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22 February 2013

Ms. Elizabeth Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C.
20549-1090

Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers

Dear Ms. Murphy,

CFA Institute[1] appreciates the opportunity to comment on the Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers consultation (the "Proposal") as proposed by the Securities and Exchange Commission ("SEC" or the "Commission"). The Proposal considers the capital and margin requirements for security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSP")[2], segregation requirements for SBSDs and notification requirements with respect to segregation for SBSDs and MSBSPs, and increased minimum net capital requirements for broker-dealers permitted to use the alternative internal model-based method for computing net capital ("ANC broker-dealers").

CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the integrity and accountability of global financial markets.

Executive Summary

As a global organization of investment professionals, CFA Institute is particularly concerned with issues that create systemic turmoil and failure within financial markets. Consequently, we are strongly supportive of efforts to 1) increase transparency of the swaps and derivatives markets globally; 2) to carefully consider, manage and regulate central clearing of swaps; 3) to trade standardized and standardizable swap instruments on transparent organized trading venues;

[1] CFA Institute is a global, not-for-profit professional association of more than 114,000 investment analysts, advisers, portfolio managers, and other investment professionals in more than 137 countries, of whom nearly 106,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 138 member societies in 60 countries and territories.

[2] See the following for a definition of an MSBSP:
http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3681%5CProposed-Definitions-of-Major-Swap.pdf

and 4) to ensure global coordination in the adoption and implementation of swaps regulations to reduce the frequency and effect of regulatory arbitrage.

With regard to the capital requirements element of this Proposal, we believe that all participants in the security-based swaps market should adhere to similar minimum capital requirements, be they SBSDs registered as broker-dealers, affiliated with bank holding companies, OTC derivatives dealers or nonbank SBSDs, or MSBSPs. We do not support permitting market participants to use internal models for calculating their own minimum capital requirements, preferring instead objective and clear capital baselines provided by regulators, with risk-based internal models to determine supplemental capital needs.

With regard to the issues of margin requirements and segregation, we believe:

1) Regulatory agencies should not exempt non-centrally cleared derivatives from margin requirements.
2) Models for appropriate margin levels should be consistent with industry practice and based on the risk of market movement for the specific instruments involved. Margin should be required for all types of instruments and market participants.
3) We do not support the use of margin models for non-centrally cleared derivatives that are based solely on models used for similar instruments that are centrally cleared without adjustments to reflect the higher risk associated with non-centrally cleared instruments.
4) We believe models established by central clearinghouses should determine minimum margin, with internal models used to determine supplemental margin needs.
5) Clearinghouses[3] should have the ability to accept a broad range of collateral types for margin requirements as long as the instruments are liquid, have transparent and verifiable valuations, appropriate valuation discounts are reflected, and regulatory approval of that collateral type has been given.
6) Position margin should be segregated by client and operational commingling with margin from other clients is acceptable.
7) Client assets should be fully segregated from proprietary firm assets.
8) CCPs and clearing members should publicly disclose the levels of protection and the costs associated with the different levels of segregation that they provide.
9) Details of the different levels of segregation provided by brokers, dealers, SBSDs, and CCPs should include a description of the main legal implications of the respective levels of segregation offered including information on the applicable insolvency laws in the relevant jurisdictions.
10) MSBSPs should have to calculate daily margin for each counterparty.

Finally, we do not believe that the SEC and CFTC should have different approaches to regulating similar issues. Disharmony of this kind will lead to additional confusion and increase the cost of

[3] In this response, we use the terms central clearinghouse, clearinghouse and central counterparty and the acronym "CCP" interchangeably.

dealing with the enormous complexities related to the swaps market. Moreover, it would likely create regulatory arbitrage opportunities for firms trading OTC derivatives.

We discuss these matters more fully in the section below.

Discussion

We strongly support the need cohesive capital, margin, and segregation requirements for non-centrally cleared derivatives as a means of mitigating systemic risk and improving investor protections. Capital, margin, and segregation requirements should not provide a competitive advantage to any of the different kinds of SBSDs, MSBSPs, and Broker-Dealers.

We have identified several issues that are relevant to our members and the investment industry generally, and offer responses to the related questions. The questions we have answered in the discussion section of this letter relate to the following issues:

1) The difference in capital standards for different kinds of firms;
2) If and which internal or external models should be allowed to calculate capital and margin;
3) If MSBSPs should be held to the same standard as SBSDs;
4) If the range of assets used to collateralize margin should be limited and how they should be treated;
5) Whether requirements should be different for legacy security-based swap ("SBS") positions;
6) If exceptions should be allowed for margin requirements in certain instances; and
7) How collateral is treated in terms of segregation.

