of excess net capital; and

(E) Any notification that the futures commission merchant is required to file with the Securities and Exchange Commission when its tentative net capital is below an amount specified by the Securities and Exchange Commission.

* * * * *

5. Section 1.18 is proposed to be amended by revising paragraphs (a) and (b)(2) to read as follows:

§ 1.18 Records for and relating to financial reporting and monthly computation by futures commission merchants and introducing brokers.

(a) No person shall be registered as a futures commission merchant or as an introducing broker under the Act unless, commencing on the date his application for such registration is filed, he prepares and keeps current ledgers or other similar records which show or summarize, with appropriate references to supporting documents, each transaction affecting his asset, liability, income, expense and capital accounts, and in which (except as otherwise permitted in writing by the Commission) all his asset, liability and capital accounts are classified into either the account classification subdivisions specified on Form 1–FR–FCM or Form 1–FR–IB, respectively, or, if such person is registered with the Securities and Exchange Commission as a securities broker or dealer and he files (in accordance with § 1.10(h)) a copy of his Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, or Part II CSE (FOCUS report) in lieu of Form 1–FR–FCM or Form 1–FR–IB, the account classification subdivisions specified on such Report, or categories that are in accord with generally accepted accounting principles. Each person so registered shall prepare and keep current such records.

(b) * * *

(2) An applicant or registrant that has filed a monthly Form 1–FR or Statement of Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, or Part II CSE (FOCUS report) in accordance with the requirements of § 1.10(b) will be deemed to have satisfied the requirements of paragraph (b)(1) of this section for such month.

* * * * *

6. Section 1.52 is proposed to be amended by revising paragraph (a) to read as follows:

§ 1.52 Self-regulatory organization adoption and surveillance of minimum financial requirements.

(a) Each self-regulatory organization must adopt, and submit for Commission approval, rules prescribing minimum financial and related reporting requirements for all its members who are registered futures commission merchants. Each self-regulatory organization other than a contract market must adopt, and submit for Commission approval, rules prescribing minimum financial and related reporting requirements for all its members who are registered introducing brokers. Each contract market which elects to have a category of membership for introducing brokers must adopt, and submit for Commission approval, rules prescribing minimum financial and related reporting requirements for all its members who are registered introducing brokers. Each self-regulatory organization shall submit for Commission approval any modification or other amendments to such rules. Such requirements must be the same as, or more stringent than, those contained in §§ 1.10 and 1.17 and the definition of adjusted net capital must be the same as that prescribed in § 1.17(c): *Provided, however,* A designated self-regulatory organization may permit its member registrants which are registered with the Securities and Exchange Commission as securities brokers or dealers to file (in accordance with § 1.10(h)) a copy of their Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934, Part II, Part IIA, or Part II CSE, in lieu of Form 1–FR: And, *provided further,* A designated self-regulatory organization may permit its member introducing brokers to file a Form 1–FR–IB in lieu of a Form 1–FR–FCM.

* * * * *

PART 145—COMMISSION RECORDS AND INFORMATION

7. The authority citation for part 145 continues to read as follows:

Authority: Pub. L. 99–570, 100 Stat. 3207; Pub. L. 89–554, 80 Stat. 383; Pub. L. 90–23, 81 Stat. 54; Pub. L. 98–502, 88 Stat. 1561–1564 (5 U.S.C. 552); Sec. 101(a), Pub. L. 93–463, 88 Stat. 1389 (5 U.S.C. 4a(j)); unless otherwise noted.

8. Section 145.5 is proposed to be amended by revising paragraphs (d)(1) and (h) to read as follows:

§ 145.5 Disclosure of nonpublic records.

