



DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

September 20, 1993

Douglas G. Preston, Esq.
Securities Industry Association
120 Broadway
New York, N.Y. 10271

Re: Rules 17h-1T and 17h-2T under the Securities and Exchange Act of 1934

Dear Mr. Preston:

This is in response to your November 3, 1992 letter on behalf of the Securities Industry Association ("SIA"), in which you asked questions regarding certain requirements under Rules 17h-1T and 17h-2T and Form 17-H under the Securities Exchange Act of 1934 ("Exchange Act").¹

I. INTRODUCTION

On July 16, 1992, the Securities and Exchange Commission ("Commission") adopted Rules 17h-1T and 17h-2T, which, together with Form 17-H, establish a risk assessment recordkeeping and reporting system for broker-dealers.² Rule 17h-1T, a recordkeeping rule, requires a broker-dealer to maintain information and other records concerning certain affiliated entities of the broker-dealer. Rule 17h-2T, a reporting rule, requires a broker-dealer to file information on Form 17-H with the Commission.

The SIA has compiled a number of requests for various interpretations of the Rules. It has asked the Division of Market Regulation ("Division") to issue an interpretative letter

¹See Securities Exchange Act Rules 17h-1T and 17h-2T; 17 C.F.R. §§ 240.17h-1T and 240.17h-2T.

²See Securities Exchange Act Release No. 30929 (July 16, 1992), 57 FR 32159 (July 21, 1992). The Rules were adopted pursuant to the authority conferred on the Commission by the Market Reform Act of 1990, which added Section 17(h) to the Exchange Act. Market Reform Act of 1990, Pub. L. No. 101-432, § 4, 104 Stat. 963, 966-973 (1990); 15 U.S.C. § 78q(h).

regarding these questions. In response to this request, the Division sets forth its interpretation of certain provisions of the Rules.

II. DETERMINATION OF MATERIAL ASSOCIATED PERSONS

Section 17(h) of the Exchange Act requires every registered broker-dealer to "obtain such information and make and keep such records" describing "those of its associated persons, other than a natural person . . . whose business activities are reasonably likely to have a material impact on the financial and operational condition" of the broker-dealer.³ The Rules amplify the statutory standard by setting forth several factors to be considered by a broker-dealer in determining which of its associated persons are Material Associated Persons.⁴ The SIA has requested guidance with respect to the circumstances set forth below.

A broker-dealer that has no holding company will be treated by the Division as an exempt broker-dealer; accordingly, this firm has no reporting or recordkeeping obligations under Rules 17h-1T and 17h-2T.⁵

³See Section 17(h)(1) of the Exchange Act. The term "associated person" is defined in section 3(a)(18) of the Exchange Act.

⁴Paragraph (a)(2) of Rule 17h-1T directs a broker-dealer to consider the following factors in its designation of Material Associated Persons: (i) the legal relationship between the broker or dealer and the associated person; (ii) the overall financing requirements of the broker or dealer and the associated person, and the degree, if any, to which the broker or dealer and the associated person are financially dependent on each other; (iii) the degree, if any, to which the broker or dealer or its customers rely on the associated person for operational support or services in connection with the broker's or dealer's business; (iv) the level of risk present in the broker's or dealer's associated persons; and (v) the extent to which the associated person has the authority or the ability to cause a withdrawal of capital from the broker or dealer.

⁵Certain broker-dealers within a holding company are affiliated with other broker-dealers that are subject to the Rules. Paragraph (b)(4) of Rule 17h-2T permits the broker-dealer with the greatest amount of capital (as of the reporting date) within a holding company to request designation as a "Reporting Broker or Dealer." The Commission recently has issued orders designating 58 broker-dealers as Reporting Brokers or Dealers under the Rules.

Further, the SIA has asked whether partnerships and Subchapter S corporations may be treated as natural persons who thereby would be outside the scope of the Rules. The Division believes that a Subchapter S corporation may be treated as a natural person for purposes of the Rules if the Subchapter S corporation is owned by one natural person. Partnerships, however, may not be treated as natural persons and, depending on the facts and circumstances, may be Material Associated Persons of the broker-dealer.