Capital Requirements:

Overview

As part of a larger section on capital requirements, this aspect of the Proposal discusses how the capital requirements and tests may differ across SBSDs, where some are non-bank SBSDs have very different business models and look more like Broker-Dealers than bank SBSDs. Where prudential regulators prescribe capital and margin requirements for bank SBSDs, it will be important to make sure that non-bank and bank SBSDs and MSBSPs are not operating under similar rules. The CFTC issued an open consultation http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-10881a.pdf about similar issues related to Swap Dealers ("SD").

The Proposal considers that nonbank SBSDs' SBS businesses are more similar to traditional securities dealer activities than to bank activities and that differences in funding models of bank and non-bank SBSDs and their access to certain types of financial support will continue to exist. Moreover, existing rules already address dealing in OTC derivatives by Broker-Dealers and, to some extent already can accommodate this type of SBS activity.

Finally, the SEC notes the proposal would increase minimum net capital requirements and establish liquidity requirements for ANC Broker-Dealers, which are Broker-Dealers that have been approved by the Commission to use internal risk models for bespoke instruments and to take credit risk charges in lieu of a 100% charge for OTC derivatives transactions.

Questions (p.22 – 25)

Question 3: Should there be different capital standards for nonbank SBSDs depending on whether they are registered as Broker-Dealers or affiliated with bank holding companies, or not registered as Broker-Dealers and not affiliated with bank holding companies? If so, explain why. If not, explain why not. For example, should stand-alone SBSDs be subject to a tangible net worth standard or, if affiliated with a bank holding company, the bank capital standard? Would different standards create competitive advantages? If so, explain why. If different capital standards would be appropriate, explain the appropriate capital standard that should apply to each of these classes of nonbank SBSDs.

> Answer: No. There should be no difference in the manner in which capital standards are applied for nonbank SBSDs, regardless of whether they are registered as Broker-Dealers or affiliated with bank holding companies. Nor should there be any differences in the application of capital standards for SBSDs which are neither registered as broker dealers nor affiliated with bank holding companies.
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> Differences in capital standards would create incentives for firms to organize in the manner that ensures the lowest cost of capital, regardless of whether such a structure is more efficient or has lower risk. For example, imposing higher standards on nonbank SBSDs than are applicable to bank SBSDs would encourage SBSDs to organize as banks, even though this would put greater pressure on prudential banking regulators should a bank SBSD fail. Likewise, differentiating between the capital standards of SBSDs and MSBSPs would lead to similar regulatory arbitrage.

Question 7: Should the Commission exempt nonbank SBSDs engaged in activities with respect to securities OTC derivatives products other than SBSs from any requirements applicable to OTC derivatives dealers? Please identify which requirements and explain why.

> Answer: No. All firms engaged in OTC derivatives activities should be subject to the same capital requirements applicable to all other firms engaged in such activities, regardless of whether they are nonbank SBSDs or OTC derivatives dealers.

Question 8: Due to the way D-F is written, stand-alone SBSDs ($20M fixed capital and $100M tentative capital) could have to register as dealer SBSDs ($1B fixed capital and $5B tentative capital) even if they only act as brokers or agents and would, as a consequence, face higher capital requirements if they used their internal models to calculate net capital. To avoid registration as a dealer and the higher capital requirements that come with it, stand-alone SBSDs would have to limit their activities on behalf of customers so that they do not fall within the definition of a broker under the [Securities Exchange Act of 1934] [the "Exchange Act"].

Commenters are requested to address this issue, including any potential changes to the proposed capital requirements for stand-alone SBSDs and Broker-Dealer SBSDs. For example, should Broker-Dealer SBSDs approved to use internal models to compute net capital and that register as Broker-Dealers only in order to conduct brokerage activities with respect to security-based swaps("SBSs"), and that do not conduct a general business in securities with customers, be subject to the minimum net capital requirements applicable to stand-alone SBSDs approved to *use internal models? If so, explain why. If not, explain why not. If different capital standards would be appropriate, explain the appropriate capital standard that should apply to this class of Broker-Dealer SBSDs and whether any limitations should apply, including with respect to the types of broker activities in which the nonbank SBSD may engage in order to qualify for a particular capital treatment. Alternatively, or in addition, should the Commission allow OTC derivatives dealers (subject to $20 million fixed/ $100 million tentative) to be dually registered as nonbank SBSDs and/or amend the rules for OTC derivatives dealers to conduct a broader range of activities than are currently permitted? If the Commission took this action, should it also remove the exemption for OTC derivatives from membership in a self-regulatory organization ("SRO")?*

