February 22, 2013

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers (Release No. 34-68071; File No. S7-08-12)

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] welcomes the opportunity to provide the Securities and Exchange Commission (the "**SEC**" or "**Commission**") with comments on the Commission's proposed capital, margin and segregation requirements (the "**Proposal**")[2] for security-based swap dealers ("**SBSDs**") and major security-based swap participants ("**MSBSPs**") pursuant to Sections 3E and 15F of the Securities Exchange Act of 1934 (the "**Exchange Act**"), as amended by Sections 763 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"). SIFMA appreciates the Commission's careful and comprehensive approach to this complex and consequential rulemaking.

---

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] SEC Release No. 34-68071 (Oct. 18, 2012), 77 Fed. Reg. 70,214 (Nov. 23, 2012) (the "**Proposing Release**").

EXECUTIVE SUMMARY

SIFMA greatly appreciates the Commission's thoughtful effort to reconcile the many difficult and, in some cases, conflicting objectives that must be addressed in fashioning capital, margin and segregation requirements for nonbank SBSDs and MSBSPs. These objectives include the mandate in Section 15F(e) of the Exchange Act for the Commission's capital and margin requirements to "help ensure the safety and soundness" of nonbank SBSDs and MSBSPs and "be appropriate for the risk associated with" uncleared security-based swaps ("**SBS**"). Section 15F(e) also requires the Commission, together with the Commodity Futures Trading Commission (the "**CFTC**") and the Prudential Regulators,[3] to the maximum extent practicable, to establish and maintain comparable capital and margin requirements for bank and nonbank swap dealers ("**SDs**"), SBSDs, major swap participants ("**MSPs**") and MSBSPs. Section 752 of Dodd-Frank similarly requires the Commission to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to SBS. Finally, Section 3(f) of the Exchange Act generally requires the Commission to consider whether its rules "will promote efficiency, competition, and capital formation," and Section 23(a)(2) prohibits the Commission from adopting any rule that "would impose a burden on competition not necessary or appropriate in furtherance of the purposes" of the Exchange Act.

SIFMA recognizes that, in implementing capital, margin and segregation requirements for nonbank SBSDs, the Commission has largely drawn from its existing broker-dealer financial responsibility rules and sought to adapt those rules for SBSDs. Nevertheless, we are concerned that this approach, without further modification, does not adequately address or conform to the statutory principles described above. We strongly believe that, in applying those principles, the Commission should take into account the broader context of regulatory reform, including the significant reduction in risks that will occur once dealers and major participants in the SBS markets are required to register and comply with basic capital requirements, standardized SBS become subject to mandatory clearing and, for uncleared SBS, variation margin is required to be exchanged. Accordingly, the modifications that we recommend the Commission make to the Proposal are intended to be evaluated within that broader context.

The Proposal Would Impose Costs That Are Disproportionate to the Risks of SBS Dealing Activity. Contrary to the statutory requirements that the Commission's capital and margin requirements "be appropriate for the risk associated with" uncleared SBS and "promote efficiency," the Proposal would impose duplicative and excessive capital and margin requirements.

In particular, we are concerned that the proposed requirement to tie a SBSD's minimum level of net capital to 8% of the level of margin required to be collected by it with respect to SBS would require the maintenance of resources far in excess of the actual risks presented by a SBSD's exposures. Similarly, the proposed requirements to apply deductions to net capital

[3] Under Dodd-Frank, the "**Prudential Regulators**" are the Board of Governors of the Federal Reserve System ("**FRB**"), the Federal Deposit Insurance Corporation ("**FDIC**"), the Federal Housing Finance Agency ("**FHFA**"), the Farm Credit Administration ("**FCA**") and the Office of the Comptroller of the Currency ("**OCC**").

based on the level of margin required for SBS would also be excessive, as well as inconsistent with the proposed capital regimes for SDs and banks SBSDs (*e.g.*, by requiring 100% deductions for collateral held by third-party custodians and legacy account positions). The six SIFMA member firms who operate alternative net capital ("**ANC**") broker-dealers have preliminarily projected that, in light of the severity of these requirements, the amount of capital that would be required for the single business line of SBS dealing under the Proposal would exceed $87 billion, the amount of capital currently devoted to *all* of those firms' securities businesses combined, including investment banking, prime brokerage, market making and retail brokerage.[4] There is no empirical evidence, nor do we believe, that the risks arising from the SBS dealing business are greater than the aggregate risks arising from all of these other businesses. Furthermore, we believe that Dodd-Frank's reforms, most notably the significant expansion of central clearing and daily exchange of variation margin for uncleared SBS, will significantly decrease the risk in the SBS dealing business.

We also believe that entity-level liquidity stress test requirements are likely to be destabilizing by trapping assets within SBSD subsidiaries and preventing centralized liquidity risk management. Given the limits on available liquid assets, it is more systemically sound for liquidity to be managed in an integrated, group-wide manner, so that a subsidiary with excess liquidity can provide resources to one that is under stress.

Additionally, SIFMA is concerned that mandatory initial margin requirements would replace potential exposure with actual exposure, reduce overall market liquidity, exacerbate pro-cyclical shocks and, if extended universally, place margin in the hands of entities not subject to prudential supervision. While we appreciate the Commission's efforts to mitigate these adverse impacts by proposing to limit initial margin requirements to the collection of initial margin by SBSDs from financial end users, even such limited initial margin requirements will have negative consequences. In this regard, SIFMA member firms have estimated that the liquidity demands associated with mandatory initial margin requirements are likely to range between approximately $1.1 trillion (if dealers are not required to collect from each other) to $3 trillion (if dealers must collect from each other) to $4.1 trillion (if dealers must post to non-dealers).[5] Moreover, in stressed conditions, we estimate that initial margin amounts collected by firms that use internal models could increase by more than 400%. These mandatory initial margin

---

[4] The firms estimated the amount capital currently devoted to their securities businesses by determining the amount of capital, after deductions for non-allowable assets and capital charges, that is necessary for them to have net capital in excess of the early warning level specified in Rule 17a-11.

[5] The ultimate amount would depend on the extent to which firms use models instead of standardized haircuts and the extent of any initial margin thresholds. A more detailed depiction of estimated initial margin levels is contained as Figure 1 in Appendix 2 to this letter. To create the estimates in Figure 1, we used data submitted by several SIFMA member firms in response to the Quantitative Impact Study ("**QIS**") conducted in connection with the international consultation on margin requirements for uncleared derivatives released in July 2012. Since SIFMA prepared these estimates, the results of the QIS were released as part of a second consultation. We are still studying those results. However, we note that the QIS results presented generally assume that all firms use approved internal models. Our estimates, in contrast, focus on a mix of model-based and haircut-based initial margin amounts. In addition, the QIS results do not take into account the increased initial margin associated with a movement from non-stressed to stressed market conditions.

requirements cannot be reconciled with the Commission's statutory mandate under Dodd-Frank and the Exchange Act, nor has the Commission offered a sufficient basis to justify their adoption consistent with that mandate. Indeed, in SIFMA's view, their adoption likely would substantially limit the availability of essential credit and magnify the adverse effects of financial shocks on the broader economy.

The Proposal Would Make Nonbank SBSDs Uncompetitive. It is essential, as both a statutory and a policy matter, for the Commission to take into account that bank and nonbank SBSDs are engaged in the same fundamental business – entering into SBS transactions with the same customers and in the same markets. Accordingly, while we recognize that there are relevant differences between bank and nonbank dealer business models (*e.g.*, relating to types of funding and access to backstop liquidity), it would be inconsistent with Dodd-Frank, and with preserving the competitiveness of nonbank SBSDs, to adopt capital and margin requirements that are not comparable to those of the Prudential Regulators to the maximum extent practicable.

Consistency between the Commission's and the CFTC's capital and margin requirements is also necessary for nonbank SBSDs to be competitive with bank SBSDs. Most SBSDs will also be registered as SDs. For nonbank SBSDs, this will mean compliance, at the same time, with both CFTC and Commission capital and margin requirements. Bank SBSDs, in contrast, will be subject to only to a single set of capital and margin requirements. As a result, subjecting dually registered nonbank SBSD-SDs to two sets of inconsistent capital and margin requirements would impair their ability to compete effectively, without offering any incremental safety and soundness benefits.

In addition, nonbank SBSDs compete for business with foreign SBSDs. Foreign SBSDs generally must comply with Basel-compliant capital requirements similar to those applied by the Prudential Regulators. They also will, in most cases, be subject to margin requirements that are consistent with emerging international standards. As noted above, Dodd-Frank requires the Commission to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation of SBS. We appreciate the steps the Commission has taken to satisfy this mandate through its participation as part of the Working Group on Margining Requirements of the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**" and, together with BCBS, "**BCBS/IOSCO**"). Because BCBS/IOSCO has not yet finalized its recommendations for international margin standards, however, it is not possible at this time to evaluate the extent and likely impact of any inconsistencies between the Proposal and international standards. Accordingly, we urge the Commission, once the BCBS/IOSCO recommendations are final, to re-propose its margin rules for further public comment to address any modifications that might be necessary to conform to those recommendations or to seek input on any inconsistencies between them.

The Proposal's Inconsistencies with Other Regulators' Regimes Would Increase Costs and Risks. To the extent that the Commission's requirements for dually registered SD-SBSDs apply in addition to, or in a manner inconsistent with, CFTC requirements, such requirements would exacerbate the burdens imposed by those existing requirements and tend to promote inefficiencies by discouraging dual registration. Discouraging dual registration is particularly problematic because conducting the swap and SBS dealing business in two different legal entities will reduce opportunities for netting, thereby increasing credit risk between the dealer and its customers and increasing the amount of margin required to be posted by, and the associated liquidity demands on, customers.

We see no justification, from a cost-benefit perspective, to applying inconsistent capital and margin regimes to a SBSD that is also registered as an SD, except to the minimum extent necessary to accommodate the applicable statutory regime created by Congress. Doing so would serve no purpose other than to require significant investment in the infrastructure necessary to monitor compliance with those regimes simultaneously without materially enhancing investor protection or safety and soundness.[6] For these reasons, we strongly urge the Commission to take every step possible to coordinate with the CFTC in the adoption of consistent capital and margin requirements.

We further note that similar considerations apply in respect of other registration categories. Many SBSDs will conduct an integrated equity derivatives business, dealing in SBS and OTC options, and so accordingly will be registered as OTC derivatives dealers.[7] In turn, many other SBSDs will, as the Commission acknowledges, be registered as broker-dealers; many such SBSDs will also be registered with the CFTC as futures commission merchants ("**FCMs**"). Consistency across the capital and margin requirements applicable under each of the SBSD, SD, broker-dealer, OTC derivatives dealer and FCM regimes should be a key objective of the Commission.

A More Risk-Sensitive Approach Would Better Achieve Dodd-Frank's Objectives. SIFMA has suggested below modifications to the Proposal that are intended to achieve Dodd-Frank's objectives while also addressing these considerations. In particular, we strongly urge the Commission to (i) adopt a more risk-sensitive minimum capital requirement, (ii) eliminate its proposed 100% capital deductions for collateral held by third-party custodians and undermargined legacy accounts, (iii) harmonize its liquidity stress test requirements with the applicable FRB and Basel requirements and (iv) focus on establishing a robust, two-way variation margin regime, rather than a mandatory initial margin regime.

In each case we believe that the suggested modification is both necessary and appropriate to make the relevant requirement more risk-sensitive or to prevent unintended risks and costs, to SBSDs or the financial system more generally. Moreover, we believe that the capital and margin regime, as modified to reflect our suggestions, would still ensure that nonbank SBSDs hold adequate capital (including for illiquid assets and unsecured exposures), prevent the buildup of unsecured exposures with respect to SBS, and generally reduce leverage in the financial system.

---

[6] We observe that differences in the regimes applicable to bank and nonbank SBSDs raise similar issues for firms that conduct SBS activities through both bank and nonbank subsidiaries.

[7] References in this letter to stand-alone SBSDs that are approved to use internal models are also intended to apply to OTC derivatives dealers that are dually registered as SBSDs.

A summary of our specific recommendations for a more risk-sensitive approach is set forth below.

Capital Requirements

- ***Minimum Capital Requirements.*** We support the Proposal's fixed dollar minimum capital requirements. However, for the adjustable minimum capital requirement, we suggest two alternative ratios to the proposed 8% margin factor that we believe will be better tailored to the actual overall risk presented by a SBSD's activities: (a) for stand-alone SBSDs that use internal models and ANC broker-dealers, a ratio based on a percentage of the entity's market and credit risk charges to capital and (b) for stand-alone and broker-dealer SBSDs that do not use internal models, a ratio based on a credit quality adjusted version of the proposed 8% margin factor.

- ***Market Risk Charges.***

  - *Adoption of Banking Agencies' Market Risk Capital Rule Revisions*. We support the incorporation of Basel 2.5 market risk standards into capital requirements for ANC broker-dealers, OTC derivatives dealers and nonbank SBSDs that use internal models, with a conforming adjustment to reflect that Basel 2.5 add-ons should not apply to assets for which the Commission already requires a firm to take a 100% haircut.

  - *VaR Model Standards and Application Process*. We request that the Commission adopt an expedited model review and approval process for models that have been approved and are subject to periodic assessment by the FRB or a qualifying foreign regulator.

  - *Standardized Market Risk Haircuts*. We suggest several modifications to the proposed standardized market risk haircuts for SBSDs that do not have approval to use internal models:

    - For cleared swaps and SBS (regardless of asset class), the capital charge should be based on the clearing organization's initial margin requirement, similar to the Commission's current treatment of futures in Appendix B of Rule 15c3-1.

    - For credit default swaps ("**CDS**"), we believe that the disparity between the proposed haircuts and capital charges derived from internal models is sufficiently wide to merit further review by the Commission of empirical data regarding the historical market volatility and losses given default associated with CDS positions.

    - For interest rate swaps, the capital charge should be calculated using solely the U.S. government securities grid, without the proposed 1% minimum haircut.

        - For transactions in highly liquid currencies, the capital charge should be based on the current haircuts for similar maturity commercial paper, bankers acceptances and certificates of deposit or U.S. government securities. The capital rules also should recognize offsets between foreign exchange transactions and swaps, SBS and securities forward transactions.

- ***Credit Risk Charges*.** We recommend that, in the case of an ANC broker-dealer or a stand-alone nonbank SBSD approved to use internal models, the Commission should not limit the use of a credit risk charge in lieu of a 100% deduction for uncollateralized receivables to SBS with a commercial end user.