III. RULE 17h-1T -- RECORDKEEPING REQUIREMENTS

A. General

Rule 17h-1T requires each broker-dealer subject to the Rules to maintain and preserve three general categories of information concerning its associated persons. The first, set forth in paragraphs (a)(1)(i) through (a)(1)(iii) of Rule 17h-1T, includes the holding company's organizational structure and risk management policies, and a description of all pending legal proceedings involving Material Associated Persons that are required to be disclosed under generally accepted accounting principles ("GAAP").⁶ The second consists of the financial statements described in paragraphs (a)(1)(iv) and (a)(1)(v) of Rule 17h-1T. The third contains the financial and securities activity-related data described in paragraphs (a)(1)(vi) through (a)(1)(x) of Rule 17h-1T and the corresponding sections of Part II of Form 17-H.

B. Information Required by Paragraphs (a)(1)(i) through (a)(1)(iii) of Rule 17h-1T

1. Organizational Chart

Paragraph (a)(1)(i) of Rule 17h-1T requires a broker-dealer to maintain and preserve an organizational chart that sets forth the broker-dealer and all its associated persons, and that designates which associated persons are Material Associated Persons. This information should preferably be maintained in a chart format; however, the broker-dealer may provide a written description of the broker-dealer's organizational structure that clearly sets forth the relationships among the broker-dealer and its associated persons.

⁶The legal proceedings required to be reported are to be disclosed by the highest level Material Associated Person holding company, not necessarily the ultimate parent holding company.

2. Risk Management Policies or Procedures

Paragraph (a)(1)(ii) of Rule 17h-1T requires a broker-dealer to maintain written policies, procedures or systems concerning, among other things, the broker-dealer's methods for monitoring the financial and operational risks to it resulting from the activities of any of its associated persons. As noted in the release accompanying the final Rules, a broker-dealer is not compelled to create such policies or procedures when none exist.⁷ The Rules, however, would require a broker-dealer that operates under informal or oral policies or procedures to summarize these policies in written form, and to file them with the Commission. Additionally, a broker-dealer that operates without the policies referred to in the Rules is required to document, in writing, the absence of such policies.⁸

C. Financial Statements Required by Paragraphs (a)(1)(iv) and (a)(1)(v) of Rule 17h-1T

Paragraphs (a)(1)(iv) and (a)(1)(v) of Rule 17h-1T require a broker-dealer to maintain and preserve quarterly consolidated and consolidating balance sheets and income statements, and consolidated cash flow statements that are prepared in accordance with GAAP, including the notes to these financial statements.⁹

1. Notes to the Financial Statements

The SIA has asked whether a broker-dealer may refer back to previous footnotes so that footnotes would not have to be repeated in subsequent Form 17-H filings. Broker-dealers may refer to notes in previously filed financial statements, but only if the notes referenced are components of a prior Form 17-H filing.¹⁰ In general, a complete set of the notes to the

⁷See Securities Exchange Act Release No. 30929 (July 16, 1992), 57 FR 32159 (July 21, 1992).

⁸Id.

⁹In general, a broker-dealer may maintain the consolidating income statements required by paragraph (a)(1)(v) of Rule 17h-1T and Item 4 of Form 17-H on a cumulative year-to-date basis rather than on a quarterly basis.

¹⁰For example, it is not acceptable for a broker-dealer to refer to notes that are components of a Form 10-Q or 10-K.

financial statements should be filed with the Commission once every year.

2. Presentation of Associated Persons in the Financial Statements

In preparing the financial statements required by paragraphs (a)(1)(iv) and (a)(1)(v) of Rule 17h-1T, broker-dealers should provide separate entries for each Material Associated Person and for each other significant associated person. Broker-dealers may combine insignificant non-Material Associated Persons in a single entry in the financial statements.

3. Financial Statements for Broker-Dealers within Multi-Tiered Holding Company Structures

The SIA has inquired about the requirement to provide the financial statements required by Rule 17h-1T in the case of multi-tiered holding company structures. Specifically, the SIA has requested clarification as to whether the financial statements are required to include only those holding companies which are Material Associated Persons, and whether the ultimate holding company which is not a Material Associated Person may be excluded.