> Answer: Regardless of the type of firm (i.e., SBSD, MSBSP, or Broker-Dealer), we have serious concerns about regulators permitting firms to use internal models to calculate their own minimum capital requirements. Moreover, we have strong concerns about the classification of financial firms that are subject to different capital requirements.
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> Our primary concern with regard to internal models is that not only do they routinely fail in a crisis, precisely when capital is most needed, they also are easily manipulated to minimize capital charges prior to such crises. The potential for manipulation can create incentives for firms and their employees to take unnecessary risks, while creating real competitive advantages for larger firms who are able to reduce their capital requirements through internal modeling relative to smaller firms which are engaged in similar activities but subject to different capital calculations.
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> Management, boards, examiners, investors and counterparties of these firms deserve an objective and clear minimum capital baseline. Wherever possible, therefore, we believe that regulators should establish minimum capital requirements. Firms should use their internal models for internal risk management purposes to help identify additional risks and to determine supplemental capital needs.
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> With regard to the classification of financial firms so as to determine the type of capital requirements to which they would be subject, we believe this would lead to regulatory arbitrage. Firms would organize themselves in ways to reduce their capital requirements and increase their leverage in order to enhance return on capital. While such efforts on the part of firms are understandable and expected, it is incumbent upon prudential regulators to ensure that capital maintained by such firms is sufficient to limit leverage and provide cushion against losses, which can occur regardless of the activities in which the firm is engaged. For these reasons, we believe capital requirements should be the same regardless of what the firms do, with the only cause for difference being the aggregate exposures taken by individual firms.

<u>Margin Requirements</u>

Overview

Proposed Rule 18a-3 (the "Rule") would establish minimum margin for non-cleared SBS transactions entered into by nonbank SBSDs and nonbank MSBSPs and would prescribe the requirements to collect or post collateral for non-cleared SBS transactions. The Rule contains a requirement for nonbank SBSDs to monitor the risk of each account and establish, maintain, and document related procedures and guidelines as part of the risk management control system.

The Rule is based on the margin rules applicable to Broker-Dealers (the "Broker-Dealer Rules") and is intended to promote consistency and facilitate SBS portfolio margining with other types of securities. The fact that the Fed and Self-regulatory Organizations ("SROs") set margin rules in securities markets along with the requirement that SROs file proposed margin rules with the Commission, has promoted consistent margin levels and mitigated the risk that SROs (and member firms) compete on lower margin.

Under the Rule, the amount of equity to be maintained in an account depends on the securities transactions being facilitated through the Broker-Dealer and increases with the use of borrowed funds or short sales with borrowed securities increases.

General Comments

We do not support exemptions from margin requirements for non-centrally cleared derivatives as exemptions for certain market participants, whether by formal regulation or informal agreement, were a significant contributor to the systemic risk disruptions during the 2008 financial crisis. Posting collateral for OTC derivatives transactions provides a critical buffer in the event of default of one of the counterparties, helps manage systemic risk, and enables central clearing - all concepts with which we firmly agree. Therefore, we do not believe that different kinds of firms transacting in SBSs should have different capital and margin requirements. Nor would we support allowing firms to use internal models for the calculation of capital or margin.

In addition, we support allowing a broad range of collateral types used for margin requirements as long as they are liquid instruments with verifiable and publicly available valuations, and appropriate valuation discounts are reflected. We encourage more standardized rules and widely agreed upon risk management criteria in determining such values.

Once margin has been posted it should be segregated by client. In the event of a default, the non-defaulting party in the transaction should be able to easily identify and apply the posted margin to offset any losses due to the default or the position close-out. Also, the structure we suggest would prevent the default of one counterparty from affecting the value of both parties to the transactions.

Proposed Margin Requirements for Nonbank SBSDs and Nonbank MSBSPs - Nonbank SBSDs

Questions (p. 169)

Question 6: Should Rule 18a-3 allow an alternative method of calculating the margin amount that would permit a nonbank SBSD to determine the margin amount for a non-cleared SBS based on the margin required by a registered clearing agency for a cleared SBS whose terms and conditions closely resemble the terms and conditions of the non-cleared SBS (similar to the CFTC's proposal)? Would there be sufficient similarity between certain cleared and non-cleared SBSs to make this approach workable? In addition, if this alternative approach was permitted, how could the potential differences in margin requirements across clearing agencies be addressed?