- ***Capital Charge In Lieu of Margin*.**

    - *Third Party Custodian Deduction*. We strongly urge the Commission to eliminate its proposed 100% deduction for collateral held by a third-party custodian. Instead, the Commission should address any concerns it has regarding custodial arrangements directly through rules regarding the terms and conditions of such arrangements, for bank and nonbank SBSDs alike.

    - *Legacy Account Deduction*. We strongly urge the Commission to modify the proposed 100% deduction for undermargined legacy accounts by instead adopting either a credit risk charge or a credit concentration charge, with an exception permitting SBSDs to elect to exclude from accounts subject to the charge any currently uncleared positions in a type of SBS for which a clearing agency has made an application to the Commission to accept the SBS for clearing.

    - *Cleared SBS Deduction*. We request that the Commission eliminate the proposed 100% deduction for a shortfall between clearing agency minimum margin requirements and proprietary capital charges, and instead address any concerns regarding clearing agency minimum margin requirements directly through its regulation of clearing agencies.

- ***Liquidity Stress Test Requirements***. While we support enhancing liquidity requirements for financial institutions, we strongly urge the Commission to modify its proposed stress test requirements to align them with applicable Basel and FRB requirements, including by adopting an exception for firms subject to consolidated stress test requirements.

- ***OTC Derivatives Dealers*.** We request that the Commission modify its OTC derivatives dealer framework through conditional exemptions that would allow an OTC derivatives dealer to dually register as a stand-alone SBSD.

- ***SBS Brokerage Activities.*** A broker-dealer SBSD that is approved to use internal models should not be subject to the higher minimum capital requirements applicable to an ANC broker-dealer if it limits the scope of its brokerage activities to brokerage activity incidental to clearing SBS and accepting and sending customer orders for execution on a SBS execution facility.

MARGIN REQUIREMENTS

- ***Initial Margin Requirements*.** As noted above, mandatory initial margin requirements would replace potential exposure with actual exposure, reduce overall market liquidity, exacerbate pro-cyclical shocks and, if extended universally, place margin in the hands of entities not subject to prudential supervision. Accordingly, we strongly urge the Commission (as well as the CFTC and the Prudential Regulators) to focus on establishing a robust, two-way variation margin regime, while continuing to evaluate, in consultation with interested constituencies, including international regulators, effective methodologies to further mitigate systemic risk without causing the adverse impacts that would result from initial margin collection requirements

- ***Exceptions to the Margin Collection Requirement***. We request that the Commission make the following modifications to the exceptions to the margin collection requirement:

    - *Commercial End Users*. We request that the Commission make the definition of commercial end user for the margin exception consistent with the definition for the mandatory clearing exception, and the margin proposals of other U.S. and international regulators.

    - *Sovereign Entities*. We request that the Commission ensure that its treatment of sovereign entities is consistent with international standards.

    - *Affiliates*. We request that the Commission apply margin requirements to inter-affiliate transactions only when one of the affiliates is unregulated.

    - *Structured Finance or Securitization SPVs*. Where alternative security arrangements are in place, we request that SBS with a structured finance or securitization SPV be excluded from margin requirements. Furthermore, a SBSD's security interest in accordance with the SPV's governing documents should be considered a substitute for the collection of collateral and no capital charge for foregone margin should be required.

- ***Eligible Collateral*.** We support the Commission's proposed requirements regarding the scope of eligible collateral, except that we request that it clarify that the requirement that the SBSD maintain possession and control of the collateral should apply only to "excess securities collateral" as defined in its proposed segregation rules.

SEGREGATION REQUIREMENTS

- ***Omnibus Segregation Requirements*.** We generally support the Commission's proposed omnibus segregation requirements, but have identified a number of technical issues and questions that we believe merit further consultation by the Commission with interested constituencies.

- ***Individual Segregation Requirements.*** We request that the Commission clarify certain aspects of the individual segregation requirements, including who should receive the notice regarding the counterparty's right to elect individual segregation, the time at which a segregation election takes effect and the scope of transactions to which it applies.

- ***Segregation Requirements for Bank SBSDs***. For a SBSD that has a Prudential Regulator, we request that the Commission adopt an exception from segregation requirements, except those pertaining to the customer's right to elect individual segregation.

PHASED IMPLEMENTATION

- We request that the Commission provide a 24-month phase-in period for variation margin requirements, with a 12-month phase-in period for uncleared SBS between SBSDs.

- We also request that the Commission's proposed capital rules (other than the application of Basel 2.5) not take effect until the later of two years from the effective date of the Proposal's margin requirements or the effective date for Basel III's minimum capital requirements.

TABLE OF CONTENTS

DISCUSSION

I. CAPITAL REQUIREMENTS

The Commission has based its proposed capital requirements for nonbank SBSDs in large part on the existing capital requirements for securities broker-dealers. This differs from the "risk-weighted assets" approach applicable to U.S. and non-U.S. banks under Basel and to nonbank SD and MSP subsidiaries of U.S. bank holding companies under the CFTC's capital proposal.[8] Instead, the Commission has proposed requirements based on the pre-Basel broker-dealer net capital regime, a regime the Commission has previously recognized as imposing substantial costs on the operations of an OTC derivatives business and making it difficult for U.S. securities firms to compete effectively with banks and foreign dealers in OTC derivatives markets.[9]

As noted above, bank and nonbank SBSDs engage in essentially identical SBS activities and compete for the same customers. When the Commission has adopted rules that facilitate the conduct of OTC derivatives business in a broker-dealer – whether a limited-purpose OTC derivatives dealer or an alternative net capital ("**ANC**") broker-dealer **–** it has generally sought to align its rules more closely with those of the Prudential Regulators.[10] Doing so is even more critical here because nonbank SBSDs will also, in many cases, dually register as SDs with the CFTC, which has proposed capital requirements based on the Basel Accords; additionally, these dually registered entities will be subject to consolidated capital and risk management requirements consistent with the Basel Accords.

Inconsistencies with these requirements will lead to many significant practical issues and costs, particularly since the Commission and the CFTC have not established rules for determining which agency's rules are to apply to a dual registrant. Assuming that a firm would therefore need to simultaneously monitor for compliance with both agencies' rules, it would need to develop and maintain multiple, overlapping risk and recordkeeping systems, the costs of which would be substantial. Such a burden would not apply if the firm conducted its SBS business in a bank subsidiary or, perhaps, in a foreign affiliate, nor would it apply to its competitors that conducted their SBS business in such entities. As a result, inconsistent capital requirements could result in competitive distortions and undermine effective group-wide risk management.

In addition, if expanded to cover the swap activities of a dual registrant, the Commission's proposed minimum capital requirement and capital deductions would pose major operational and risk management challenges. The Commission has proposed to require, for instance, minimum capital equal to 8% of the initial margin required for *both* cleared *and* uncleared positions, as well as capital deductions for collateral held by third-party custodians and undermargined legacy accounts. The CFTC has not proposed such requirements. These

---

[8] *See* 76 Fed. Reg. 27,802 (May 12, 2011) (the "**CFTC Capital Proposal**") at 27,805-06.

[9] SEC Release No. 34-39454 (Dec. 17, 1997), 62 Fed. Reg. 67,940, 6,7941 (Dec. 30, 1997).

[10] *See id.* at 67,947; *see, also* SEC Release No. 34-62872 (Oct. 24, 2003), 68 Fed. Reg. 62,872, 62,874 (Nov. 6, 2003).

requirements, which are unnecessary and unwarranted for stand-alone SBSDs, would be particularly harmful for dual registrants if they applied to CFTC-regulated swap products. Applying the requirements in this way would encourage firms to divide their swaps and SBS portfolios into separate legal entities, which would weaken risk management, increase credit risk by reducing opportunities for contractual netting and increase operational risk.

In the following sections, we elaborate on these considerations in the context of specific aspects of the Proposal's capital requirements. We also suggest modifications to those requirements, which are intended to better address these considerations, as well as to align the Commission's proposed requirements more closely with those proposed by the CFTC and the Prudential Regulators.

A. Minimum Net Capital Requirement

Under the Proposal, the minimum net capital requirement for a nonbank SBSD would be the greater of a fixed dollar amount or a financial ratio, which would vary depending on whether the SBSD is also registered as a broker-dealer and whether it is authorized to use internal models to compute market and credit risk charges to capital. The fixed dollar amount would be either $20 million (for stand-alone SBSDs, whether using internal models or not, and for broker-dealer SBSDs that do not use internal models) or $1 billion (for ANC broker-dealers). The financial ratio would be either 8% of the firm's "risk margin amount"[11] (for stand-alone SBSDs) or the sum of that 8% margin factor and the financial ratio requirement for broker-dealers under Rule 15c3-1 (for broker-dealer SBSDs).[12] In addition, stand-alone SBSDs that use internal models would be required to have tentative net capital of at least $100 million, and ANC broker-dealers would be required to have tentative net capital of at least $5 billion (with an early warning level of $6 billion).[13]

We support the proposed fixed dollar minimums because they are consistent with existing requirements and practices for OTC derivatives dealers and ANC broker-dealers and have not, in our experience, proven to produce significant disparities with other capital regimes. We also support the adoption of an alternative capital requirement that is scalable to the volume, size and risk of a SBSD's activities. Applying a risk-based minimum capital requirement would be consistent with the safety and soundness and risk appropriateness standards mandated by Dodd-

---

[11] The "risk margin amount" would be defined as the sum of: (1) the greater of the total margin required to be delivered by the nonbank SBSD with respect to SBS transactions cleared for SBS customers at a clearing agency or the amount of deductions that would apply to the cleared SBS positions of the SBS customer pursuant to the applicable SEC capital rule and (2) the total margin amount calculated by the SBSD with respect to non-cleared SBS pursuant to the proposed new margin rule. Proposal § 15c3-1(c)(16); Proposal § 18a-1(c)(6). We assume that the Commission did not include proprietary cleared SBS positions within this definition because the nonbank SBSD is not responsible for customer collateral for those positions. We believe that a similar rationale supports excluding SBS transactions for which the nonbank SBSD has not collected collateral because an exception applies.

[12] Rule 15c3-1(a) requires a broker-dealer to apply one of two financial ratios: (a) 15-to-1 aggregate indebtedness to net capital or (b) 2% of the aggregate debit items in Exhibit A to Rule 15c3-3.

[13] "Tentative net capital" means net capital after making deductions for illiquid assets but before applying deductions for market and credit risk charges. *See* Rule 15c3-1(c)(15).

Frank and the Basel Accords. It also would maintain comparability to the requirements established by the CFTC and the Prudential Regulators.

However, as described in more detail below, we are very concerned that the proposed 8% margin factor is not appropriately risk-based. Accordingly, we have suggested two alternatives that would be tailored more effectively to the overall risk, rather than simply the volume, of a SBSD's activities: (a) for stand-alone SBSDs that use internal models and for ANC broker-dealers, a ratio based on a percentage of the entity's market and credit risk charges to capital, which would be similar to the minimum capital requirements adopted under the Basel Accords and the capital rules of the Prudential Regulators, and (b) for stand-alone and broker-dealer SBSDs that do not use internal models, a ratio based on a credit quality adjusted version of the proposed 8% margin factor. These alternatives are designed to satisfy several key principles for a sound minimum capital requirement that the SEC and SIFMA share. In particular, we believe that a minimum capital requirement should: (1) reduce leverage and increase with the risk of a registrant's activities; (2) be simple to administer, drawing from existing measures of the risks of a registrant's activities; (3) recognize the complementary nature of margin and capital; (4) be consistent with prudent risk management practices; (5) for dual registrants, be consistently applied across the full range of regulated activities and (6) for firms subject to consolidated capital requirements, be consistent with those requirements.

1. **<u>The Proposed 8% Margin Factor Is Not Risk-Sensitive</u>**

The Proposal explains that the amount computed under the 8% margin factor generally would increase as a SBSD increases the volume, size and risk of its SBS transactions.[14] This is true to some extent. The larger the net position a SBSD has with a particular customer, and the more customers it has, the more initial margin it would be required to collect. There are, however, several respects in which the 8% margin factor would not be risk-sensitive. Specifically, as described in more detail below, it would not take into account offsets between uncleared positions with different customers within a well-managed dealing portfolio, interrelationships between a SBSD's SBS positions and its other positions, credit diversification, variations in creditworthiness across customers or the complementary relationship between margin and capital. It also is not calibrated to the margin levels that will be required for SBS, nor is it consistent with capital requirements that will apply at the holding company level. As a result, it would not align with prudent risk management practices or efficient capital allocation, would tend to increase concentration and barriers to entry in the SBS markets and would render nonbank SBSDs uncompetitive vis-à-vis bank SBSDs and foreign SBSDs.

a. **<u>The 8% Margin Factor Overestimates the Risk of a Dealing Portfolio</u>**

It is important to note the distinction between a dealing business and a clearing brokerage business. A dealer takes principal positions and is exposed to the market risk of those positions. In contrast, a clearing broker (such as an FCM) acts as an agent and guarantor of its customers in

[14] Proposing Release at 70,223.

connection with their cleared positions. A clearing broker is not generally exposed to the market risk of those positions unless a customer fails to post collateral. Because it is directly exposed to the market risk of its customer positions, a dealer, as opposed to a clearing broker, typically runs its business so that its customers positions offset each other or are otherwise offset. As a result, the volume, size and risk of a SBSD's overall portfolio is not merely a function of the number of SBS customers it has, the size of its SBS positions with a given customer or even the risk of individual positions. Even if a SBSD's positions are spread across a large number of customers, the *net* risk of these positions may be relatively small if the SBSD has effectively minimized the market risk of its overall portfolio. When such a SBSD has obligations to one set of customers, another set of customers will have obligations to it.[15] Recognizing these characteristics of dealing activity is critical to preserving the ability for SBSDs to provide liquidity to other market participants by making markets.

The 8% margin factor would not, however, distinguish between a dealer with a non-directional portfolio and another entity with a much riskier directional portfolio concentrated on one side of the market. This is because initial margin is calculated and collected by a SBSD on a gross basis across its customers. A SBSD that has exactly offsetting long and short positions with two different customers would still be required to collect initial margin from each of those customers. This requirement is based on the fact that initial margin is intended to protect the SBSD from its potential future credit exposure to each of those customers. Capital, on the other hand, is intended to address the full range of credit, market and other financial risks to which a SBSD is subject. Yet, because the 8% margin factor effectively conflates initial margin with capital, it would require a SBSD with exactly offsetting positions with two counterparties to hold the same level of capital as an entity with two non-offsetting positions with the same two counterparties.