* * * * *

(d) Trade secrets and commercial or financial information obtained from a person and privileged or confidential, including, but not limited to:

(1)(i) Reports of stocks of grain, such as Forms 38, 38C, 38M and 38T required to be filed pursuant to 17 CFR 1.44;

(ii) Statements of reporting traders on Form 40 required to be filed pursuant to 17 CFR 18.04;

(iii) Statements concerning special calls on positions required to be filed pursuant to 17 CFR part 21;

(iv) Statements concerning identification of special accounts on Form 102 required to be filed pursuant to 17 CFR 17.01;

(v) Reports required to be filed pursuant to parts 15 through 21 of this chapter;

(vi) Reports concerning option positions of large traders required to be filed pursuant to part 16 of this chapter;

(vii) Form 188; and

(viii) The following reports and statements that are also set forth in paragraph (h) of this section, except as specified in 17 CFR 1.10(g)(2) or 17 CFR 31.13(m): Forms 1–FR required to be filed pursuant to 17 CFR 1.10; FOCUS reports that are filed in lieu of Forms 1–FR pursuant to 17 CFR 1.10(h); Forms 2–FR required to be filed pursuant to 17 CFR 31.13; the accountant's report on material inadequacies filed in accordance with 17 CFR 1.16(c)(5); and all reports and statements required to be filed pursuant to 17 CFR 1.17(c)(6);

* * * * *

(h) Contained in or related to examinations, operating, or condition reports prepared by, on behalf of, or for the use of the Commission or any other agency responsible for the regulation or supervision of financial institutions, including, but not limited to the following reports and statements that are also set forth in paragraph (d)(1)(viii) of this section, except as specified in 17 CFR 1.10(g)(2) or 17 CFR 31.13(m): Forms 1–FR required to be filed pursuant to 17 CFR 1.10; FOCUS reports that are filed in lieu of Forms 1–FR pursuant to 17 CFR 1.10(h); Forms 2–FR required to be filed pursuant to 17 CFR 31.13; the accountant's report on material inadequacies filed in accordance with 17 CFR 1.16(c)(5); and all reports and statements required to be filed pursuant to 17 CFR 1.17(c)(6); and

* * * * *

PART 147—OPEN COMMISSION MEETINGS

9. The authority citation for part 147 continues to read as follows:

Authority: Sec. 3(a), Pub. L. 94–409, 90 Stat. 1241 (5 U.S.C. 552b); sec. 101(a)(11), Pub. L. 93–463, 88 Stat. 1391 (7 U.S.C. 4a(j) (Supp. V, 1975)), unless otherwise noted.

10. Section 147.3 is proposed to be amended by revising paragraphs (b)(4)(i) and (b)(8) to read as follows:

§ 147.3 General requirement of open meetings; grounds upon which meetings may be closed.

* * * * *

(b) * * *

(4)(i) Disclose trade secrets and commercial or financial information obtained from a person and privileged or confidential including, but not limited to:

(A) Reports of stocks of grain, such as Forms 38, 38C, 38M and 38T, required to be filed pursuant to 17 CFR 1.44;

(B) Statements of reporting traders on Form 40 required to be filed pursuant to 17 CFR 18.04;

(C) Statements concerning special calls on positions required to be filed pursuant to 17 CFR part 21;

(D) Statements concerning identification of special accounts on Form 102 required to be filed pursuant to 17 CFR 17.01;

(E) Reports required to be filed pursuant to parts 15 through 21 of this chapter;

(F) Reports concerning option positions of large traders required to be filed pursuant to part 16 of this chapter;

(G) Form 188; and

(H) The following reports and statements that are also set forth in paragraph (b)(8) of this section, except as specified in 17 CFR 1.10(g)(2) or 17 CFR 31.13(m): Forms 1–FR required to be filed pursuant to 17 CFR 1.10; FOCUS reports that are filed in lieu of Forms 1–FR pursuant to 17 CFR 1.10(h); Forms 2–FR required to be filed pursuant to 17 CFR 31.13; the accountant's report on material inadequacies filed in accordance with 17 CFR 1.16(c)(5); and all reports and statements required to be filed pursuant to 17 CFR 1.17(c)(6);

* * * * *

(8) Disclose information contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of the Commission or any other agency responsible for the regulation or supervision of financial institutions, including, but not limited to the following reports and statements that are also set forth in paragraph (b)(4)(i)(H) of this section, except as specified in 17 CFR 1.10(g)(2) or 17 CFR 31.13(m): Forms 1–FR required to be filed pursuant to 17 CFR 1.10; FOCUS reports that are filed in lieu of Forms 1–FR pursuant to 17 CFR 1.10(h); Forms 2–FR required to be filed pursuant to 17 CFR 31.13; the accountant's report on material inadequacies filed in accordance with 17 CFR 1.16(c)(5); and all reports and statements required to be filed pursuant to 17 CFR 1.17(c)(6);