Answer: No, we do not believe that margin models for non-centrally cleared derivatives should be based *solely* on margin models use for similar products that are centrally cleared for a number of reasons. First, centrally cleared and non-centrally cleared derivatives have different characteristics. If they were similar, then non-centrally cleared instruments would be clearable. The fact that one instrument is not centrally cleared while another, seemingly similar instrument is centrally cleared suggests that there are additional, potentially significant, differences in the nature and risk profile of the two instruments. For example, non-centrally cleared swaps are typically less liquid than those cleared by central counterparties. If a centrally cleared swap were used as the sole basis for calculating margin on the non-centrally cleared, it would fail to consider the time and cost the counterparties would face finding a buyer, or unwinding the contract.

Furthermore, it is unclear who would determine which centrally cleared and non-centrally cleared derivatives are similar and how these determinations would be applied and updated in the internal margin models. Finally, firms should only use similar cleared derivatives models as a baseline and one input to a broader non-centrally cleared model. The other inputs should include additional collateral to act as a buffer to counteract illiquidity, the custom nature of the contract, counterparty risk and other issues inherent in bilateral trading.

Question 7: In addition to internal models, should external models be permitted such as: (1) a model currently in use for margining cleared SBSs at a clearing agency; (2) a model currently in use for modeling non-cleared swaps by an entity subject to regular assessment by a prudential regulator; or (3) a model available for licensing to any market participant by a vendor? What would be the advantages and disadvantages of permitting external models?

Answer: Using external models in some cases is preferable to internal models because there is less potential for firms to manipulate their collateral needs. However, we recognize that there are some limitations for using different kinds of external models. We support the use of pre-approved CCP models as one input into minimum margin determination of non-centrally cleared derivatives. The predictability of such models would help market participants understand what margin they must provide prior to a trade, thus making it easier for end-users to manage the risks of their businesses. However, it is critical that this is only one input and a baseline for additional buffers to collateral required for non-centrally cleared transactions.

We do not support the use of vendor-supplied models for the calculation of margin, due to concerns that vendors would develop models that help firms minimize required margin, regardless of the potential effect on safety and soundness of the clearing system.

In both regulatory and private models, careful attention must be paid to the inputs and assumptions used to ensure the effectiveness of the margin determinations. For example, given recent history, it would not be prudent for any model to use bell-shaped distributions to estimate the likelihood or severity of default outcomes.

Proposed Margin Requirements for Nonbank MSBSPs

Overview

This section discusses the calculations and definitions for margin requirements for nonbank MSBSPs.

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Question 2: Should nonbank MSBSPs be required to calculate a daily margin amount for each counterparty? For example, even if they were not required to collect collateral to cover potential future exposure, would the calculation of the margin amount better enable them to measure and understand their counterparty risk?

> Answer: Yes, we believe that nonbank MSBSPs should have to calculate daily margin for each counterparty. Doing so will allow MSBSPs to better measure and understand their aggregate counterparty risk.

Question 4: Would nonbank MSBSPs have the systems and personnel necessary to operate daily margin collateral programs to calculate a daily margin amount?

> Answer: Nonbank MSBSPs should have the personnel necessary to operate daily margin collateral programs to calculate daily margin. Appropriate systems and understanding the risks and collateral associated with a derivatives trade are critical to risk control.

Account Equity Requirements for Nonbank SBSDs

Overview

Nonbank SBSDs would have to calculate the amount of equity and margin for each counterparty's account as of the close of each business day with collection of cash, securities, and/or money market instruments ("Acceptable Collateral") on the next business day to cover any margin shortfalls. Under the Rule, nonbank SBSDs could not accept other types of assets as collateral. In addition, the fair market value of acceptable instruments held in the account of a counterparty would be subject to discounts applicable to nonbank SBSDs for determination of minimum account equity required. Accordingly, instruments with no "ready market" or which cannot be publicly offered or sold because of statutory, regulatory, or contractual arrangements or other restrictions would have no value in meeting the account equity requirement. Further, haircuts applied to the value of all other securities and money market instruments in the account would increase for instruments with greater market risk.