In addition, many SBSDs, particularly those that use internal models, engage in business lines other than SBS dealing. These other business lines include dealing in securities and securities options, dealing in swaps, trading in futures and engaging in securities finance activities. In particular, SBS dealing is typically conducted as part of an integrated credit or equities business that involves both single-name and index swaps, securities options and cash trading activities. The 8% margin factor would not be sensitive to the overall level of risk arising from these business activities. In particular, it would not recognize natural market risk offsets between SBS and non-SBS positions; indeed, except to the extent portfolio margining is permitted, it would not even recognize such offsets within a portfolio of transactions between a SBSD and a single customer.

As a result, the proposed 8% margin factor would be inconsistent with prudent risk management practices and other aspects of the net capital rule, particularly for SBSDs that use internal models, which recognize market risk offsets. Any capital or risk management benefit

[15] Although we recognize that the SBSD's ability to meet its obligations to in-the-money customers depends on it prudently managing its credit risk to out-of-the-money customers, we do not regard the 8% margin factor as an effective means for addressing credit risk. Rather, as discussed below, the 8% margin factor is not sensitive to credit risk, nor would it be consistent with prudent credit risk management practices.

achieved from offsetting the market risk arising from a position with one customer would need to outweigh the increase in capital and margin that would be required if the SBSD's hedge increased its net position with another customer.

b. <u>The 8% Margin Factor Is Not Consistent With Prudent Credit Risk Management Practices</u>

In addition to overestimating the risk in a well-managed dealing portfolio, there are several respects in which the 8% margin factor would be inconsistent with prudent credit risk management practices. First, the 8% margin factor would not take into account the complementary relationship between margin and capital: the more margin a firm collects from a customer, the less capital the firm should need to hold to absorb potential losses arising from its exposure to that customer. In addition, because the same 8% factor would be applied to all customers, it would ignore variation in creditworthiness and would in fact discourage the separate evaluation of each counterparty's creditworthiness, a key objective of prudent risk management.

To illustrate these issues, we have prepared the below example, which compares the amount of capital that would be required by the 8% margin factor against the amount that would be required by Basel II, each as applied to a particular trade for which the initial margin requirement is $113,126,[16] and with a set of hypothetical customer exposures that vary based on whether the SBSD has collected variation margin and by the creditworthiness of the customer:

Variation Margin Collected from Customer			
Customer Credit Rating	8% of Initial Margin ("**IM**")	Capital Required under Basel II	Ratio of 8% of IM to Basel II Capital
A	$9,050	$103	87.9
BBB	9,050	175	51.7
BB	9,050	440	20.6

Variation Margin Not Collected from Customer			
Customer Credit Rating	8% of IM	Capital Required under Basel II	Ratio of 8% of IM to Basel II Capital
A	$9,050	$3,309	2.83
BBB	9,050	5,561	1.63
BB	9,050	13,645	0.66

As this example illustrates, for collateralized customer exposures, the 8% margin factor produces minimum capital requirements that are significantly and unnecessarily higher than equivalent risk-weighted capital requirements. This is because of the complementary relationship between margin and capital: when a firm collects variation margin, its remaining credit risk is significantly reduced. In contrast, for uncollateralized exposures to customers that are less creditworthy, the 8% margin factor may not require enough capital. By ignoring these

[16] This example assumes that the initial margin of the trade equals the loss that would be experienced from an adverse 10-day spread move at the 99% confidence level.

differences, the 8% margin factor would be inconsistent with prudent credit risk management practices, and would not incentivize prudent practices, such as seeking more creditworthy customers and collecting additional collateral from less creditworthy customers.

Additionally, the 8% margin factor would effectively reward concentration and penalize diversification of counterparty exposures. This is because, as noted above, initial margin is collected by a SBSD on a gross basis across customers. As a result, a SBSD that seeks to diversify its credit exposures by trading with a wider range of customers would face higher capital requirements than one that had concentrated exposures to fewer customers. Not only would this be inconsistent with prudent risk management practices by a particular SBSD, but it would also distort competition within the market as a whole. New entrants to the market, whether customers or other SBSDs, would find it more difficult to locate SBSDs willing to establish trading relationships with them because of the additional capital those relationships would require above and beyond the exposures they generate. Even established market participants would face less competitive pricing because the 8% margin factor would discourage SBSDs that did not already have well-established portfolios with them from competing aggressively for their business. Significantly, this facilitation of market concentration would run counter to financial stability objectives.

c. The 8% Margin Factor Is Not Appropriately Calibrated to Initial Margin Levels for Swaps or SBS

As the Proposal observes, the 8% margin factor is similar to an existing requirement in the CFTC's net capital rule that requires FCMs to maintain minimum adjusted net capital in excess of 8% of the risk margin for futures, options and cleared OTC derivatives.[17] This requirement was developed based on the CFTC's analysis of the futures markets.[18] Applying it to the SBS markets would, again, overestimate (and in some cases underestimate) risks and fail to account for the complementary relationship between margin and capital.

As the Commission notes, because exchange-traded futures are generally more liquid and have lower margin levels than non-cleared SBS with the same notional amount, the proposed 8% margin factor (which includes margin for both cleared and non-cleared SBS) would require substantially more capital to support a non-cleared SBS contract than a futures contract.[19] Beyond this, however, the Commission has not quantified the impact of applying the 8% margin factor to SBS. Additionally, when the CFTC expanded its existing 8% margin factor in 2009 to

[17] CFTC Rule 1.17.

[18] Specifically, prior to 1998, FCMs were required to maintain adjusted net capital greater than 4% of their segregated funds. In 1998, several futures exchanges established the 8% margin factor as a more risk-based substitute for that requirement. In 2001, the CFTC staff conducted a study comparing the 8% margin factor to the 4% of segregated funds requirement as applied to the 190 FCMs then registered. CFTC Division of Trading and Markets, "Review of SRO Risk-Based Capital Requirement and Comparison to the Commission's Minimum Net Capital Requirements" (Apr. 2001). That study served as the basis for the CFTC's adoption of an 8% margin factor for futures in 2004. 69 Fed. Reg. 49,784 (Aug. 12, 2004).

[19] Proposing Release at 70,310.

include cleared OTC derivatives,[20] it did not conduct any empirical analysis as to whether the 8% factor was appropriate, given the level of initial margin collected for OTC derivatives. Nor did the CFTC conduct such an analysis before proposing to apply the 8% margin factor to dually registered FCM-SDs as part of the CFTC Capital Proposal in 2011.

The difference in margin levels between futures, on the one hand, and swaps or SBS, on the other, can be quite substantial. We have illustrated the difference through the comparison below of a simple portfolio of two offsetting cleared interest rate swaps against a similar portfolio of Treasury note futures:[21]

	10-Year Cleared Interest Rate Swaps[1]				
	Client	**Direction**	**DVO1[2]**	**Notional**	**Estimated Client IM**
Client #1 ⇨	#1	Long	$100,000	$111,070,000	$3,872,355
Client #2 ⇨	#2	Short	(100,000)	111,070,000	5,208,839
	Aggregate	**Flat**	**0**	**222,140,000**	**9,081,194**

	10Y US Treasury Futures				
	Client	**Direction**	**DVO1[2]**	**# of Contracts[3]**	**Estimated Client IM[4]**
Client #1 ⇨	#1	Long	$100,000	1,211	$1,332,100
Client #2 ⇨	#2	Short	(100,000)	1,211	1,332,100
	Aggregate	**Flat**	**0**	**2,422**	**2,664,200**

1. **10-year $100 Million interest rate swaps (2.09% fixed rate)**
2. **DVO1 measures the dollar value of a one basis point change in interest rates**
3. **Contract Size is $100,000 in notional**
4. **Margin Limit per contract is $1,100**

As this comparison demonstrates, the initial margin required for a simple cleared swap portfolio can be more than three times greater than the initial margin required for a futures portfolio of comparable risk. Normally, a higher margin requirement for a portfolio of comparable risk would tend to decrease capital requirements, since the additional collateral reduces a firm's exposure and is thus a complement to capital. However, because the 8% margin factor is not calibrated to reflect the greater level of initial margin required for swaps or SBS, it

[20] 74 Fed. Reg. 69,279 (Dec. 31, 2009).

[21] We have chosen to compare interest rate swaps to Treasury note futures because they are examples for which there is readily available data for initial margin levels across an OTC derivative and a futures contract that have similar risk profiles.

simply scales upward, resulting in capital requirements that are disproportionate to the level of risk involved.

2. SIFMA's Proposed Minimum Capital Requirements

In light of the considerations described above, SIFMA recommends that the Commission adopt two alternatives to the proposed 8% margin factor that would more effectively be tailored to the risk presented by a SBSD's activities: (a) for stand-alone SBSDs that use internal models and ANC broker-dealers, a ratio based on a percentage of the entity's market and credit risk charges to capital and (b) for stand-alone and broker-dealer SBSDs that do not use internal models, a ratio based on a credit quality adjusted version of the proposed 8% margin factor.

In designing these alternatives, we have sought to create capital requirements that align with prudent risk management practices for each category of firms, yet retain the benefits of the 8% margin factor. Compared with estimated capital requirements derived from the Proposal's approach, our alternatives would establish capital requirements that are better correlated to the risk of a firm's activities and more consistent with the capital requirements of the CFTC and the Prudential Regulators. Therefore, consistent with the statutory mandate for the agencies to adopt consistent capital requirements to the maximum extent practicable, our alternatives would foster a more harmonized approach to risk management across corporate structures and between regulated entities that engage in similar activities. At the same time, the alternatives would maintain important characteristics of the 8% margin factor. In particular, they would still reduce a SBSD's leverage and increase its required capital with the volume of its activities, while being relatively simple to administer.

In addition, we have designed these alternatives to be appropriate to the differences between firms that do, and those that do not, use internal models. Stand-alone SBSDs that use internal models and ANC broker-dealers are more likely to have multiple business lines than are SBSDs that do not use internal models. As a result, it is more important for the minimum capital requirement for these firms to take into account the interrelationships between SBS and non-SBS activities. Such firms are also more likely to be subject to the Basel Accords on a consolidated basis, making it more important that their minimum capital requirement be consistent with the Basel Accords. Otherwise, there will be distortions in the way in which such firms allocate capital among their subsidiaries, since the level of capital that they are required to have at the holding company level for a particular subsidiary would be inconsistent with the level required at the subsidiary level.

SBSDs that do not use internal models, on the other hand, could not readily apply a capital requirement based on a percentage of their market and credit risk charges because those charges are of necessity blunt instruments that tend to overstate the risk of their activities. For those firms, a modified version of the 8% margin factor would scale more accurately to the size, volume and risk of their activities.

a. Stand-alone SBSDs Using Internal Models and ANC Broker-Dealers: Risk-Weighted Minimum Capital Requirement

For stand-alone SBSDs that use internal models and ANC broker-dealers, we suggest that the Commission adopt an adjustable minimum capital requirement equal to a specified percentage of an entity's market and credit risk charges.

This minimum capital requirement is designed to scale directly to the risk of the entity's overall activities, providing a buffer for those instances under which applicable deductions may not, in all circumstances, fully cover the losses that might arise from a particular position or exposure. It also would limit leverage because, as the entity's credit risk charges increase, so would its minimum capital requirement. It would be relatively simple to administer, since it would be based on the market and credit charges that will already be a part of the entity's net capital computation. As a result, it would not require the Commission to determine how to apply and interpret the Basel Accords.

Concurrently, such a risk-weighted capital requirement would generally be based on market and credit risk charges calculated using the same internal models used by the entity's parent to compute its consolidated capital requirements for those activities. Thus, as those models dictate that the entity's holding company increase its minimum capital because of an increase in the risk of its portfolio, they also would dictate an increase in minimum net capital for the entity itself. Consequently, it would promote integrated group-wide risk management and reduce incentives for regulatory arbitrage within a holding company group.

In addition, because the risk-weighted capital requirement would take into account risks across all of an entity's trading activities, not just SBS or securities, it could be applied uniformly across registration categories. Thus, the same uniform minimum capital requirement could apply under the Commission's broker-dealer and SBSD capital rules and the CFTC's FCM and SD capital rules.

We have prepared the below example to illustrate how an entity would calculate its net capital under the risk-weighted approach. This table shows (1) the total amount of the entity's regulatory capital (*i.e.*, its equity capital and subordinated debt), (2) the deductions the entity would take for illiquid assets and operational charges (which results in the entity's tentative net capital), (3) the deductions the entity would take for market and credit risk charges (which results in the entity's net capital), (4) the calculation of the entity's minimum capital requirement as a percentage of market and credit risk charges and (5) the entity's excess net capital over its minimum capital requirement:[22]

[22] This example is solely illustrative, although it is based on a rough approximation of the capital position of a large firm based on members' experiences. All numbers are in millions of dollars.

Illustration of SIFMA's Proposed Risk-Weighted Approach

Equity Capital	$7,500
Subordinated Debt	7,500
Total Regulatory Capital	15,000
Operational Charges	(100)
Un-admitted Assets	(900)
Securities with 100% Haircuts	(3,000)
Tentative Net Capital	11,000
Market Risk Charges	(2,000)
Credit Risk Charges	(2,000)
Net Capital	7,000
Market Risk Haircuts	2,000
Credit Risk Capital Charges	2,000
Base for Computation	4,000
Multiplier	x 12.5%*
Minimum Capital Requirement	500
Excess Net Capital	6,500

***This 12.5% multiplier is solely illustrative**

We note that, in the Proposal, the Commission suggested that a minimum capital requirement of 25% of the firm's market risk deductions could better scale the requirement to the risk of the proprietary positions held by the SBSD.[23] The above illustration, in turn, uses a 12.5% multiplier applied to the firm's market risk *and* credit risk charges, although for illustrative purposes only. However, we emphasize that both the multiplier and the scope of the charges to which it applies should not be chosen arbitrarily.

In particular, we observe that the multiplier should be set at a level that, depending on the market and credit risk framework, would be consistent with the U.S. implementation of Basel III, which is proposed to apply a 12.5% multiplier against risk-weighted assets.[24] Although the market and credit risk multiplier and the Basel multiplier would be applied to different amounts (total of market and credit risk charges or risk-weighted assets, respectively), the market and credit risk multiplier could be calibrated to create similar capital requirements for bank SBSDs and nonbank SBSDs vis-à-vis their overall activities. At the same time, the Commission's overall net liquid assets standard would be maintained, with full 100% capital charges applied to

[23] Proposing Release at 70,309.

