

developments. Off-balance sheet derivatives such as interest rate swaps and foreign currency transactions were identified as particularly important categories for risk assessment rules given their high growth rates and the limited public information available regarding their magnitude and use.

Affiliates conducting these largely unregulated activities can attain a degree of leverage and assume credit risks that brokers and dealers, which are subject to the capital and customer protection rules of the Treasury and the SEC, cannot attain. The business activities of these affiliates could have significant and adverse effects on the financial health of brokers and dealers. For example, large losses at the parent company level might cause the credit rating of the parent to decline, which could cause liquidity problems at the broker or dealer. Thus, the Reform Act specifically provided the SEC with direct access to information concerning the business activities of brokers' and dealers' affiliates that are outside of SEC oversight.

In September 1991, the SEC published for comment proposed temporary Rules 17h-1T and 17h-2T, which together with proposed Form 17-H, would establish a risk assessment recordkeeping and reporting system for registered brokers and dealers.³ After reviewing the 63 comment letters it received and making modifications, the SEC issued in July 1992 final temporary risk assessment rules.⁴ Rule 17h-1T⁵ is a recordkeeping rule identifying and describing the records that registered brokers and dealers are required to maintain and preserve. Rule 17h-2T⁶ sets forth requirements for registered brokers and dealers to submit quarterly reports summarizing the information required to be maintained under Rule 17h-1T. The preamble of the SEC's final temporary rules stated that the SEC staff would issue for public comment a study evaluating the effectiveness of the SEC's risk assessment rules within 90 days after the rules have been fully operative for two years. At that time, the SEC will consider what, if any, modifications to its rules would be appropriate. Treasury will consult with the SEC regarding the study and assessment of its rules to determine whether any of the SEC's findings are germane to Treasury's risk assessment rules.

The Commodity Futures Trading Commission ("CFTC") was also authorized to promulgate risk assessment rules applicable to registered futures commission merchants ("FCMs") pursuant to the Futures Trading Practices Act of 1992.⁷ The CFTC published its proposed risk assessment rules in March 1994.⁸ The CFTC extended its comment period twice before promulgating the first part of its final risk assessment rules in December 1994,⁹ which require certain FCMs to maintain and file key information addressing the overall structure of holding companies involving the FCMs. The CFTC deferred action on other portions of its proposed rules pending further review and consultation with other regulators.

Treasury published its risk assessment amendments in proposed form on November 15, 1994,¹⁰ and the comment period closed on January 17, 1995. The Department received no comments in response to the proposal.

II. Analysis

A. Reporting and Recordkeeping Requirements

The Department's risk assessment rules incorporate the SEC's final temporary risk assessment Rules 17h-1T and 17h-2T, with minor modifications that reflect both the specialized activities of registered government securities brokers and dealers and the Department's analysis of the SEC's interpretive letter to the Securities Industry Association ("SIA") in September 1993.¹¹ Under the Department's rules, two general categories of records will be required: (1) Information concerning the holding company organization, risk management policies, and material legal proceedings; and (2) financial and securities information pertinent to assessing risk in the holding company system (e.g., consolidating and consolidated financial statements and positions in various financial instruments). The information required to be maintained and preserved pursuant to the recordkeeping rules will be subject to routine inspection by the SEC and the self-regulatory organizations. Under the reporting rules, registered government securities brokers and dealers will be

required to file with the SEC quarterly summaries of the information that must be maintained under the recordkeeping rules. These quarterly summaries will be required to be filed on the SEC's Form 17-H. A more detailed discussion of the Department's specific risk assessment requirements is included in the preamble to the proposed rules.

The information required to be maintained and reported by the firms pertains only to the firms' "Material Associated Persons" ("MAPs"). The Reform Act did not define MAPs. However, the legislative history accompanying the statute specified a number of factors that should be considered when determining which affiliates (associated persons) might have a "material" impact on the financial or operational condition of brokers and dealers. These factors have been incorporated into paragraph 17h-1T(a)(2), thereby providing guidelines for determining which affiliates of the brokers and dealers are MAPs. The initial designation of MAPs will be made by the affected registered government securities brokers and dealers.

The term "associated persons," as explained in the legislative history, is based on the definition at 3(a)(18) of the Exchange Act (15 U.S.C. 78c(a)(18)), except that natural persons are excluded for the purposes of the risk assessment rules (which automatically excludes natural persons from the definition of MAPs). Consistent with the SEC approach,¹² partnerships will not be treated as natural persons and, depending on the circumstances, may be deemed to be MAPs of the registered government securities broker or dealer. Subchapter S corporations may be treated as natural persons for purposes of the amendments if the Subchapter S corporation is owned by one natural person.

Note that, with respect to the Department's risk assessment rules, the definition of "associated persons" differs from the definition of that term as specified in § 400.3 of the GSA regulations. The term as used in § 400.3 specifically applies to certain natural persons who are associated with government securities brokers or dealers.

B. Exemptions and Special Provisions

The Department is incorporating, with modifications and supplements, the SEC's exemptive provisions (17 CFR 240.17h-1T(d) and 240.17h-2T(b)). The Department's provisions will exempt registered government securities brokers

⁷ Pub. L. 102-546, 106 Stat. 3590 (1992).

⁸ 59 FR 9689 (March 1, 1994).

⁹ 59 FR 66674 (December 28, 1994).

¹⁰ 59 FR 58792 (November 15, 1994).

¹¹ See letter from Michael Macchiaroli, Associate Director, Division of Market Regulation, Securities and Exchange Commission to Douglas G. Preston, Esq., Securities Industry Association (September 20, 1993). (1993 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 76,696.

¹² Id.

³ Securities Exchange Act Release No. 34-29635 (August 30, 1991), 56 FR 44014 (September 6, 1991).

⁴ Securities Exchange Act Release No. 34-30929 (July 16, 1992), 57 FR 32159 (July 21, 1992).

⁵ 17 CFR 240.17h-1T.

⁶ 17 CFR 240.17h-2T.