The prudential regulators and the CFTC are proposing to specifically identify the asset classes that would be eligible collateral for purposes of their margin rules. Rule18a-3 as proposed would not limit collateral in this way. However, the SEC is proposing certain additional requirements for eligible collateral, which are modeled on the existing collateral requirements in Appendix E to Rule 15c3-1.

A nonbank SBSD would have to take a capital charge if a counterparty does not deliver Acceptable Collateral to meet an account equity requirement within one business day. In addition, Rule 18a-3 would require prompt steps to liquidate securities and money market instruments in the account to the extent necessary to eliminate the account equity deficiency.

This provision, modeled on requirements in the Broker-Dealer margin rules, may require nonbank SBSDs to liquidate positions in accounts to reduce debits arising from those transactions. The proposed rule is designed to give such firms flexibility to conduct orderly liquidations.

The Proposal includes exceptions for a) commercial end-users; b) counterparties that are SBSDs; c) counterparties that elect segregation; and accounts holding legacy SBSs. For the SBSD counterparties exception, a nonbank SBSD either would not need Acceptable Collateral from the SBSD counterparty ("Alternative A") — an approach consistent with Broker-Dealer margin rules — or it would have to collect the Acceptable Collateral to cover both the negative equity and the margin for a counterparty that is another SBSD ("Alternative B").

Moreover, the Acceptable Collateral would have to be segregated in an account at an independent third-party custodian under the Exchange Act. Alternative B is consistent with the proposals of the prudential regulators and the CFTC."

Questions (p. 192 - 197)

Question 1: Would it be appropriate to limit the assets that could be used to collateralize the negative equity and margin amounts in an account to cash, securities, and money market instruments? Are there other types of assets that should be permitted to meet the account equity requirements in Rule 18a-3? If so, identify the other asset types and compare their liquidity to cash, securities, and money market instruments.

> Answer: The range of assets that could be used to collateralize negative equity and margin should be consistent with the types of assets permitted for margin and collateral in other instances. Within appropriate risk parameters, such as valuation haircuts based on liquidity, volatility, and likelihood of maintaining its value in a crisis, we believe this should be consistent with the types of collateral proposed as acceptable in the BCBS/IOSCO Consultation on Margin Requirements for Non-centrally Cleared Derivatives (the "Basel-IOSCO Consultation"). These would include the following, with appropriate discounts:
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> - Cash;
> - High-quality government and central bank securities;
> - High-quality corporate bonds;
> - High-quality covered bonds;
> - Equities included in major stock indices; and
> - Gold.

Question 5: Is the proposed exception to the account equity requirements for commercial end users appropriate? If not, explain why not. Should commercial end users be required to collateralize negative equity and the margin amount in their accounts? Explain why or why not. Should the exception apply only to the margin amount (i.e., should commercial end users be required to collateralize the negative equity in their accounts)? Explain why or why not.

Answer: We believe that all entities should have to post margin to cover negative equity in their accounts and there should not be any exceptions.

Exemptions from having to post margin or collateral, due in part to the misguided belief that the regulatory structure under which it operated was sufficient to provide surety of performance without such requirements, contributed significantly to the 2008 financial crisis. In response to these events, we believe all market participants should be subject to the margin requirements envisioned by the Proposal and exceptions should be solely for truly de minimis amounts.

Question 10: Should there be a two-tiered approach with respect to the account equity requirements for financial end users based on whether they are low risk or high risk, similar to the proposed approach of the prudential regulators and the CFTC? If so, explain why.

Answer: Ideally the SEC and the CFTC would be in agreement on this proposed rule; however, we do not believe that there should be a two-tiered approach with respect to the account equity requirements for financial end-users based on whether they are low-risk or high-risk. What is low-risk today can become high-risk in the future. Nonbank SBSDs need to have risk controls and credit procedures in place to determine whether counterparties are creditworthy. If they are not, the dealer should not trade with it. Account equity requirements should be based on risk and volatility of the transaction and implemented appropriately.

Question 20: Would the proposed exception to the account equity requirements for accounts that elect to hold legacy SBSs be appropriate? If not, explain why not.

Answer: Generally, we do not agree with account equity exceptions for SBSDs. Account equity rules are in place to mitigate risk and any exceptions to the rule should be few and far between, if any are allowed at all.

Nevertheless, we believe that new rules should not be required for legacy SBSs and would not consider legacy SBSs to be exceptions to the rules. When those contracts were initiated, these rules did not exist. SBSDs were not given an opportunity to plan for them. However, such exemptions should only apply only until the legacy contracts expire or are revised.