[24] 77 Fed. Reg. 52,792 (Aug. 30, 2012).

illiquid assets.[25] The Commission's fixed dollar minimum capital requirements would also apply, which would provide a floor for the minimum capital requirement.

In addition, the minimum capital requirement should be designed to apply where, given the framework for market and credit risk deductions, an additional capital buffer might be necessary. In particular, where the net capital rule already applies a 100% deduction to net worth for a particular position or exposure, the maximum potential loss is already accounted for by the rule, and no buffer should be necessary. In this regard, we note that the Proposal would apply several additional 100% deductions, most notably for undermargined accounts (other than the SBS accounts of commercial end users), collateral held at a third-party custodian and legacy SBS accounts. Including these deductions within the base for any minimum capital requirement – whether it be the 8% margin factor or our proposed risk-weighted minimum capital requirement – would double-count those exposures, requiring a SBSD to hold capital equal to more than 100% of its potential losses.

Moreover, these deductions would significantly increase the level of capital required for a nonbank SBSD to conduct its activities, in effect already providing a substantial buffer above and beyond the estimated potential risk of those activities. In this connection, whether a particular multiplier is appropriate should be based on whether the minimum capital requirement it produces, when taken cumulatively with applicable deductions, produces an overall level of capital that is proportional to the risk of the firm's overall business and economical to the conduct of that business. Accordingly, in our view, the amount of the buffer provided by the minimum capital requirement should vary inversely to the level of capital required by other aspects of the SBSD capital rules (*e.g.,* 100% deductions, if any, ultimately adopted by the Commission), and based on an empirical analysis of the level of capital required to support the business after taking into account those deductions. We would be pleased to work with Commission staff to facilitate such an analysis.

b. Stand-alone SBSDs and Broker-Dealer SBSDs Not Using Internal Models: Credit Quality Adjusted Minimum Capital Requirement[26]

As discussed above, the 8% margin factor is inconsistent with prudent credit risk management practices. In addition, it would double-count exposures for which the SBSD is already applying a 100% capital charge in lieu of margin, requiring a SBSD to hold capital equal to 108% of an exposure. To address these issues for stand-alone SBSDs that do not use internal

[25] Because the entity would already be required to maintain net capital equal to the full market value of those assets and could not suffer losses greater than the level of capital it already holds for those assets, it should not need to include the 100% capital charges it has already taken against those assets in any calculation of additional required capital. The entity also should not be required to include any operational charges, nor the new charge that the Commission has proposed to apply for collateral held at a third-party custodian, should it be adopted.

[26] If the Commission decides not to adopt the proposed risk-weighted capital requirement for stand-alone SBSDs that use internal models and ANC broker-dealers, then we suggest that it apply this requirement to the SBS activities of those entities, too.

models, we suggest that the Commission adopt an adjustable minimum net capital requirement computed by modifying the 8% margin factor to adjust for the creditworthiness of customers and to take into account other mitigants to the SBSD's exposures. For broker-dealer SBSDs that do not use internal models, we suggest that this requirement apply in addition to the existing broker-dealer financial ratio requirement.

First, we urge the Commission to exclude from the risk margin amount[27] any amounts for SBS transactions for which the SBSD does not hold customer collateral because an exception applies. This modification would prevent double counting exposures for which the SBSD is already applying a 100% capital charge in lieu of margin. In addition, it would exclude other instances, such as when the customer has waived protection of its collateral, for which there is no customer protection objective to be served by requiring a SBSD to hold additional capital. In this regard, we note that the traditional purpose of the 8% margin factor has been to supplement requirements to safeguard customer property.[28]

We also urge the Commission to adjust the risk margin amount for any given customer by applying a credit against that amount for excess collateral collected by the SBSD and then multiplying the resulting amount by the credit risk weight for that customer under Appendix E of Rule 15c3-1. Adjusting the risk margin amount to account for excess collateral and creditworthiness would be consistent with prudent credit risk management practices by rewarding the collection of excess collateral and penalizing exposures to less creditworthy customers. Applying these adjustments would also help account for the higher margin requirements applicable to SBS transactions.

The following table illustrates how a firm would calculate minimum net capital under our credit quality adjusted approach for exposure to a hypothetical customer subject to a 0.2 risk weighting under Appendix E:

[27] As discussed in more detail below, it would not be appropriate, in our view, to require SBSDs to compute their capital, either for purposes of determining the risk margin amount or applying capital charges, based on the greater of the total margin required to be delivered by the nonbank SBSD with respect to SBS transactions cleared for SBS customers at a clearing agency or the amount of deductions that would apply to the cleared SBS positions of the SBS customer pursuant to the applicable SEC capital rule. Rather, solely the total margin required to be delivered should be relevant.

[28] *See* 68 Fed. Reg. 40,835 (July 3, 2003) (describing the CFTC's minimum capital requirement as intended to provide protection to customers by requiring FCMs to maintain a minimum level of assets that are readily available to be contributed to cover a shortfall in segregated customer funds).

Illustration of SIFMA's Proposed Credit Quality Adjusted Approach

Risk Margin Requirement	$1,000,000
Less: Margin Exceptions	(250,000)
Less: Excess Collateral	(250,000)
Adjusted Risk Margin Requirement	500,000
Credit Weight Multiplier	x 0.2
Credit-Adjusted Margin Requirement	(100,000)
8% Risk Margin Factor	x 8%
Minimum Capital Requirement	8,000

Finally, these modifications would also, in our view, be appropriate for swap dealing activities. Accordingly, an entity that is dually registered as a SBSD and an SD could apply a minimum capital requirement equal to the sum of this credit quality adjusted risk margin factor for swap and SBS transactions.

➢ ***Recommendation:*** *SIFMA recommends that the Commission adopt two alternatives to the proposed 8% margin factor that would more effectively be tailored to the risk presented by a SBSD's activities: (a) for stand-alone SBSDs that use internal models and ANC broker-dealers, a ratio based on a percentage of the entity's market and credit risk charges to capital and (b) for stand-alone and broker-dealer SBSDs that do not use internal models, a ratio based on a credit quality adjusted version of the proposed 8% margin factor.*

B. Market Risk Charges

1. Adoption of Banking Agencies' Market Risk Capital Rule Revisions

On June 7, 2012, the OCC, the FDIC and the FRB (collectively, the "**Banking Agencies**") approved revisions to their market risk capital rules intended to implement Basel 2.5.[29] These revisions enhance the use of financial models for capital purposes by adding (i) a stressed value-at-risk ("**VaR**") capital requirement, (ii) further specific risk "add-on" capital requirements, including for certain securitization positions that are not correlation trading positions, (iii) an "incremental risk" capital requirement for a bank that measures the specific risk of a portfolio of debt positions using internal models, where incremental risk consists of the risk of default and credit migration risk of a position, (iv) a "comprehensive risk" capital requirement relating to the measurement of price risk for correlation trading positions, where the comprehensive risk measure is based on a combination of modeled price risk and a specific risk add-on and (v) a capital requirement for *de minimis* exposures. The Proposal seeks comment on

[29] *See* 77 Fed. Reg. 53,059 (Aug. 30, 2012).

whether these revisions should be incorporated into the capital requirements for ANC broker-dealers, OTC derivatives dealers and nonbank SBSDs that use internal models.[30]

SIFMA generally supports the incorporation of these Basel 2.5 market risk standards into the capital requirements for all ANC broker-dealers, OTC derivatives dealers and nonbank SBSDs that use internal models. Adoption of these standards would promote consistent capital requirements across different subsidiaries for institutions affiliated with banks that already are subject to Basel 2.5. It would also prevent firms not subject to Basel 2.5 from gaining a competitive advantage over those that are subject to Basel 2.5.[31]

However, we believe that one modification to the Basel 2.5 market risk standards is necessary in order to apply them to ANC broker-dealers, OTC derivatives dealers and nonbank SBSDs. Unlike banks, these entities are required, consistent with the net liquid assets approach of Rule 15c3-1, to apply 100% deductions to their net capital for certain illiquid assets. These assets include some of the assets that would be subject to capital add-ons under Basel 2.5. In our view, the Commission should not apply a Basel 2.5 add-on to assets for which the Commission already requires a firm to take a 100% haircut, because the 100% haircut already covers the maximum possible loss.

➢ ***Recommendation:*** *The Commission should incorporate Basel 2.5 market risk standards into capital requirements for ANC broker-dealers, OTC derivatives dealers and nonbank SBSDs that use internal models, with a conforming adjustment to reflect that the Commission should not apply a Basel 2.5 add-on to assets for which the Commission already requires a firm to take a 100% haircut.*

2. VaR Model Standards and Application Process

The Proposal would permit a nonbank SBSD to use internal VaR models to compute deductions for proprietary securities positions, including SBS positions, in lieu of standardized haircuts, subject to an application to, and approval by, the Commission and satisfaction of qualitative and quantitative requirements set forth in Appendix E of Rule 15c3-1.[32] SIFMA supports this aspect of the Proposal.

In addition, the Proposal seeks comment on whether there are ways to facilitate the timely review of applications from nonbank SBSDs to use internal models if a large number of applications are filed at the same time, such as by using a more limited review process if a banking affiliate of a nonbank SBSD has been approved by a Prudential Regulator to use the same model the nonbank SBSD intends to use.[33]

---

[30] Proposing Release at 70,230.

[31] In this regard, we note that the Banking Agencies' revisions incorporate standardized approaches for firms where they are not able to undertake additional model-based computations.

[32] Proposal § 18a-1(d).

[33] Proposing Release at 70,240.

We support the adoption of a more limited review process for applications pertaining to internal models that have already received approval by a Prudential Regulator or a qualifying foreign regulator, as described further below.[34] The Commission estimates that nonbank SBSDs will include 10 ANC broker-dealers and 6 stand-alone SBSDs that use internal models.[35] Since there are currently 6 ANC broker-dealers, this estimate suggests that the Commission expects to receive applications to use internal models from 4 new ANC broker-dealers and 6 stand-alone SBSDs; existing ANC broker-dealers may also seek to expand the range of products for which they are approved to use internal models. In our experience, the application process requires a significant investment of firm and Commission staff resources over several months, particularly when the staff is evaluating multiple applications simultaneously. In addition, requiring firms to comply with the new capital and margin requirements before their initial application process is complete would place them at a severe competitive disadvantage. As a result, an expedited review process would help facilitate timely implementation of those requirements.

To ensure that the models approved through the expedited review process are rigorous and reliable, we suggest that the Commission apply several conditions to their approval: (1) the model must be approved by (a) the FRB or (b) a foreign regulator that has adopted a capital regime in accordance with the Basel Accords and whose implementation of the Basel Accords yields risk-weighted assets that are comparable to the U.S. implementation of the Basel Accords, based on the findings of the Basel Standards Implementation Group (such foreign regulator, a "**qualifying foreign regulator**"); (2) the FRB or qualifying foreign regulator requires the SBSD's holding company to maintain uniform policies, procedures and governance requirements relating to the use of models across all the subsidiaries within its holding company group; and (3) the SBSD's use of internal models is subject to (a) prior approval by the FRB or qualifying foreign regulator of any new models or material changes to existing models, (b) notification to the FRB or qualifying foreign regulator of any non-material changes to existing models, (c) periodic assessment by the FRB or qualifying foreign regulator and (d) remediation of any material weaknesses identified by the FRB or qualifying foreign regulator. Once a model had received Commission approval based on a full, non-expedited review process, it would no longer be subject to these conditions. Consistent with the existing ANC broker-dealer capital rules, we understand that the Commission will closely examine backtesting exceptions when considering whether to approve or disapprove models approved by foreign regulators.

➢ ***Recommendation:*** *The Commission should adopt an expedited model review and approval process for models that have been approved and are subject to periodic assessment by the FRB or a qualifying foreign regulator.*

[34] We note that such a process would be similar to the CFTC's proposal to rely on models approved by the FRB or the SEC. CFTC Capital Proposal § 23.103(e).

[35] Proposing Release at 70,293. We note that this estimate does not appear to account for the possibility of foreign entities registering with the Commission and, therefore, may be too low.

3. Standardized Market Risk Haircuts

Under the Proposal, a nonbank SBSD (both stand-alone and broker-dealer) that does not have approval to use internal models would be required to apply standardized market risk haircuts to its swap and SBS positions. These haircuts, which are based on modified versions of the haircuts applicable under current Rule 15c3-1, are generally calculated by applying a multiplier to the notional amount of the relevant swap or SBS, subject to reductions in specified cases in which the swap or SBS position offsets or is offset by a related position.

The Proposal requires a SBSD to protect itself against credit exposure by collecting initial and variation margin for its SBS transactions, with initial margin intended to ensure the performance or close-out of a contract without loss to the SBSD. If a SBSD fails to collect the required amount of margin, it generally must take a capital charge equal to the amount of the margin deficiency. In this way, credit risk is already addressed by the Proposal. The Proposal's capital requirements for market risk, on the other hand, are intended to ensure that a SBSD has sufficient capital to absorb market losses on its principal positions. Because credit risk is already accounted for, there is no need to apply haircuts in excess of expected potential market losses.

SIFMA has extensive experience with the Commission's methodologies for computing capital requirements to account for market risk. While we recognize that standardized haircuts are blunt instruments that overstate risks, we believe that, for a number of commonly assumed hedged positions, the disparities between model-based capital requirements and capital requirements generated from standardized haircuts are wide enough to merit the Commission's review and revision of its standardized haircut requirements. Similarly, given that the CFTC Capital Proposal would apply a different set of haircuts, based largely on Basel I, we believe that it is critical for the Commission to coordinate its rules with the CFTC to ensure a consistent set of haircuts for dual registrants. As noted previously in this letter, it would not be justifiable for a dual registrant to be subject to inconsistent capital requirements for the same positions.