In preparing the financial statements required by the Rules, broker-dealers must provide financial statements for the ultimate holding company only where the holding company is a Material Associated Person. The Division believes that financial statements should be maintained in this manner for most broker-dealer holding company structures.

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Cases in which the ultimate parent holding company is a non-Material Associated Person are unusual. For example, an ultimate holding company that engages primarily in non-financial or non-securities activities such as manufacturing or retailing, and has an intermediate holding company that does engage in financial and securities activities (including funding the broker-dealer) probably is not a Material Associated Person. In such a case, it would be sufficient for the financial statements required by the Rules to include only the intermediate holding company, which is a Material Associated Person.

4. Auditing of Financial Statements

A broker-dealer is not required to have the financial statements described in paragraphs (a)(1)(iv) and (a)(1)(v) of Rule 17h-1T audited by an independent public accountant. If these statements, however, are audited for purposes other than

compliance with the Rules, then the broker-dealer should file the audited financial statements with the Commission.¹¹

D. Financial and Securities Information Required by Paragraphs (a)(1)(vi) through (a)(1)(x) of Rule 17h-1T

1. Consolidated Reporting for Material Associated Persons

The financial and securities-related data described in paragraphs (a)(1)(vi) through (a)(1)(x) of Rule 17h-1T must be maintained by a broker-dealer, and filed with the Commission on Part II of Form 17-H. Part II of Form 17-H requires a separate column, or a separate form, to be completed for each Material Associated Person. In the cases where a broker-dealer has an associated person which is not a Material Associated Person, which associated person in turn has subsidiaries that are Material Associated Persons, the broker-dealer may maintain and report the financial information set forth in paragraphs (a)(1)(vi) through (a)(1)(x) of Rule 17h-1T for the subsidiaries that are Material Associated Persons on a consolidated basis through the non-Material Associated Person.

2. Aggregate Securities and Commodities Positions

Paragraph (a)(1)(vi) of Rule 17h-1T requires a broker-dealer to maintain and preserve data reflecting the aggregate securities and commodities positions at quarter-end (and month-end if greater than quarter-end) for the broker-dealer and each Material Associated Person, including a separate listing for each "single unhedged securities or commodities position that exceeds the Materiality Threshold."¹² The following guidelines should be used in complying with this paragraph:

- (1) Generally, the determination of whether a securities or commodities position is unhedged for purposes of paragraph (a)(1)(vi) of Rule 17h-1T should be made by each broker-dealer. In determining whether a position is unhedged for the purposes of this paragraph, broker-dealers should

¹¹See Securities Exchange Act Release No. 30929 (July 16, 1992), 57 FR 32159 (July 21, 1992).

¹²The term "Materiality Threshold" is defined in paragraph (a)(4) of Rule 17h-1T to mean the greater of: (i) \$100 million; or (2) 10% of the broker or dealer's tentative net capital based on the most recently filed FOCUS Report or 10% of the Material Associated Person's tangible net worth, whichever is greater.

consider only existing positions; if a broker-dealer needs to put on further positions in the event of a market move, such additional position(s) should be considered unhedged for purposes of this paragraph.

- (2) A Reporting Broker or Dealer should compare the relevant position or exposure to its own capital level in determining whether an item has exceeded the Materiality Threshold.

3. Certain Financial Instruments

Paragraph (a)(1)(vii) of Rule 17h-1T, in part, requires a broker-dealer to maintain data concerning the value, as of quarter-end, of financial instruments with off-balance sheet risk and with concentrations of credit risk.¹³ A broker-dealer should maintain and report this data in the manner set forth below:

- (1) Commodities positions should be reported on Part II, Section (II)(E) of Form 17-H.
- (2) Interest rate swaps that are neither U.S. denominated nor cross currency (*e.g.*, D-Mark/D-Mark, D-Mark/Yen, etc.) should be reported on Part II, Section (II)(B)(2) of Form 17-H.
- (3) Two foreign forward transactions should be treated as a foreign exchange swap, and should be reported on Part II, Section (II)(C)(1) of Form 17-H.
- (4) For purposes of reporting the "contractual value of naked written option contracts," the term "contractual value" means mark-to-market value. For the purposes of this section, the term "naked" refers to option positions that are not offset by underlying securities positions, or commodities, forwards or other instruments.
- (5) Foreign currency swaps should be reported on Part II, Section (II)(C)(1) of Form 17-H.
- (6) Broker-dealers are required to report the "aggregate current cost of replacing contracts by counterparty in which the Material Associated

¹³The financial instruments described in paragraph (a)(1)(vii) of Rule 17h-1T include commodities positions as set forth in Part II, Section (II)(E) of Form 17-H.

