

notified by an independent public accountant of a material inadequacy in its accounting system, internal accounting controls, procedures for safeguarding customer and firm assets, or other systems. The FCM or IB also is required to file a written report setting forth the steps taken, or that are being taken, to correct the material inadequacy within five business days of the original notice.

The Commission is proposing to amend Rule 1.12(c) and (d) so that the time frames for reporting a failure to maintain current books and records and for reporting a material inadequacy in accounting systems are consistent with the time frames established by SEC rules for securities brokers and dealers. The Commission and SEC have attempted, to the extent possible, to develop capital and financial reporting rules that are consistent in order to simplify and to clarify the rules and procedures for firms that are dually-registered as securities brokers or dealers and FCMs or IBs. SEC Rule 17a-11(d) and (e) are analogous to Commission Rule 1.12(c) and (d). SEC Rule 17a-11(d), however, requires a broker or dealer to transmit within 48 hours a report to the SEC stating what the broker or dealer has done or is doing to correct the situation that has caused it to fail to maintain current books and records. SEC Rule 17a-11(e) requires a broker or dealer to notify the SEC within 24 hours of discovering a material inadequacy in its accounting systems and to transmit a report to the SEC within 48 hours of such discovery.

The Commission believes that financial surveillance would be improved if all FCMs and IBs, whether dual registrants or not, were required to file notices with the Commission in accordance with the earlier thresholds required by the SEC. The time frames in the Commission's rules were adopted in 1978 and have not been amended since then to reflect advances in technology that may help ensure more prompt reporting. The Commission further believes that FCMs and IBs and brokers and dealers would benefit if the Commission's and SEC's rules were harmonized so that the same time frames apply for compliance with both agencies.

VI. Equity Capital and Subordinated Agreements

The Commission also is proposing to make conforming changes to Rule 1.17(e) and Rule 1.17(h), as these rules also include adjusted net capital requirements that are based upon percentages of the Segregated Amount.

Pursuant to these rules, an FCM³⁰ must maintain adjusted net capital in excess of its minimum adjusted net capital requirement in order to undertake or avoid undertaking certain actions in connection with the FCM's equity capital and subordination agreements.³¹ Thus, for example, Rule 1.17(e) prohibits the withdrawal of equity capital from an FCM if, among other conditions, the FCM's adjusted net capital after giving effect to such withdrawals would be less than the greatest of:

a. 120 percent of the minimum dollar amount in 1.17(a)(1)(i)(A) or (a)(1)(ii)(A);³²

b. Six percent of the Segregated Amount;

c. 120 percent of the amount of adjusted net capital required by a registered futures association of which the FCM is a member; or

d. For FCMs that also are registered with the SEC as securities brokers or dealers, the amount of net capital required by SEC Rule 15c3-1(e).

Similarly, several paragraphs of Rule 1.17 that address subordination agreements—(h)(2)(vi)(C) (restricting reductions of the unpaid principal balance under a secured demand note subject to a subordination agreement); (h)(2)(vii)(A) (restricting prepayments) and (B) (restricting special prepayments);³³ (h)(2)(viii)(A)

³⁰ Both FCMs and IBs must maintain specified levels of adjusted net capital for purposes of the actions that are either restricted or required under Regulations 1.17(e) and 1.17(h). Only FCMs, however, are required to include in their capital computations the funds that FCMs are required to segregate and set aside for the FCMs' customers. The discussion in this proposal is therefore limited to FCMs, since the proposed change relates to adjusted net capital computations that are based on funds required to be segregated and set aside for the FCMs' customers.

³¹ Subordination agreements that meet the requirements of Rule 1.17(h) will be deemed "satisfactory subordination agreements," thus permitting an FCM, pursuant to Rule 1.17(c)(4)(i), to exclude the subordinated debt that is governed by these agreements as liabilities when computing net capital.

³² The Commission redesignated paragraph (a)(1)(ii)(A) of Rule 1.17 as paragraph (a)(1)(iii)(A) in 2001. 66 FR 53510 (October 23, 2001). The Commission therefore also proposes a technical amendment to Rule 1.17(e) to correct the reference to 1.17(a)(1)(ii)(A) to read 1.17(a)(1)(iii)(A).

³³ "Special prepayments" is the term used by the rule for prepayments made under revolving subordinated agreements. Because revolving agreements may permit prepayments at any time, such payments ordinarily would conflict with Rule 1.17(h)(2)(vii) (prohibiting prepayment within one year of the date upon which the governing subordination agreement became effective.) In 1982, the Commission determined that special prepayments would be acceptable if subject to various conditions, including a higher level of adjusted net capital (10 percent of segregated funds) than is required for prepayments that are subject to the one-year restriction (7 percent of segregated funds.) 47 FR 22352 (May 24, 1982).

(requiring suspension of repayment); (h)(3)(ii) (requiring notice of maturity or accelerated maturity) and (h)(3)(v) (restricting use of temporary subordinations)—also include adjusted net capital calculations that refer to specified percentages of the Segregated Amount.³⁴ The required percentages range from six percent to ten percent, all of which exceed the percentage (four percent) applied to the Segregated Amount for purposes of the minimum adjusted net capital requirement under Rule 1.17(a).

The Commission therefore is proposing to amend paragraphs (e) and (h) of Rule 1.17 to conform to the risk-based capital requirement that the Commission is proposing for Rule 1.17(a). The proposed amendments to paragraphs (e) and (h) of Rule 1.17 would: (i) Eliminate calculations based on the Segregated Amount; (ii) adopt calculations based on the required margin for customer and noncustomer futures and option positions carried by an FCM; and (iii) apply percentage requirements that reflect the same proportional increase currently required under 1.17(e) and (h). Thus, for example, where Rule 1.17(e) included a calculation based upon six percent of the Segregated Amount, the Commission proposes to eliminate this calculation and require 150 percent of the Risk-Based Capital amount that the Commission is proposing for FCMs under Rule 1.17(a)(1)(B).

The Commission also is proposing to "grandfather" in agreements that, prior to the effective date of the proposed amendments, have been determined to be satisfactory subordination agreements pursuant to Rule 1.17(h). The Commission is proposing to amend paragraph (h)(3)(vii) of Rule 1.17 to provide that any such agreement would continue to be deemed satisfactory until its maturity, so long as the agreement is not amended or renewed. If for any reason the agreement is amended or renewed, such amended or renewed agreement must comply with Rule 1.17 as amended.³⁵

³⁴ The cited paragraphs contain references to 1.17(a)(1)(ii)(A), which has been redesignated. (See discussion in footnote 31 of this release.) The Commission is proposing a technical amendment to change the reference to read as 1.17(a)(1)(iii)(A).

³⁵ Rule 1.17(h)(3)(vii) presently applies to satisfactory subordination agreements that were entered into prior to the date that Rule 1.17(h) first became effective (December 20, 1978). The Commission provided a period of up to five years for such agreements to come into compliance with Rule 1.17(h), and this period has long since expired. The Commission therefore is also proposing technical amendments to eliminate provisions in Rule 1.17(h)(3)(viii) that are applicable to