Accordingly, in the following sections, we have suggested ways to modify the proposed standardized haircuts to better reflect the risk in a derivatives portfolio.

a. Cleared Swaps and SBS

The primary reason why a firm would be subject to the net capital rule's standardized haircuts is because it has not developed, or received approval for, internal models. In such a case, however, we believe that it would be appropriate for the firm to use external models that have been approved. The Commission has already recognized this approach implicitly in Appendix B of Rule 15c3-1, which bases a broker-dealer's haircut for futures positions on the maintenance margin requirement of the relevant exchange. Futures exchanges typically use risk-based models, including VaR models, to calculate maintenance margin requirements. Consistent with this approach, for cleared swaps and SBS (regardless of asset class), we suggest that the broker-dealer and SBSD capital rules be modified to apply a capital charge based on the clearing organization's initial margin requirement, similar to the Commission's current treatment of futures in Appendix B of Rule 15c3-1.[36]

Because clearing organizations typically use risk-based models to calculate initial margin requirements, applying the Appendix B methodology to cleared swaps and SBS would allow those firms that are not eligible to use internal models nonetheless to use risk-based models to calculate minimum net capital. In addition, clearing organizations incorporate a liquidation time assumption into initial margin requirements for cleared swaps and SBS that is longer than what is used for futures contracts. In this way, differences in the liquidity profiles of futures contracts, on the one hand, and cleared swaps and SBS, on the other, are already addressed by the clearing organization's initial margin requirement.

- ***Recommendation:*** *For cleared swaps and SBS, the Commission should apply a standardized capital charge based on the clearing organization's initial margin requirement, similar to the treatment of futures in Appendix B of Rule 15c3-1.*

b. Credit Default Swaps

The Proposal would apply standardized haircuts to CDS using a "maturity grid" approach based on two variables: the length of time to maturity of the CDS and the amount of the current offered basis point spread on the CDS.[37] The deduction for an unhedged long position in a CDS (*i.e.*, when the broker-dealer or nonbank SBSD is the buyer of protection) would be 50% of the applicable deduction in the grid. The Proposal also contains several scenarios under which long and short positions in the same or related products could be netted or a reduced deduction could be taken.

Based on our estimates, the haircuts specified in the Proposal's maturity grids would be significantly greater than the capital charges that would apply to the same positions using a VaR model in accordance with Appendix E of Rule 15c3-1. We have illustrated this difference through the below chart, which compares the proposed haircuts with the VaR capital charge[38] for three long positions in single-name corporate CDS with a maturity of 5 years and spreads of 100 or less, 101-300 and 301-400.

---

[36] Rule 15c3-1b. Applying this methodology to cleared swaps and SBS would require broker-dealers and SBSDs to take the following deductions from net worth: (1) for firms that are members of the clearing organization, deduct the clearing organization's initial margin requirement and (2) for other firms, deduct 200% of the clearing organization's initial margin requirement. In both cases, the deduction would be reduced by any overcollateralization for the swap or SBS, if such overcollateralization is not otherwise included in net worth.

[37] Proposal § 15c3-1(c)(2)(vi)(O)(1); Proposal § 15c3-1b(b)(1)(i); Proposal § 18a-1(c)(1)(vi)(A); Proposal § 18a-1b(b)(1)(i).

[38] Consistent with Appendix E of Rule 15c3-1, this VaR capital charge is based on three times a VaR measure using a 99%, one-tailed confidence level with price changes equivalent to a ten-business-day movement in rates and prices.

Single-Name CDS Basis Point Spread	Proposed Standardized SEC Market Risk Haircut	Rule 15c3-1e VaR Capital Charge
55	4%	1.9%
218	7%	2.9%
323	15%	4.1%

We believe that this disparity between the proposed haircuts and VaR capital charges is sufficiently wide to merit further review by the Commission of relevant empirical data regarding the market risk associated with CDS positions. In particular, we believe that it would be relevant for the Commission to consider such factors as the historical volatility of CDS positions, the probability of default for CDS underliers and the recovery rates for CDS that have been triggered. SIFMA would be pleased to work with Commission staff to facilitate such a review.

➢ ***Recommendation:*** *In light of the wide disparity between the proposed haircuts and capital charges derived from internal models, we recommend that the Commission conduct further review of empirical data regarding the historical market volatility and losses given default associated with CDS positions.*

c. Equity SBS

The Proposal would apply haircuts for portfolios of equity SBS and related equity positions using the methodology set forth in Appendix A of Rule 15c3-1.[39] We support this proposal. As the Commission observes, using Appendix A would allow broker-dealer and nonbank SBSDs to employ a more risk-sensitive approach to computing net capital than if the position were treated in isolation. We also note that there are ongoing efforts to enhance Appendix A to take into account portfolio diversification, better recognize offsetting long and short positions across underlying values, and penalize portfolio concentration, which we support.

➢ ***Recommendation:*** *As proposed, the Commission should apply haircuts for portfolios of equity SBS and related equity positions using the methodology set forth in Appendix A of Rule 15c3-1.*

d. Interest Rate Swaps

The Proposal would apply haircuts for an interest rate swap equal to a percentage of the notional amount of the swap derived by converting each side of the interest rate swap into a synthetic bond position that would be placed into the standardized haircut grid in Rule 15c3-1 for U.S. government securities.[40] However, unlike for government securities, any synthetic bond equivalent that would be subject to a standardized haircut of less than 1% under this approach, including fully hedged positions, would be subject to a minimum deduction equal to a 1% charge against the notional value of the swap. This minimum haircut of 1% is designed to account for

[39] Proposal § 15c3-1a(a)(4); Proposal § 18a-1a(a)(4).

[40] Proposal § 15c3-1b(b)(2)(i)(C); Proposal § 18a-1b(b)(2)(i)(C).

potential differences between the movement of interest rates on U.S. government securities and interest rates upon which swap payments are based.[41]

SIFMA generally supports the application of the standardized haircut grid for U.S. government securities to interest rate swaps. However, we believe the proposed minimum 1% haircut is far too onerous. To illustrate the extent to which the proposed minimum would result in disproportionate capital charges if left unaddressed, we have created the following simple portfolio containing three interest rate swaps comprising $123 million in notional, of which $50 million is fully hedged:

Sample Interest Rate Swap Portfolio #1

Swap	Side	Type	Notional	Next Reset Date	Maturity
1	Receive	Floating 3-Month LIBOR	$70,000,000	12/27/2012	12/30/2020
	Pay	Fixed 3.857%	70,000,000		12/30/2020
2	Receive	Floating 3-Month LIBOR	18,000,000	01/03/2013	04/07/2021
	Pay	Fixed 3.9775%	18,000,000		04/07/2021
3	Receive	Fixed 3.556%	25,000,000	02/26/2013	02/28/2021
	Pay	Floating 3-Month LIBOR	25,000,000		02/28/2021

The below table compares the capital charges for this portfolio under the Proposal to those capital charges that would apply if an approach that is more consistent with the existing U.S. government securities grid were used instead. As this table illustrates, the 1% minimum haircut would result in a very significant increase in capital charges (roughly 45%), which in our view far outweighs the movement of the rates underlying interest rate swaps relative to the more volatile movement of the rates that drive the pricing of U.S. government securities.

(In 000's)			Capital Charge					
			Proposed Rule			Government Grid		
Maturity Category	Short	Long	Hedged @ 1%	(A) Unhedged	Total	Hedged @ 1%	(B) Unhedged	Total
Less than 3 months	$ 25,000	$ 88,000	$ 250	$ 630	$ 880	$ -	$ -	$ -
5 - 10 years	88,000	25,000	250	2,520	2,770	-	2,520	2,520
Grand Total	**$113,000**	**$113,000**	**$ 500**	**$ 3,150**	**$3,650**	**$ -**	**$ 2,520**	**$2,520**

(A) The haircut applied to the un-hedged positions under the proposed rule is 1% for the less than 3 months category and 4% for the 5 - 10 year category.

(B) The haircut applied to the un-hedged positions under the government grid is 0% for the less than 3 months category and 4% for the 5 - 10 year category.

41 Proposing Release at 70,249.

We have also estimated that, for a well-hedged dealing portfolio of $12.05 trillion gross notional with only $216 billion notional in directional risk, the proposed haircuts would require a firm to hold $123 billion in capital, of which over $119 billion results from the application of the proposed 1% minimum haircut to fully hedged positions. In comparison, the related VaR for the same portfolio would be significantly less. This disparity would effectively prevent broker-dealers and nonbank SBSDs that do not use internal models from dealing in interest rate swaps.

➢ ***Recommendation:*** *The Commission should eliminate the proposed 1% minimum haircut for interest rate swaps, and solely apply the existing U.S government securities grid.*

e. Foreign Exchange Transactions

Under the Proposal, the haircut for un-hedged foreign exchange transactions referencing the euro, British pounds, Canadian dollars, Japanese yen or Swiss francs, would be 6%.[42] In our view, this haircut does not reflect the deep liquidity of the foreign exchange markets, which, for the major currencies, are at least as liquid as markets for sovereign debt. At least for transactions in the top 13 deliverable currencies (by volume) described in the Bank for International Settlements' Triennial Central Bank Survey, Report on Global Foreign Exchange Market Activity,[43] we suggest that the Commission apply a haircut that is based on the current haircuts for similar maturity commercial paper, bankers acceptances and certificates of deposit under Rule 15c3-1(c)(2)(vi)(E). These haircuts are applied to the greater of the long or short position, and range from 0% for a maturity less than 30 days to 0.5% for a maturity between 271 days and 1 year. For a maturity beyond one year, the U.S government securities haircuts in Rule 15c3-1(c)(2)(vi)(A) should be applied. These haircuts would better reflect the deep liquidity of these foreign exchange markets.

In addition, we note that the Proposal's method for computing haircuts for foreign exchange transactions would only permit offsets between two foreign exchange transactions or between an open futures contract or commodity option and a foreign exchange transaction. However, firms commonly use foreign exchange transactions to hedge other positions. For instance, a firm with an equity swap position denominated in a foreign currency might use a foreign exchange derivative to hedge its foreign exchange exposure. Accordingly, we suggest that the Commission treat a foreign exchange transaction that is covered by an open swap, SBS or securities forward in the same manner as a foreign exchange transaction that is covered by an open futures contract or commodity option.

➢ ***Recommendation:*** *For transactions in highly liquid currencies, the Commission should apply a haircut based on the current haircuts for similar maturity commercial paper,*

[42] Proposing Release at 70,249.

[43] Those currencies are the U.S. dollar, Euro, Japanese yen, Pound sterling, Australian dollar, Swiss franc, Canadian dollar, Hong Kong dollar, Swedish krona, New Zealand dollar, Singapore dollar, Norwegian krone and Mexican peso.

bankers acceptances and certificates of deposit or U.S. government securities. It also should recognize offsets between foreign exchange transactions and swaps, SBS and securities forward transactions.

C. Credit Risk Charges

Under current Appendix E of Rule 15c3-1, an ANC broker-dealer or an OTC derivatives dealer is permitted to add back to its net worth uncollateralized receivables from counterparties arising from OTC derivatives transactions, and then take a credit risk charge based on the uncollateralized credit exposure to the counterparty instead of the 100% deduction for the receivable. Under the Proposal, however, an ANC broker-dealer, as well as a stand-alone nonbank SBSD approved to use internal models,[44] would only be permitted to apply a credit risk charge under Appendix E for a SBS with a commercial end user. All other uncollateralized or under-collateralized OTC derivatives exposures outstanding more than one business day, including exposures to commercial end users under swaps, would be subject to a 100% deduction from net capital.

We urge the Commission not to limit the circumstances in which a credit risk charge may be taken in lieu of a 100% deduction. Under Dodd-Frank, a firm will fail to collect margin in only one of two situations. In the first situation, a customer has failed to post margin even when required to do so. Requiring a firm to take a 100% deduction to net capital in this situation would immediately penalize it for an event that, in most cases, is only very temporary in nature. It effectively assumes that a customer will never post margin, when typically a delay is due to operational considerations that can be addressed in a matter of days. It also does not take into consideration that, if the customer's account remains undermargined for a longer period, the SBSD would typically act to liquidate the customer's positions. In this regard, we note that existing Rule 15c3-1 provides broker-dealers with five days to cure a margin deficiency, not one day. Even though we are not suggesting that a similar grace period be adopted for SBS, we do believe that a credit risk charge adequately addresses the risks of an undercollateralized position during the interim period before margin is posted. Therefore, a punitive 100% deduction is unnecessary.

In the second situation, a specific exception to the margin requirement applies. We discuss the exceptions proposed by the Commission in the following section. In addition, however, the CFTC has also proposed an exception from margin requirements for an SD trading with a non-financial entity.[45] Requiring a SBSD to hold additional capital for each dollar of margin it did not collect from a non-financial entity for a swap would effectively undermine that exception. It also would deter the dual registration of nonbank SBSDs as SDs. Neither of these consequences appears intended, nor consistent with the statutory mandate for the CFTC and the Commission to adopt consistent capital margin requirements to the maximum extent practicable. We cannot discern a clear policy basis for this distinction between swaps and SBS. Even taking into account the anticipated higher volume for swaps, we are aware of no empirical basis upon

---

[44] The Proposal does not address credit risk charges for OTC derivatives dealers.

[45] *See* 76 Fed. Reg. 23,732 (Apr. 28, 2011) at § 23.154.

which to conclude that counterparty credit risk charges are insufficient to account for the risk to the nonbank SBSD arising from its failure to collect margin. Accordingly, we urge the Commission to permit ANC broker-dealers and stand-alone SBSDs approved to use internal models to apply a counterparty credit risk charge in lieu of a 100% deduction for swaps with non-financial entities that qualify for an exception from CFTC margin requirements.

In addition, in Part II of this letter, we suggest that the Commission, if necessary to harmonize its rules with international standards, adopt exceptions to margin requirements for SBS with sovereigns, central banks and supranational institutions. We also suggest that the Commission adopt exceptions for SBS with certain affiliates to facilitate effective group-wide risk management. As with swaps or SBS with commercial end users, applying a 100% capital charge to undermargined accounts with these counterparties would undermine the exception. Accordingly, we also urge the Commission to permit ANC broker-dealers and stand-alone SBSDs approved to use internal models to apply a counterparty credit risk charge in lieu of a 100% deduction for swaps and SBS with sovereigns, central banks, supranational institutions and affiliates, to the extent that an exception to applicable margin requirements applies.

With respect to inter-affiliate swaps and SBS more generally, we strongly urge the Commission to permit firms a one-day grace period before a capital charge will apply to an undermargined account, provided that the undermargined account is held for an entity that is subject to U.S. or comparable non-U.S. prudential regulation. We recognize that this approach would differ from the one the Commission has historically taken with respect to broker-dealers' intercompany exposures, for which there has been no grace period before a broker-dealer is subject to a capital charge. Implicit in the Commission's historical approach is a desire to assure that intercompany transactions are not used as a means to transfer value from a broker-dealer to an unregulated affiliate in a manner that would contravene restrictions on the withdrawal of capital from the broker-dealer. Inter-affiliate swaps and SBS, following Dodd-Frank, generally do not present this risk. For the first time, swap and SBS dealing activities will be required to be conducted in registered entities subject to capital requirements.