Person has a gain" on Part II of Form 17-H with respect to financial instruments with off-balance sheet risk and concentration of credit risk. This information may be reported net of any collateral or other securities received and may be offset by contracts in a loss position where a master netting arrangement exists as defined in Financial Accounting Standards Board Interpretation No. 39. If information is reported on a net or offset basis, the broker-dealer should indicate such reporting in its filing.

4. Extensions of Credit

Paragraph (a)(1)(viii) of Rule 17h-1T requires a broker-dealer to maintain and preserve data on bridge loans and other material unsecured extensions of credit (not including intra-group receivables) for each of its Material Associated Persons at quarter-end. The term "intra-group" refers to exposures within the ultimate holding company structure; accordingly, Rule 17h-1T requires a broker-dealer to maintain data only on extensions of credit outside the holding company (i.e., to unrelated third parties).

5. Data Relating to Real Estate Activities

Paragraph (a)(1)(x) of Rule 17h-1T requires a broker-dealer to maintain and preserve data relating to real estate activities conducted by each Material Associated Person. This paragraph of Rule 17h-1T and the corresponding section of Form 17-H pertain only to real estate development for investment purposes, not to "real estate development for use wholly or substantially by the broker-dealer, its holding company, or its other affiliates."¹⁴

IV. RULE 17h-2T -- REPORTING REQUIREMENTS

A. Method of Filing

Paragraph (a) of Rule 17h-2T requires broker-dealers subject to the Rules to file with the Commission the information maintained pursuant to Rule 17h-1T on Form 17-H. Broker-dealers should not file Form 17-H on the EDGAR system; rather, Form 17-H will be considered filed when the report, together with the facing page of Form 17-H, is received at the Commission's principal office in Washington, D.C.

¹⁴See H. Rep. No. 524, 101st Cong., 2d Sess. 27, 30 (1990).

B. Form 17-H Filing Requirements

1. Description of the Information Reported on Parts I and II of Form 17-H

Form 17-H is comprised of two parts. Part I consists of the organizational, policy and legal information required by paragraphs (a)(1)(i) through (a)(1)(iii) of Rule 17h-1T, in addition to the financial statements required by paragraphs (a)(1)(iv) and (a)(1)(v) of Rule 17h-1T.

Part II of Form 17-H contains line items for reporting the data required by paragraphs (a)(1)(vi) through (a)(1)(x) of Rule 17h-1T. The information reported on Part II of Form 17-H should not include broker-dealer positions that are reported in the broker-dealer's FOCUS Report. In addition, it should be noted that a broker-dealer should report each Material Associated Person's gross positions, including intercompany positions, which positions will be netted out in the cumulative consolidating financial statements filed by the broker-dealer at the end of each fiscal quarter.

2. Time Periods for Filing Form 17-H

Paragraph (a)(1) of Rule 17h-2T requires a broker-dealer to file a Part I and Part II of Form 17-H with the Commission within 60 calendar days of the end of its fiscal quarter for the first three fiscal quarters. The fourth fiscal quarter Part II filing should be filed within 60 days of the end of the broker-dealer's fiscal year. The cumulative year-end financial statements described in paragraphs (a)(1)(iv) through (a)(1)(v) of Rule 17h-1T may be filed separately within 105 calendar days of the end of the fiscal year. If the information reported in the cumulative year-end financial statements is materially different from the information in the fourth fiscal quarter filing, the differences should be reflected in an amended fourth quarter filing. In the event a broker-dealer finds it necessary to amend a Form 17-H that has been filed with the Commission, the broker-dealer should refile the pertinent part of the Form, as soon as practicable, together with a newly executed facing page.