Question 22: Should counterparties be required to post variation margin with respect to legacy swaps? Is this consistent with current market practice?

Answer: Counterparties should have to post variation margin, regardless of whether the positions are legacy or new. Without this type of protection, counterparties are exposed to potential losses as a consequence of the default of trading partners. Given the need for concern about potential systemic risks, we believe it is imperative that all swaps should be subject to variation margin.

Question 23: Should there be an exception from the account equity requirements for small banks, savings associations, farm credit system institutions, and credit unions from the account equity requirements (e.g., for entities with assets of $10 billion or less)? Explain why or why not.

> Answer: We do not believe that there should be an exception from the account equity requirements for small banks, savings associations, farm credit system institutions, and credit unions from the account equity requirements. Please note our response to question 5 for additional rationale.

Question 24: Should there be an exception from the account equity requirements for affiliates of the nonbank SBSD? For example, do affiliates present less credit risk than non-affiliates? If there should be an exception for affiliates, should it be limited to certain affiliates? For example, should the exception only apply to affiliates that are subject to capital and other regulatory requirements? Please explain.

> Answer: We do not believe that there should be an exception from the account equity requirements for affiliates of the nonbank SBSD. Please note our response to question 5 for additional rationale.

Question 25: Should there be an exception for foreign governmental entities? Explain why or why not. Should types of foreign governmental entities be distinguished for purposes of an exception? For example, are there objective benchmarks based on creditworthiness that could be used to distinguish between foreign governmental entities for which the exception to the account equity requirements would and would not be appropriate? If so, identify the benchmarks and explain how they could be incorporated into the rule.

> Answer: As noted in question 5, we believe that all entities should post margin based on the risk of the market movement of the specific instruments involved, and there should not be any exemptions.

Account Equity Requirements for Nonbank MSBSPs

Overview

The Proposal would require nonbank MSBSPs to calculate equity in the account of each counterparty as of the close of each business day, with delivery of Acceptable Collateral due the following day. Accounts with negative equity would have to post Acceptable Collateral to cover the negative equity. Accounts with positive equity would receive Acceptable Collateral equal to the amount of positive equity.

Unlike nonbank SBSDs, nonbank MSBSPs would not have to discount the fair market value of instruments held for counterparties (or delivered to a counterparty) for purposes of determining whether equity meets the minimum requirement.

There are 3 proposed exceptions to the rule:

1) Nonbank MSBSPs would not have to collect collateral from commercial end-users when the account has negative equity, consistent with the proposed exception for commercial

end-users at nonbank SBSDs. Nonbank MSBSPs in this case would not have to take a credit risk charge or capital charge relating to the uncollected amount.

2) Nonbank MSBSPs would not have to collect Acceptable Collateral from SBSDs to cover negative equity of the SBSDs' accounts. This is different from the proposed rules for nonbank SBSDs which would have to collect collateral from nonbank MSBSPs to cover negative equity and margin in their accounts. A nonbank SBSD would have to collect collateral from a nonbank MSBSP to cover any negative equity and margin amount in the MSBSP's account. Once collected, the nonbank MSBSP would have a current exposure to the nonbank SBSD equal to the positive equity.

3) Nonbank MSBSPs would not have to collect Acceptable Collateral to collateralize the negative equity in SBS legacy accounts. In addition, MSBSPs would not be required to deliver collateral to cover positive equity in such accounts.

Questions (p. 202)

Question 2: Should nonbank MSBSPs be required to reduce the fair market value of securities and money market instruments for purposes of determining whether the level of equity in the account meets the minimum requirement? What would be the impact of not requiring nonbank MSBSPs to reduce the fair market value of securities and money market instruments for purposes of determining whether the level of equity in the account meets the minimum requirement?

Answer: Yes, nonbank MSBSPs should discount the fair market value of securities and money market instruments when determining whether the level of equity in the account meets the minimum requirement. We believe that all entities should post margin based on the risk of the market movement of the specific instruments involved, and there should not be any exceptions.

Question 3: Should nonbank MSBSPs be required to collect or deliver cash, securities, and/or money market instruments to collateralize a margin amount (potential future exposure) in addition to the negative equity amount (current exposure)? Should they be required to deliver cash, securities, and/or money market instruments to a commercial end user to collateralize a margin amount? Please explain.

Answer: In addition to collecting or delivering Acceptable Collateral to collateralize current exposures, MSBSPs should have to collateralize potential future exposures. All entities should post margin based on the risk of market movements in the specific instruments involved, and there should not be any exceptions.