In the circumstance in which a SBSD is trading with such a regulated affiliate, applying an immediate capital charge before there is operationally a means for transferring collateral to a SBSD would only serve to undermine beneficial risk management activities. Wholly-owned affiliated entities within a holding company group often engage in inter-affiliate swap and SBS transactions in order to manage risk effectively within their corporate group. For example, a parent company may issue floating rate notes and enter into an offsetting fixed-for-floating rate swap with one of its affiliates. Additionally, due to a range of commercial, tax, regulatory and market considerations, a counterparty may prefer to face one entity in a group (*e.g.*, a foreign affiliate) even though, from a risk management perspective, a different entity (*e.g.*, a U.S. affiliate) is better positioned to incur the exposure. Similarly, one affiliate may have a risk exposure that another affiliate is better positioned to manage. Inter-affiliate transactions are often used in each of these cases, and should not be penalized.

- ***Recommendation:*** *The Commission should not limit the circumstances in which a credit risk charge should be taken in lieu of a 100% deduction for uncollateralized receivables to SBS with a commercial end user.*

- ***Recommendation:*** *Inter-affiliate transactions between a SBSD and a regulated affiliate should have a 1-day grace period before the SBSD incurs a capital charge for a failure to collect margin, consistent with the treatment of transactions with third parties.*

D. Capital Charge in Lieu of Margin Collateral

The Proposal would require a SBSD, when calculating its net capital for regulatory capital purposes, to take capital deductions for the full value of: (1) the margin amount calculated for a SBS with a commercial end user, less any positive equity in the customer's account, unless the SBSD is approved to use internal models (in which case it could apply a counterparty credit risk charge, as described above);[46] (2) the amount of cash required in the account of each SBS customer to meet the margin requirements of a clearing agency or the Commission, after application of calls for margin, marks to market, or other required deposits that are outstanding for one business day or less;[47] (3) margin collateral posted by a SBS customer held by a third-party custodian, less any positive equity in the account of the customer (the "**Third-Party Custodian Deduction**");[48] (4) the margin amount calculated for a legacy SBS customer, less any positive equity in the account of the customer (the "**Legacy Account Deduction**");[49] and (5) for each account carried by the SBSD for another person that holds cleared SBS transactions, the amount of the deductions that the positions in the account would incur pursuant to the applicable Commission capital rule if owned by the SBSD, less the margin value of collateral held in the account (the "**Cleared SBS Deduction**").[50]

As described in further detail below, each of the Third-Party Custodian Deduction, the Legacy Account Deduction and the Cleared SBS Deduction (collectively, the "**Deductions**") would adversely affect customers in ways that are either inconsistent with Dodd-Frank or that undermine competitiveness, or both. The Deductions would also impose punitive economic costs on SBSDs that are not necessary to achieve the underlying policy goal of ensuring that SBSDs have sufficient resources to manage risks associated with their SBS transactions. These Deductions would also not apply under the capital regimes proposed by the CFTC and the Prudential Regulators. As a result, only nonbank SBSDs would be subject to the Deductions, thereby leading to significant competitive disparities. Further, if the Commission required the Deductions to apply to all customer accounts of a SBSD, including swaps and SBS accounts, the

---

[46] Proposal § 15c3-1(c)(2)(xiv)(B)(1); Proposal § 18a-1(c)(1)(viii)(B)(1).

[47] Proposal § 15c3-1(c)(2)(xv); Proposal § 18a-1(c)(1)(ix).

[48] Proposal § 15c3-1(c)(2)(xiv)(B)(2); Proposal § 18a-1(c)(1)(viii)(B)(2).

[49] Proposal § 15c3-1(c)(2)(xiv)(B)(3); Proposal § 18a-1(c)(1)(viii)(B)(3).

[50] Proposal § 15c3-1(c)(2)(xiv)(A); Proposal § 18a-1(c)(1)(viii)(A).

capital deductions required for swap accounts under the Commission's rules may force market participants to remove all swap activity from nonbank SBSDs. This would lead to capital reallocation and netting inefficiencies without any meaningful improvement in risk management.

1. Third-Party Custodian Deduction

SIFMA strongly urges the Commission to eliminate the Third-Party Custodian Deduction. It would be harmful to customers by frustrating their ability to enter into custodial arrangements that are beneficial to them and expressly provided for by Congress. Moreover, under these arrangements, the SBSD is fully protected, with well-established and enforceable legal rights to obtain and dispose of collateral upon a customer's default. Applying a punitive deduction in such a circumstance would be disproportionate to the risks presented, imposing a unique burden on nonbank SBSDs and their customers.

a. The Third-Party Custodian Deduction Is Inconsistent with Dodd-Frank and Would Harm Customers

In Dodd-Frank, Congress amended the Exchange Act to require both bank and nonbank SBSDs, upon customer request, to permit a customer to segregate its initial margin at an independent third-party custodian.[51] By enacting this provision, Congress clearly intended that SBS customers be able to choose the custodian that holds initial margin posted in connection with uncleared SBS transactions. Congress did so because these custodial arrangements are considered to be beneficial to customers, protecting them from credit risk to the dealer for the return of initial margin.

The Third-Party Custodian Deduction, if implemented, would frustrate customers' ability to enter into these arrangements, and so is clearly at odds with Congress's manifest intent. In particular, it would impose unwarranted costs on a SBSD when a customer exercises the right to segregation established by Congress, making it more difficult for a nonbank SBSD to trade with a customer desiring to exercise that right at prices that are comparable to those offered by bank SBSDs and foreign SBSDs.

In this regard, initial margin for a SBS transaction that a customer requests be segregated at an account held by a third-party custodian is similar to other instances in which a contrary regulatory policy objective prevents a broker-dealer from being permitted to hold collateral pledged to it by a customer. These other instances include, for instance, investment companies registered under the Investment Company Act of 1940 and employee benefit plans and governmental plans subject to the Employee Retirement Income Security Act of 1974. As in those instances, a dealer should not be penalized simply for satisfying a separate regulatory policy objective.

---

[51] Exchange Act Section 3E. A similar requirement applies to swap transactions. *See* Commodity Exchange Act ("**CEA**") Section 4s(l).

b. <u>The Third-Party Custodian Deduction Is Not Necessary Because SBSDs Are Fully Protected Under Applicable Creditor's Rights Rules and Liquidity Risk Management Practices</u>

Consistent with Congress's intent, third-party custodial arrangements are already used today in SBS transactions. Such arrangements permit the SBSD to perfect a security interest in the collateral held by the custodian while giving the customer the option of selecting the custodian to which it will take credit risk.

While the terms of third-party custody arrangements are subject to bilateral negotiation, in each case they enable the SBSD to establish a perfected security interest in the collateral held by the third-party custodian and clearly specify the rights of the SBSD to access the collateral pledged to it. Accordingly, the Commission's concerns that the collateral is not in the "control" of the SBSD or capable of being liquidated by the SBSD are misplaced.

Although we recognize that there may be circumstances, following a SBSD's own default, when third-party custodial arrangements might slow the rate at which customers whose collateral is held by the SBSD are paid relative to those that elect individual segregation, such customers still retain rights to their requisite share of customer property. The Proposal would impose an additional cost on the SBSD when a customer elects to hold its collateral with a third party custodian, creating a tiered-cost structure that disadvantages those customers who so elect. It would not be consistent with Dodd-Frank for the Commission to favor those customers who do not opt for third-party custody over those who do, when the customers opting for third-party custody are merely exercising a right that Congress intended for them to have.

In addition to legal arrangements, firms manage risk in third-party custodial arrangements through liquidity risk management. In the unlikely event of a dispute with a custodian for the delivery of collateral, a SBSD may have delayed access to collateral in which it has a first-priority security interest. However, this risk is only *when*, not *if*, the SBSD will gain access to the collateral. SBSDs manage this risk through liquidity risk management practices, which account for timing gaps in the availability of collateral. In addition, bank holding companies with SBSD subsidiaries will be subject to the Basel III Liquidity Coverage Ratio, which excludes high-quality assets held by a custodian from inclusion in the pool of assets deemed available to meet short-term funding requirements. Accordingly, any liquidity risk in such custodial arrangements is adequately addressed through existing regulatory frameworks, and therefore does not require any additional treatment through the capital regime.

c. <u>The Third-Party Custodian Deduction Would Make Nonbank SBSDs Uncompetitive</u>

As noted above, Dodd-Frank expressly mandates that the Commission, together with the Prudential Regulators and the CFTC, "shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements" for SBSDs.[52] Neither the Prudential Regulators nor the CFTC included the Third-Party Custodian Deduction in their proposed capital rules for SDs and SBSDs. The Commission's Proposal is inconsistent with these other proposed capital regimes, and would result in huge disparities in capital requirements for bank SBSDs and nonbank SBSDs engaged in identical market activities. Notably, we also are not aware of any major jurisdiction outside the United States that either has or has proposed to apply a capital penalty similar to the Third-Party Custodian Deduction.

If the Third-Party Custodian Deduction is included in the Commission's final rules, nonbank SBSDs will be forced to compete at a significant disadvantage with bank SBSDs and foreign SBSDs. The deduction may effectively force nonbank SBSDs to exit certain SBS markets entirely, which would have the unfortunate consequence of pushing such activity into less regulated, or even unregulated, global markets. This outcome would not be consistent with Congress's desire to create a well-regulated SBS market in the United States.

d. Segregation Rules Would Better Address the Commission's Concerns

To the extent that the Commission is concerned that there may be some types of custodial arrangements that pose unusual risks to a SBSD prior to its insolvency, it retains the authority under Section 3E to prescribe rules regarding the terms of third-party custodial arrangements. We emphasize that, to ensure that there is not a competitive disparity between nonbank SBSDs and bank SBSDs, any such rules should be adopted pursuant to Section 3E and apply equally to both classes of SBSDs, rather than as an exception from a requirement for a nonbank SBSD to take a capital charge for assets held away.

- ***Recommendation:*** *To address the SBSD's credit risk to the custodian, the Commission could require that, under the arrangement the custody account is maintained with a "bank" (as defined in Section 3(a)(6) of the Exchange Act), U.S. broker-dealer or non-U.S. bank or broker-dealer that has total regulatory or net capital in excess of $1 billion (such bank or broker-dealer, the "**custodian**").[53] Such custodian should be permitted to include an affiliate of the SBSD.*

  - ***Recommendation****: To better assure that a SBSD has clear contractual rights to access collateral promptly, the Commission could require that:*

    (1) the custodian must either:

    (a) establish the custody account in the name of the SBSD and recognize the SBSD as the account holder; or

---

[52] Exchange Act Section 15F(e)(3)(D)(ii).

[53] *Cf.* SEC Release Nos. 34-61662 (Mar. 5, 2010) and 34-61975 (Apr. 23, 2010) (exemptions in connection with the clearing of CDS that placed similar conditions on the use of a third-party custodian).

(b) *establish the custody account in the name of the customer as pledgor and SBSD as pledgee;*

(2) *the custody agreement must:*

(a) *clearly specify the conditions under which the customer may instruct the custodian to transfer any amount of property from the custody account without the transfer-specific instruction or consent of the SBSD;*

(b) *restrict any such transfer to cases where the customer certifies that (i) such a specified condition has occurred, (ii) the customer has terminated any transactions secured by property in the custody account and (iii) the customer is entitled to the transfer of such amount following a net settlement calculation pursuant to the terms of governing transaction documentation;*

(c) *require the custodian to comply with any instruction given by the SBSD exercising its rights as a secured party under the transaction documentation with the customer to transfer or redeem property from or with respect to the custody account, or to sell or otherwise dispose of such property, without the customer's consent; and*

(d) *include an acknowledgement by the custodian that the property in the custody account is not subject to any right, charge, security interest, lien, or claim of any kind in favor of the bank, or any person claiming through the custodian, other than the SBSD's claim pursuant to the custody agreement and for fees, expenses and charges lawfully accruing in connection with the custodial arrangement and, if the custody agreement or the underlying transaction agreement includes a covenant on the part of the customer that it will deliver only cash or fully-paid for securities into the account, for any advances made by the custodian in connection with assets credited to the account; and*

(e) *if the account is in the customer's name, the custody agreement must not permit the custodian to disregard (or not to comply with) any instruction from the SBSD regarding the transfer or sale of assets in the custody account on the basis of any contrary instruction from the customer other than a previous instruction from the customer that complies with the restrictions set out in (2)(b) above.*

2. Legacy Account Deduction

SIFMA also urges the Commission to modify the Legacy Account Deduction.[54] The deduction, as currently proposed, would unfairly penalize SBSDs and their customers for

[54] We discuss other issues relating to legacy accounts in Part II.D of Appendix 2 of this letter.

transactions entered into before the effectiveness of the margin rules. Notably, no other regulator has proposed to impose a similar penalty.

By way of further background, regulatory margin requirements have not previously existed for SBS. In many cases, SBSDs have required their counterparties to post initial margin, recognizing that they should collateralize their credit and market risk on these transactions. These collateral arrangements, however, are commercial negotiations that do not generally permit the SBSD to demand any amount of initial margin from the counterparty at a subsequent point in the life of the trade. There are serious operational and market practice constraints that would prevent SBSDs from unilaterally demanding that counterparties post the full amount of margin for legacy trades as calculated under as-yet un-finalized margin rules. Recognizing this, the Commission has not required SBSDs to collect margin on legacy accounts, citing the "impracticality of renegotiating contracts governing security-based swap transactions that predate the effectiveness" of the Proposal.[55]

Even while recognizing the impracticality of forcing SBSDs to collect regulatory-specified margin amounts on legacy accounts, the Proposal would nonetheless require a SBSD to take a capital deduction for the full amount of any under-margined legacy accounts. Any SBSD with a sizeable legacy account portfolio would thus be placed in the untenable position of requiring legacy account counterparties to post regulatory margin for old trades (which the Commission itself recognizes is impractical) or take a capital deduction equal to the amount of any deficiency. Most troublingly, if put into effect immediately upon the effective date of the margin requirements, the Legacy Account Deduction would result in sudden capital shortfalls. To avoid choosing between collecting margin when doing so is impractical, on the one hand, and suffering a capital shortfall, on the other, some market participants may cease engaging in any new SBS activity so as to avoid registration as a SBSD, while others would be forced to terminate or novate existing portfolios. Instigating such a forced withdrawal from the market or liquidation of positions would not help ensure the safety and soundness of nonbank SBSDs.