* * * * *

Issued in Washington, DC, on October 4, 2005 by the Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 05–20258 Filed 10–7–05; 8:45 am]

BILLING CODE 6351–01–P

SOCIAL SECURITY ADMINISTRATION

20 CFR Parts 404 and 416

[Regulations Nos. 4 and 16]

RIN–0960–AE93

Exemption of Work Activity as a Basis for a Continuing Disability Review

AGENCY: Social Security Administration (SSA).

ACTION: Notice of proposed rulemaking.

SUMMARY: We are proposing to amend our regulations to include rules to carry out section 221(m) of the Social Security Act (the Act). Section 221(m) affects our rules for when we will conduct a continuing disability review if you work and receive benefits under title II of the Act based on disability. (We interpret this section to include you if you receive both title II disability benefits and Supplemental Security Income (SSI) payments based on disability.) It also affects our rules on how we evaluate work activity when we decide if you have engaged in substantial gainful activity for purposes of determining whether your disability has ended. In addition, section 221(m) of the Act affects certain other standards we use when we determine whether your disability continues or ends. We are also proposing to make certain other revisions to our regulations for how we determine whether your disability continues or ends. These other proposed revisions would codify our existing operating instructions for how we consider certain work at the last two steps of our continuing disability review process. In addition, we are proposing to incorporate into our disability regulations some rules which are contained in another part of our regulations and which apply if you are using a ticket under the Ticket to Work and Self-Sufficiency program (the Ticket to Work program). Finally, we are proposing to amend our regulations to eliminate the secondary substantial gainful activity amount that we currently use to evaluate work you did as an employee before January 2001.

DATES: To be sure that your comments are considered, we must receive them by December 12, 2005.

ADDRESSES: You may give us your comments by: using our Internet facility (*i.e.*, Social Security Online) at *http://policy.ssa.gov/pnpublic.nsf/LawsRegs* or the Federal eRulemaking Portal: *http://www.regulations.gov;* e-mail to *regulations@ssa.gov;* telefax to (410) 966–2830; or letter to the Commissioner of Social Security, PO Box 17703, Baltimore, MD 21235–7703. You may also deliver them to the Office of Regulations, Social Security Administration, 100 Altmeyer Building, 6401 Security Boulevard, Baltimore, MD 21235–6401, between 8 a.m. and 4:30 p.m. on regular business days. Comments are posted on our Internet site, or you may inspect them physically on regular business days by making arrangements with the contact person shown in this preamble.

Electronic Version: The electronic file of this document is available on the date of publication in the **Federal Register** at *http://www.access.gpo.gov/su_docs/aces/aces140.html.* It is also available on the Internet site for SSA (*i.e.*, Social Security Online) at *http://www.socialsecurity.gov/regulations/.*

FOR FURTHER INFORMATION CONTACT: Kristine Erwin-Tribbitt, Policy Analyst, Office of Program Development and Research, Social Security Administration, 6401 Security Boulevard, Baltimore, Maryland 21235–6401. Call (410) 965–3353 or TTY (410) 966–5609 for information about these proposed rules. For information on eligibility or filing for benefits, call our national toll-free number 1 (800) 772–1213 or TTY 1 (800) 325–0778. You may also contact Social Security Online at *http://www.socialsecurity.gov/.*

SUPPLEMENTARY INFORMATION:

What is the purpose of this notice of proposed rulemaking (NPRM)?

In this NPRM, we propose to amend our disability regulations to carry out section 221(m) of the Act. These proposed changes would apply to you if you are a working beneficiary who is entitled to Social Security disability benefits under title II of the Act and you have received such benefits for at least 24 months. If you are a person who meets these requirements, we propose to change our rules on when we will start a continuing disability review to decide whether you are still disabled. In addition, we propose to amend our rules to provide that, under the medical