We have concerns, however, with the suggestion that MSBSPs deliver Acceptable Collateral to commercial end-users ("CEUs") to collateralize margin accounts. In particular, we are concerned that CEUs do not normally operate under the fiduciary obligations applicable to financial firms for the safekeeping of client funds and therefore are unequipped with handle such collateral while a contract is open. A better solution would be for the MSBSP to deliver the Acceptable Collateral to a third-party financial institution for safekeeping.

Question 5: Is the proposed exception to the account equity requirements for credit exposures to SBSDs appropriate? If not, explain why not.

> Answer: No, the proposed exception to the account equity requirements for credit exposures to SBSDs is not appropriate. We believe that all entities should post margin based on the risk of the market movement of the specific instruments involved, and there should not be any exceptions.

Question 6: Is the proposed exception to the account equity requirements for credit exposures in SBS legacy accounts appropriate? If not, explain why not.

> Answer: We support the proposed exception to the account equity requirements for credit exposures in SBS legacy accounts, as well. Generally, we believe that new rules should not be required for legacy SBSs. When those transactions were initiated, these rules did not exist. MSBSPs were not given an opportunity to plan for them. If an MSBSP would like to adopt new rules on legacy positions before they are required, they should be encouraged and rewarded for it.

Specific Request for Comment to Limit the Use of Collateral

Overview

Rule 18a-3 does not specifically identify classes of assets that could be used to meet account equity requirements. The Commission is considering whether it would be appropriate to adopt limits on eligible collateral similar to those the prudential regulators and the CFTC have proposed. The SEC is seeking comment on whether to define the term eligible collateral in order to narrowly prescribe the classes of assets that would qualify as collateral to meet the account equity requirements.

Questions (p 209 - 211)

Question 1: Should the types of assets that could be used to meet the nonbank SBSD account equity requirements in Rule 18a-3 be more limited? Explain why or why not. For example, are the proposed provisions that would require a nonbank SBSD to mark-to-market the value of the collateral, apply haircuts to the collateral, and adhere to the collateral requirements incorporated from Appendix E to Rule 15c3-1 sufficient to ensure that collateral is able to serve the purpose of protecting the nonbank SBSD from the credit exposure of a counterparty to a non-cleared SBS? If so, explain why. If not, explain why not.

> Answer: We would not support strict limits on the types of assets that could be used to meet the nonbank SBSD account equity requirements in Rule 18a-3. Instead, we suggest that the Commission accept the types of collateral proposed by the Basel-IOSCO Consultation, which include but are not limited to:
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> - Cash;
> - High-quality government and central bank securities;
> - High-quality corporate bonds;

- High-quality covered bonds;
- Equities included in major stock indices; and
- Gold.

We believe these types of assets are appropriate, with appropriate discounts based on volatility and volatility in times of stress. We believe it is important that a wide range of collateral is acceptable for the liquidity and the health of the market.

Question 3: Should the types of assets that could be used to meet the nonbank MSBSP account equity requirements in Rule 18a-3 be more limited? Explain why or why not. Since nonbank MSBSPs would not be required to apply haircuts to the collateral or adhere to the collateral requirements incorporated from Appendix E to Rule 15c3-1.

Answer: We do believe that MSBSPs should have to apply the haircuts to collateral and adhere to the collateral requirements from Appendix E to Rule 15c3-1. Furthermore, if this were the case, we would support the use of broader assets as eligible collateral.

However, if those collateral requirements and haircuts are not required, we do believe that the types of assets used to meet the nonbank MSBSP account equity requirements in Rule 18a-3 should be more limited.

Question 10: Should there be separate eligible collateral requirements for collateralizing negative equity and the margin amount? For example, should the assets permitted to collateralize negative equity be limited to cash and U.S. government securities, while the assets permitted to collateralize the margin amount encompass a broader range of securities?

Answer: No. We believe that collateral requirements should be the same for collateralizing negative equity and the margin account. We do not think there should be a difference.

Segregation Requirements

Overview

The U.S. Bankruptcy Code provides special protections for customers of stockbrokers. Among other protections, customers share ratably with other customers ahead of all other creditors in the customer property held by the failed stockbroker. Segregation requirements are designed to identify customer property as distinct from the proprietary assets of the firm and to protect it by preventing the firm from using it to make proprietary investments. The goal of segregation, therefore, is to facilitate the prompt return of customer property either before or during a liquidation proceeding if the firm fails.