Moreover, not only would the Legacy Account Deduction result in these negative consequences, it also is not necessary to protect SBSDs. The risk to a SBSD arising from a legacy account is, by definition, limited because such an account can only be used to hold SBS entered into prior to the effective date of the margin rules and collateral for those SBS.[56] In the worst case, those SBS will simply expire in the normal course, meaning that any risk to the SBSD will only be temporary in nature. Additionally, for legacy SBS that become eligible for central clearing, the SBSD will in many cases backload those SBS into the clearing agency, since doing so will increase the potential for multilateral netting and therefore tend to reduce the SBSD's overall margin requirements at the clearing agency for newly executed SBS. Once backloaded, the SBS would of course not be subject to the Legacy Account Deduction.

---

[55] Proposing Release at 70,269.

[56] Proposal § 18a-3(b)(9).

Given the limited risk profile for legacy SBS, we believe that the Commission should consider alternative measures to account for legacy SBS in its capital rules. For example, instead of applying the Legacy Account Deduction to all legacy accounts, the Commission could instead apply the deduction to (i) those accounts for which the margin amount less any positive equity in the accounts exceeds, in the aggregate, 50% of the SBSD's tentative net capital and (ii) any individual legacy account for which the margin amount less any positive equity in the account exceeds 5% of the SBSD's tentative net capital. This approach would ensure that the SBSD does not have undue concentration to legacy SBS counterparties to which its potential future exposure is uncollateralized. Alternatively, the Commission could require SBSDs to take credit risk capital charges for legacy accounts, *i.e.*, nonbank SBSDs approved to use internal models and ANC broker-dealers could simply apply Appendix E to Rule 15c3-1, and other nonbank SBSDs could apply a credit risk charge based on the CFTC Capital Proposal for SDs that do not use internal models (under which the credit risk charge would be equal to 8% of the credit risk factor-adjusted sum of current exposure plus potential future exposure).[57]

Additionally, regardless of the type of capital charge that the Commission requires for legacy accounts, we urge it to permit SBSDs to elect to exclude from accounts subject to the charge any currently uncleared positions in a type of SBS for which a clearing agency has made an application to the Commission to accept for clearing. Such an exception would provide an incentive for SBSDs to encourage an expansion of central clearing and to backload positions into central clearing once it becomes available.

- ***Recommendation:*** *The Commission should modify the Legacy Account Deduction by instead adopting either a credit risk charge or a credit concentration charge, with an exception permitting SBSDs to elect to exclude from accounts subject to the charge any currently uncleared positions in a type of SBS for which a clearing agency has made an application to the Commission to accept for clearing.*

3. Cleared SBS Deduction

The Cleared SBS Deduction would also harm customers because it would provide an incentive for the collection of margin by SBSDs beyond the amount determined by the clearing agency, under applicable Commission rules and supervision, to be appropriate to the risks of the relevant transactions. Such amount also would not, as has historically been the case when a clearing member collects excess collateral, be tied to any credit evaluation of the customer by the SBSD.

Accordingly, we urge the Commission to eliminate the Cleared SBS Deduction. If the Commission believes that clearing agency margin requirements are not sufficiently standardized or do not adequately address risk, it should address those considerations directly through its regulation of the clearing agency. For instance, the Commission could adopt similar

---

[57] Potential future exposure would be determined by applying a conversion factor to the notional amount for a position and, for multiple positions held under a master netting agreement, applying a 60% netting factor. *See* CFTC Capital Proposal at 27,809.

requirements to the CFTC, which requires derivatives clearing organizations to apply initial margin requirements calculated based on estimated price movements over a specified liquidation horizon that varies by product, with the coverage of the initial margin requirement, along with projected measures of the models' performance, required to meet an established confidence interval of at least 99%, based on data from an appropriate historic time period.[58] Establishing similar requirements would promote consistency in the regulation of clearing organizations while avoiding the adverse consequences to customers and SBSDs triggered by the Cleared SBS Deduction.

➢ ***Recommendation:*** *The Commission should eliminate the Cleared SBS Deduction and instead address any concerns it has directly through its regulation of clearing agencies.*

E. Liquidity Stress Test Requirements

Under the Proposal, ANC broker-dealers and stand-alone SBSDs approved to use internal models would be subject to liquidity risk management requirements to (i) perform a liquidity stress test at least monthly that takes into account certain assumed conditions lasting for 30 consecutive days, (ii) maintain at all times liquidity reserves, composed of unencumbered cash or U.S. government securities, based on the results of the liquidity stress test and (iii) establish a written contingency funding plan.[59]

SIFMA generally supports the enhancements of liquidity requirements for financial institutions; however, we urge the Commission in the strongest possible terms to modify the test to protect the management and use of liquidity in ways that are critical to the business of our member firms. In particular, we emphasize that it is critical to align the Commission's liquidity requirements with applicable Basel and FRB requirements. Enhanced liquidity has been a key focus of the Basel Committee following the 2008 financial crisis, and the FRB in particular has sought through its enhanced prudential standards under Title I of Dodd-Frank to ensure that systemically important financial institutions establish and maintain adequate liquidity reserves.[60]

First, the Commission should eliminate the requirement that liquidity reserves be maintained "at all times," because this will unfairly penalize the use of excess liquidity intraday or overnight. The ability to make use of excess liquidity intraday is critical to the business of our member firms. Instead, the Commission should adopt language similar to the Basel and FRB regimes, which would require institutions to monitor, measure and manage their intraday liquidity risk exposure. Second, the Commission should expand the range of assets that are allowable as liquidity reserves to be consistent with the Basel and FRB regimes, which allow liquidity reserves to include investment-grade corporate debt, certain foreign sovereign securities, certain unencumbered equities and certain mortgage-backed securities. Finally, the Commission

---

[58] CFTC Rule 39.13(g)(2)(ii).

[59] Proposal § 15c3-1(f); Proposal § 18a-1(f).

[60] *See* 77 Fed. Reg. 594 (Jan. 5, 2012).

should align its liquidity requirements with those regimes by permitting liquidity to be managed at an institution's holding company, rather than trapping assets in one or more particular subsidiaries. In particular, we recommend that the Commission adopt an exception from the Proposal's liquidity requirements for an ANC broker-dealer or stand-alone SBSD that is subject, on a consolidated basis, to comparable liquidity requirements administered by the FRB or by a foreign supervisor that has adopted requirements consistent with the Basel Accords, where those comparable liquidity requirements take into account the liquidity needs of the ANC broker-dealer or stand-alone SBSD. If this exception is not adopted, then, at a minimum, in light of the centralized liquidity management function at most large financial holding companies, and the comprehensive liquidity management requirements that apply to these companies on a consolidated basis, SIFMA respectfully submits that ANC broker-dealer and SBSD subsidiaries of such holding companies should be permitted to rely on intercompany funding sources for purposes of the Commission's stress testing regime.

If these inconsistencies are not addressed, the Proposal's liquidity requirements would give rise to unintended risks and adverse consequences. Trapping assets within a subsidiary, in particular, increases liquidity risk by preventing a subsidiary with excess liquidity from providing resources to one that is under stress. Given the limits on available liquid assets, it is more systemically sound for liquidity to be managed in an integrated, group-wide manner. Moreover, the Proposal's liquidity requirements should not be evaluated in isolation. The rest of the Proposal would seek to assure that ANC broker-dealers and SBSDs have sufficient resources in the form of additional capital and collateral to absorb the liquidity needs arising from their business. Layering additional entity-level liquidity requirements on top of entity-level capital and margin requirements would therefore require firms to sequester a level of resources in SEC-registered subsidiaries that would be highly disproportionate to such subsidiaries' actual liquidity risk. These disproportionate costs would, in turn, make business much more expensive for the customers of nonbank SBSDs and ANC broker-dealers.

- ***Recommendation:*** *The Commission should modify its liquidity risk requirements to make them consistent with FRB and Basel liquidity risk requirements by:*
    - *Instead of requiring liquidity reserves to be maintained "at all times," requiring institutions to monitor, measure and manage their intraday liquidity risk exposure;*
    - *Expanding the range of assets allowable as liquidity reserves to include investment-grade corporate debt, certain foreign sovereign securities, certain unencumbered equities and certain mortgage-backed securities;*
    - *Adopting an exception from the Proposal's liquidity requirements for an ANC broker-dealer or stand-alone SBSD that is subject, on a consolidated basis, to comparable liquidity requirements administered by the FRB or by a foreign supervisor that has adopted requirements consistent with the Basel Accords, where those comparable liquidity requirements take into account the liquidity needs of the ANC broker-dealer or stand-alone SBSD; and*

- *Permitting ANC broker-dealer and SBSD subsidiaries of financial holding companies to rely on intercompany funding sources.*

F. OTC Derivatives Dealers

The Proposal seeks comment on whether (i) stand-alone SBSDs will seek to effect transactions in securities OTC derivatives products other than SBS, such as OTC options, that would necessitate registration as a broker-dealer; (ii) registering as a limited purpose broker-dealer under the provisions applicable to OTC derivatives dealers provides a workable alternative to registering as a full-service broker-dealer; and (iii) the requirements for OTC derivatives dealers should be amended (by exemptive relief or otherwise) to accommodate firms that want to deal in SBS.[61] The Proposal also suggests that merging the OTC derivatives dealer regime with the regime for stand-alone SBSDs could raise practical difficulties because, for instance, OTC derivatives dealers are not subject to a customer asset protection regime, while stand-alone SBSDs are.[62] As an alternative, the Proposal suggests that the Commission could provide conditional relief on a case-by-case basis to allow a firm that is registered as a SBSD to conduct dealing activity in derivatives other than SBS, pending further Commission consideration of how and whether to reconcile the SBSD and OTC derivatives dealer regimes.[63]

In response to the Proposals' request for comment, SIFMA recommends that the Commission modify its OTC derivatives dealer framework through conditional exemptions that would allow an OTC derivatives dealer to dually register as a stand-alone SBSD. The debt and equity derivatives business is conducted on an integrated basis, without regard to Dodd-Frank's distinctions between swaps and SBS, on the one hand, and OTC options, on the other. As a result, preventing a single legal entity from dealing in both types of instruments would result in significant inefficiencies, for dealers and customers alike. In addition, the economic distinctions between both types of instruments do not, in our view, prevent the SBSD regime from adequately protecting OTC options customers; the SBSD regime is generally at least, if not more, stringent than the broker-dealer regime.

➢ ***Recommendation:*** *The Commission should permit an OTC derivatives dealer that is dually registered as a SBSD is permitted, with appropriate customer disclosures, to deal in OTC options and qualifying forward contracts subject to the rules applicable to SBS.*[64]

---

[61] Proposing Release at 70,220.

[62] *Id.* at 70,310-11.

[63] *Id.* at 70,311.

[64] Appendix 1 to this letter provides a more detailed description of our proposal for accomplishing this result. In addition, as noted above, references in this letter to stand-alone SBSDs that are approved to use models are also intended to refer to OTC derivatives dealers that are dually registered as SBSDs. *See* Note 7, *supra*.

G. SBS Brokerage Activities

The Proposal observes that, because Dodd-Frank's SBSD definition does not include acting as a broker or agent in SBS, entities engaging in brokerage activities with respect to SBS could be required to register as broker-dealers.[65] As a result, to the extent these broker-dealer SBSDs wanted to use models to compute net capital, they would be subject to the higher minimum net capital requirements applicable to ANC broker-dealers.[66] The Proposal seeks comment regarding this topic, including whether 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 SBS, and that do not conduct a general business in securities with customers, should be subject to the minimum net capital requirements applicable to stand-alone SBSDs approved to use internal models.[67]

In addition, we note that there is ambiguity regarding whether a SBSD clearing SBS for customers should be required to register as a broker-dealer. Section 3E of the Exchange Act clearly contemplates that a person that accepts collateral from a customer for cleared SBS may register as either a SBSD or a broker-dealer. Consistent with this, the Proposal's "risk margin amount" definition, its proposed requirement for a capital charge in lieu of margin for cleared SBS and its proposed segregation requirements each contemplate that a stand-alone SBSD may act as a clearing member in SBS for customers. On the other hand, a person acting in such a capacity arguably is acting as a broker in SBS, since it is an agent for the customer in submitting SBS for clearing and facilitating the transfer of funds and securities in connection with the customer's clearance and settlement of SBS.[68]

- ***Recommendation:*** *We recommend that the Commission permit a broker-dealer SBSD that is approved to use internal models to comply with the minimum capital requirements applicable to a stand-alone SBSD approved to use internal models if it limits its securities brokerage activities to (i) performing brokerage activities incidental to accepting money, securities, or property from, for, or on behalf of a SBS customer to margin, guarantee, or secure a SBS cleared by or through a clearing agency and (ii) accepting and sending customer orders for execution on a SBS execution facility. In our view, these limitations on the entity's activities would ensure that it does not present the risks to customers and the public that are the basis for the higher minimum capital requirements applicable to ANC broker-dealers.*

---

[65] Proposing Release at 70,220.

[66] *Id.*

[67] *Id.*

[68] *See, e.g.*, SEC Release No. 34-64795 (July 1, 2011) (noting that the Exchange Act "broker" registration requirements will apply to broker activities involving SBS by persons that are members of a clearing agency that functions as a central counterparty).

II. Margin Requirements

The Commission proposed two alternatives for a margin regime for SBSDs. Under both alternatives, a SBSD would collect daily variation margin. Under the first alternative ("**Alternative A**"), there would be an exception from the obligation to collect initial margin when a SBSD trades with another SBSD. Under the second alterative ("**Alternative B**"), SBSDs would be required to exchange and segregate initial margin exchanged with each other.

Sharp increases in initial margin requirements during periods of market stress can produce significant destabilizing and pro-cyclical forces. These forces have the potential to increase systemic fragility precisely at the point of greatest vulnerability. Even in times of relative market stability, regulatory requirements for initial margin could significantly reduce the supply of high-quality collateral that is necessary for the credit creation that supports economic activity. The full macro-economic impact of initial margin requirements must also be assessed against the background of multiple other regulatory requirements for the sequestration of high quality collateral. These assessments must consider impacts both during periods of market stability and market stress.