C. Material Associated Persons under the Supervision of a Federal Banking Agency

1. Recordkeeping and Reporting

Paragraph (b)(1) of Rule 17h-1T and paragraph (c) of Rule 17h-2T contain special provisions pertaining to a broker-dealer with a Material Associated Person that is a domestic or foreign banking association which is under the supervision of a Federal

banking agency. Under these paragraphs, a broker-dealer with a Material Associated Person that is a U.S. bank may file with the Commission copies of the reports filed on Form FR Y-9C and FR Y-6 for use by Federal banking regulators. Similarly, a broker-dealer with a Material Associated Person that is a foreign bank subject to U.S. banking regulation may file with the Commission copies of Form FR Y-7 that are prepared for Federal banking regulators.

It should be noted that these paragraphs do not apply with respect to the information described in paragraphs (a)(1)(i) through (a)(1)(iii) of Rule 17h-1T, (i.e., the organizational chart, policy data and disclosure of legal proceedings). Accordingly, broker-dealers are required to maintain the information set forth in paragraphs (a)(1)(i) through (a)(1)(iii), complete Items 1, 2 and 3 under Part I of Form 17-H, and file Form 17-H with the Commission.

2. Time Periods for Filing Federal Banking Reports with the Commission

Federal banking reports should be filed with a separately executed facing page of Form 17-H when they are due to the Federal banking agency, even if this differs from the time period required for the broker-dealer's filing by Rule 17h-2T.

D. Material Associated Persons under the Supervision of a Foreign Financial Regulatory Authority

1. Recordkeeping and Reporting

Paragraph (c) of Rule 17h-1T and paragraph (d) of Rule 17h-2T set forth special provisions that apply to a broker-dealer with a Material Associated Person that is under the supervision of a Foreign Financial Regulatory Authority.¹⁵ Under these paragraphs, a broker-dealer may file with the Commission those

¹⁵The term "foreign financial regulatory authority" is defined in Section 3(a)(51) of the Exchange Act to include any: (A) foreign securities authority; (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent or other financial activities; or (C) membership organization a function of which is to regulate participation of its members in the activities listed above.

reports that are filed with the primary banking, financial or securities entity that exercises regulatory authority over its Material Associated Person.

It should be noted that these paragraphs do not apply with respect to the information described in paragraphs (a)(1)(i) through (a)(1)(iii) of Rule 17h-1T, (i.e., the organizational chart, policy data and disclosure of legal proceedings). Accordingly, broker-dealers are required to maintain the information set forth in paragraphs (a)(1)(i) through (a)(1)(iii), complete Items 1, 2 and 3 under Part I of Form 17-H, and file Form 17-H with the Commission.

Rule 17h-1T does not require a broker-dealer to maintain copies of ancillary materials such as working papers, that were used by its Material Associated Person to prepare the reports. Paragraph (c) of Rule 17h-1T does require the broker-dealer to maintain copies of these reports within the United States.

Broker-dealers should file along with the report a short narrative setting forth the material differences between U.S. and foreign conventions (for example, a statement explaining the differences between foreign accounting conventions and U.S. GAAP, etc.). A quantitative reconciliation is not required.¹⁶

2. Time Periods for Filing with the Commission
Reports that are Filed with a Foreign Financial
Regulatory Authority

Broker-dealers should file with the Commission the most recent report filed with a Foreign Financial Regulatory Authority, even if the time period for reporting to the Foreign Financial Regulatory Authority differs from that required by Rule 17h-2T. For example, a broker-dealer with a calendar end fiscal year may file the report filed with a foreign financial regulatory authority on September 30 along with the broker-dealer's Form 17-H due on or before March 1.


¹⁶The Rule requires a reporting broker-dealer to file with the Commission one copy of the original report, and a copy translated into the English language.

Douglas G. Preston, Esq.
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V. CONCLUSION

You should understand that the positions stated in this letter are staff positions and do not necessarily reflect the views of the Commission. If you have any further questions, please do not hesitate to contact me at (202) 272-2904, or Roger G. Coffin at (202) 272-7375.

Sincerely,

A handwritten signature in cursive script that reads "Michael A. Macchiaroli".

Michael A. Macchiaroli
Associate Director