The Dodd-Frank Act contains provisions designed to ensure that cash and securities held by SBSDs relating to SBSs will be deemed customer property under the stockbroker liquidation provisions.

The Exchange Act applies the customer protection elements of the stockbroker liquidation provisions to cleared SBSs. It provides that a broker, dealer, or SBSD will treat and deal with all collateral of any SBS customer received as belonging to the customer. These assets will be separately accounted for and not commingled with the funds of the broker, dealer, or SBSD or used for the benefit of any other SBS customer. Collateral of cleared SBS customers may, for convenience, be commingled and deposited in one or more accounts with any bank, trust company, or clearing agency.

With respect to non-cleared SBSs, SBSDs and MSBSPs must notify counterparties at the beginning of non-cleared SBS transactions that they have the right to require segregation of their funds or other property. If requested, the SBSDs or MSBSPs would segregate the assets and maintain them in segregated accounts, separate from the assets and other interests of the SBSDs or MSBSPs. The segregated accounts will be carried by independent third-party custodians and be designated as a segregated account for and on behalf of the counterparty ("individual segregation").

In the case of non-cleared SBSs, each counterparty has the right to require its collateral to be isolated in an account at an independent custodian that identifies the counterparty by name, rather than commingled with collateral of other counterparties. Segregation requirements for non-cleared SBSs apply only to initial margin, but not to variation margin payments. Such requirements do not preclude any commercial arrangement concerning the investment of segregated collateral that may only be invested in SEC-approved investments, and the related allocation of gains and losses resulting from any investment of the segregated funds or other property. Finally, if the counterparty does not choose to require segregation, SBSDs or MSBSPs must send quarterly reports to them detailing the firm's back office procedures relating to margin and collateral requirements.

Proposed new Rule 18a-4would establish an alternative omnibus, or "commingled," segregation approach for non-cleared SBSs, which would be the default requirement for non-cleared SBSs. The rules would not apply to MSBSPs, which would be subject only to the segregation requirements with respect to the collateral, and not required to segregate the collateral unless the counterparty required individual segregation. In addition, counterparties would be able to negotiate customized segregation agreements with MSBSPs.

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Question 2: Should there be rules with respect to how an SBSD and an MSBSP may invest funds or other property relating to non-cleared SBSs to supplement the individual segregation provisions? If so, describe the types of requirements the rules should impose. For example, should the rules require that the funds may be invested only in U.S. government securities or in qualified securities in Rule 18a-4? Explain why or why not.

> Answer: Yes, there should be rules with respect to how SBSDs and MSBSPs may invest funds or other property relating to non-cleared SBS. It is important that if there is a failure of the firm, customers can immediately retrieve their funds. Because of this fact, it is critical that collateral is invested in cash and marketable securities valued with appropriate haircuts. The most important factors of the investments are liquidity and the likelihood that the securities retain their values in times of stress.

Question 4: Should MSBSPs be required to comply with all the omnibus segregation requirements of Rule 18a-4? If so, explain why. If not, explain why not.

> Answer: Yes, MSBSPs should be required to comply with all of the omnibus requirements of Rule 18a-4. The customers should be just as safe investing with MSBSPs as they are with SBSDs. We believe that MSBSPs are capable of providing this service. It is critical that they can mitigate systemic risk, counterparty risk, and credit risk if investing in SBSs. If MSBSPs are exempted from these rules, it will encourage SBSDs and other firms to become MSBSPs as a way to get around the new segregation rules and to enable them to commingle their customers' assets in proprietary activities that may jeopardize client funds.

Question 5: Should the omnibus segregation requirements accommodate the ability to hold swaps in SBS customer accounts to facilitate a portfolio margin treatment for related or offsetting positions in the account? What practical or legal impediments may exist to doing so? If swaps could be held in the account along with SBSs, how would the existence of differing bankruptcy regimes for securities and commodities instruments impact the ability to unwind positions or distribute assets to customers in the event of insolvency of the SBSD?

> Answer: Yes, omnibus segregation requirements should accommodate the ability to hold swaps in SBS customer accounts to facilitate a portfolio margin treatment for related or offsetting positions in the account. We believe that this would provide efficiencies and add liquidity to the market.

Conclusion

We appreciate the opportunity to comment on the SEC Proposal on Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or Beth Kaiser, CFA, CIPM at beth.kaiser@cfainstitute.org or 434.951.5614.

Sincerely,

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