It must also be recognized that, at the level of an individual firm posting margin, the mandatory exchange of initial margin effects a net increase in credit risk, replacing potential future exposure to a counterparty for variation payments following a default with actual current exposure to that counterparty for the return of collateral. The Commission's net capital rule implicitly recognizes this effect by defining initial margin delivered by a SBSD as an unsecured receivable that is deducted from the SBSD's net worth.[69] Seeking to address this issue by requiring segregation, on the other hand, would significantly exacerbate the adverse liquidity and macro-economic effects noted above.

Each of these concerns would be magnified significantly if the two-way exchange of initial margin extended not only to trades between SBSDs, but also to trades between SBSDs and unregulated financial entities,[70] as proposed by the BCBS/IOSCO Working Group on Margining Requirements.[71]

In order to better address the credit risk management objectives associated with margin requirements, while avoiding unintended and undesirable consequences, SIFMA strongly supports the adoption of rigorous variation margin collection requirements. Rigorous variation margin requirements have the potential to significantly reduce systemic risk by eliminating the accumulation of uncollateralized current exposures, while avoiding the potentially destabilizing

[69] *See* Proposing Release at 70,267.

[70] Any requirement that a SBSD place its collateral in the hands of a non-prudentially supervised counterparty would be manifestly inconsistent with Dodd-Frank's requirements that margin requirements for uncleared SBS (and swaps) be established so as to ensure the safety and soundness of SBSDs.

[71] BCBS/IOSCO, Consultative Document, Margin Requirements for Non-Centrally Cleared Derivatives (July 2012) (the "**Initial BCBS/IOSCO Consultation**" and, together with the Second BCBS/IOSCO Consultation, the "**BCBS/IOSCO Consultations**").

and pro-cyclical effects of initial margin, and, at the same time, moderating unsustainable demands for the segregation of high quality liquid assets.

With respect to initial margin, recognizing the concerns noted above, the Commission proposed an initial margin collection, rather than a two-way exchange, requirement for SBSDs trading with financial end users. Additionally, if adopted, Alternative A would exclude a regulatory requirement for the two-way exchange of initial margin between SBSDs. However, SBSDs would be obligated to collect initial margin from financial end users, subject to certain exceptions.

While, for the reasons noted above, Alternative A would avoid some of the adverse impacts of Alternative B, we remain concerned by the inherent adverse consequences of initial margin requirements, even when limited to collection obligations. In light of other emerging demands for high quality liquid collateral and uncertainty regarding the scope and evolution of the over-the-counter SBS (and swap) markets as a result of the market structure reforms affected by Dodd-Frank, any effort to predict and measure these impacts would be fraught with unavoidable speculation and uncertainty. As a result, while we recognize that Dodd-Frank contains a mandate for the adoption of initial margin requirements for uncleared SBS (and swaps), we believe the adoption of those requirements would be premature at this time.

Accordingly, we urge the Commission (as well as the CFTC and the Prudential Regulators) to focus on establishing a robust, two-way variation margin regime, while continuing to evaluate, in consultation with interested constituencies, including international regulators, effective methodologies to further mitigate systemic risk without causing the adverse impacts that would result from initial margin collection requirements.

A daily variation margin requirement alone would bring the uncleared SBS market into conformity with practices in other financial markets, such as foreign exchange and repo, where initial margin is not generally considered to be necessary. Based on our experience with those markets, we do not believe that deferral of an initial margin regime would increase systemic risk; on the contrary, because it would moderate the excessive demands for access to liquid resources, reduce pro-cyclicality and mitigate credit risk, deferral of mandatory initial margin requirements may well significantly mitigate systemic risk.

In addition to discussing these issues further, we also provide below a few other targeted recommendations regarding (i) the application of margin requirements to transactions with commercial end users, sovereign entities, affiliates and structured finance and securitization special purpose vehicles ("**SPVs**") and (ii) eligible margin collateral.

A. <u>Concerns About Mandatory Initial Margin Requirements</u>

As noted above, while we fully support a robust, two-way variation margin collection requirement, we have very serious concerns that the adverse liquidity, pro-cyclicality, and credit and custodial risk consequences associated with initial margin – especially, the two-way exchange that would be required under Alternative B – would outweigh any incremental potential to reduce systemic risk. Mandating the exchange of initial margin is also unnecessary to incentivize counterparties to clear SBS.

1. Mandatory Initial Margin Requirements Could Limit Credit Availability and Be Destabilizing

The net reduction in liquidity resulting from initial margin requirements, on a gross basis and subject to restrictions on re-hypothecation or re-use, would be very substantial. For example, the universal two-way margin proposal published by BCBC/IOSCO would, we estimate, require the collection and sequestration of approximately $4.1 trillion.[72] We estimate that the Commission's proposed Alternative B, if extended to all asset classes (not just SBS) and adopted across the relevant jurisdictions (not just for Commission registrants), would require the collection and sequestration of approximately $3 trillion.[73] By way of comparison, the total amount of U.S. federal debt currently held by the public is estimated at approximately $11.58 trillion.[74] The combined balance sheet assets of the FRB and the European Central Bank are approximately $6.9 trillion.[75] This figure also ignores the anticipated liquidity impact of initial margin requirements and guaranty fund contributions for cleared derivatives, which the International Monetary Fund ("**IMF**") has estimated at approximately $100-200 billion.[76]

One way to estimate the possible liquidity impact of a universal two-way initial margin requirement is to compare it to other circumstances involving a sharp decrease in the use/availability of collateral. According to an estimate by IMF staff economist Manmohan Singh, the decline in the use/re-use of collateral from 2007 to 2011 was approximately $4-5 trillion.[77] This decline was roughly equal to the aggregate increase in the traditional money supply in the United States and Europe over the same period, thereby potentially offsetting the entire monetary stimulus impact of the combined activities of the FRB, European Central Bank and Bank of England during this period.[78]

Additionally, a shortage of high-quality collateral can have destabilizing behavioral effects. For instance, the IMF has suggested that the growing demand for safe assets due to

---

[72] The ultimate amount would depend greatly on the extent to which firms use models instead of standardized haircuts and the extent of any initial margin thresholds. A more detailed depiction of estimated initial margin levels is contained as Figure 1 in Appendix 2 to this letter.

[73] These estimates are based on an assumption that firms could portfolio margin correlated swap and SBS positions. If they could not, then the estimates would naturally increase.

[74] U.S. Bureau of the Public Debt, *http://www.treasurydirect.gov/NP/BPDLogin?application=np* (last accessed Jan. 8, 2013).

[75] Federal Reserve Statistical Release H.4.1 (Jan. 2, 2013); European Central Bank, "Consolidated financial statement of the Eurosystem as at 28 December 2012" (Jan 2, 2013).

[76] IMF, Global Financial Stability Report (April 2012), at p. 96.

[77] Manmohan Singh, "The (Other) Deleveraging," IMF Working Paper 12/179 (July 2012), at p. 15.

[78] *Id.* at p. 14 (noting that a "shortage of acceptable collateral would have a negative cascading impact on lending similar to the impact on the money supply of a reduction in the monetary base").

prudential measures (including the increased collateralization of derivatives) and central bank operations, combined with a shrinking range of assets perceived as safe, could lead to adverse consequences such as increased short-term volatility jumps, herding behavior and runs on sovereign debt.[79]

These considerations suggest that unduly stringent margin requirements can have undesirable economic effects that include, but go well beyond, direct liquidity costs. As a result, the imposition of requirements that do not afford clear, meaningful and demonstrable financial stability benefits must be avoided.

2. **Mandatory Initial Margin Requirements Would Have Undesirable Pro-Cyclical Effects**

Initial margin requirements are unlikely to contribute significantly to financial stability and, indeed, may have destabilizing pro-cyclical effects. To be risk sensitive, initial margin models are typically dynamic, adjusting based on prevailing levels of market volatility and liquidity. We estimate that moving from normal to stressed conditions could increase initial margin requirements by more than 400%. The liquidity drain associated with increased initial margin requirements in conditions of increasing volatility are likely to create a pro-cyclical feedback loop, as calls for additional collateral force market participants to unwind positions, thereby potentially exacerbating volatility (and downward market forces) and, as a result, initial margin requirements.[80]

In contrast to cleared SBS, uncleared SBS have no central supervisory body, such as a clearing agency risk committee or global supervisor, to dampen the pro-cyclical feedback loop impact where necessary. Rather, decentralized market participants, each complying with their own regulatory and internal corporate mandates, could serve as vectors for propagating (and amplifying) this pro-cyclical feedback loop across markets and borders.

Although the use of fixed, standardized haircuts can mitigate the adverse volatility (and pro-cyclicality) impacts of an initial margin requirement, they cannot mitigate other credit and liquidity impacts. Moreover, because initial margin requirements would be significantly larger if only standardized haircuts are used (approximately $7.6-10.2 trillion vs. $600-800 billion),[81] such an approach would substantially exacerbate the credit and liquidity impact of initial margin requirements (and significantly increase the credit risk faced by all firms required to post initial margin). As a result, the mandatory exchange of initial margin necessarily entails an undesirable trade-off between mitigating the overall liquidity impact of the requirements versus mitigating the pro-cyclical impact of the requirements. Neither side of the equation would promote financial strength or stability.

---

[79] IMF, *supra* Note 76, at p. 81.

[80] *See* Daniel Heller and Nicholas Vause, "Expansion of Central Clearing," BIS Quarterly Review (June 2011), at p. 77.

[81] *See* Figure 1 in Appendix 2 for more details regarding these estimates.

3. Mandatory Initial Margin Requirements Would Increase, Not Decrease, Credit Risk

Initial margin is intended to cover the potential increase in mark-to-market exposure over a supposed liquidation horizon following default. As a result, initial margin inherently imposes some degree of over-collateralization relative to current exposure. Consequently, on a current basis, initial margin presents the posting party with credit risk to the collecting party for the return of the margin it has posted. The Commission's net capital rule recognizes this credit risk posed to a party posting initial margin by requiring a SBSD or broker-dealer to treat assets that are delivered by it as margin collateral to another party as unsecured receivables from the party holding the collateral to be deducted in full when calculating the firm's net capital.[82] Under a two-way margin regime, this overcollateralization effect is, almost by definition, more than doubled in the case of SBSDs, who have largely matched derivatives dealing books, even though it is a certainty that a SBSD cannot incur losses (and present or incur a credit risk) on both of its offsetting derivatives positions.

In addition to this over-collateralization effect, the exchange of initial margin requires a comparison of the direct and indirect benefits of protecting the collecting party from potential adverse mark-to-market movements following the posting party's default against the direct and indirect costs of exposing the posting party to the risk that its initial margin will not be returned following the collecting party's default. Whether requiring initial margin in a particular case will increase or mitigate credit risk depends on whether the defaulting party is the posting party or the collecting party, respectively, a fact that is unknowable *ex ante*. Thus, to require initial margin is to decide that the benefits of mitigating *potential future* credit exposure outweigh the creation of *current* exposure. Moreover, requiring a two-way exchange of initial margin under the BCBS/IOSCO Consultations or the Commission's proposed Alternative B would, by definition, increase credit risk in the system because both parties cannot each simultaneously default while owing the other money.

Accordingly, while it may seem intuitive that more initial margin equates to greater systemic safety, the risk mitigation benefits of expanding the collection of initial margin are actually far more mixed. There is simply no permutation under which the requirement that SBSDs exchange initial margin with each other will reduce the net amount of current credit risk in the system.

4. Initial Margin Requirements Are Not Needed to Promote Central Clearing

The Proposal requests comment regarding how initial margin requirements would promote the central clearing of SBS.[83] In our view, it is unnecessary to use initial margin requirements to incentivize counterparties to clear SBS because the Commission has the power to require standardized SBS to be cleared. We also respectfully submit that this operating

[82] *See* Proposing Release at 70,267.

[83] *See* Proposing Release at 70,270.

premise will produce inefficiencies and discontinuities that are not offset by financial stability or other social or economic benefits.

The counterparties subject to margin requirements in connection with uncleared SBS are the same counterparties that are subject to Dodd-Frank's mandatory clearing requirements. Under Dodd-Frank, all SBS that are sufficiently standardized and liquid to support widespread central clearing will become subject to a clearing mandate upon the Commission's determination that the SBS should be required to be cleared.[84] The most effective means to promote central clearing is to do so directly, by requiring standardized SBS to be cleared, when the Commission determines that such a mandate is appropriate. It would be a different matter entirely if counterparties subject to uncleared SBS margin requirements did not have to clear SBS subject to Dodd-Frank's central clearing mandate, or if there were not broad overlap in the communities eligible for clearing and margin exceptions.

Consistent with this, nowhere does Dodd-Frank suggest that margin requirements should be used to promote central clearing. Rather, Dodd-Frank solely requires that margin requirements be designed to ensure the safety and soundness of SBSDs and be appropriate for the risk of uncleared SBS.[85] As described above, mandatory initial margin requirements would be contrary to safety and soundness by increasing pro-cylicality and current credit risk. An approach more consistent with promoting safety and soundness and mitigating systemic risk would be to use the enhanced data collected through SBS data reporting to take a pro-active approach to the exercise of the Commission's mandatory clearing authority.

Calibrating margin requirements beyond a risk-appropriate level to promote central clearing other than in circumstances required by the clearing mandate would result in uneconomic decision making and could drive market participants to seek central clearing of SBS before they have the requisite level of standardization, price transparency or liquidity. Doing so may also force market participants to accept basis risk by unduly increasing the costs of non-standardized SBS even in circumstances where there is not a cost-effective or risk-correlated cleared substitute. These results would not be beneficial from either a systemic risk mitigation or economic efficiency perspective.

When a clearing mandate does not apply to a SBS, the cost of disincentivizing the uncleared transaction should be carefully considered. Capital requirements already differentiate the perceived differences in risk presented by cleared versus uncleared SBS. These differences, together with the multilateral netting benefits of central clearing, create significant incentives for the use of cleared SBS.

Counterparties' decisions to incur the greater costs associated with uncleared SBS, whether as a result of incremental capital or margin costs, reflects an implicit economic evaluation of the significance of the basis risk associated with the use of standardized products to

---

[84] *See* Section 3C of the Exchange Act (mandating that all financial entities clear SBS subject to the clearing mandate).

[85] Section 15F(e) of the Exchange Act.

mitigate bespoke risk exposures. The imposition of arbitrary, outsized disincentives, such as initial margin requirements that impose costs that outweigh the risk mitigation benefits, should be avoided. Such measures may prove economically detrimental by increasing systemic risk in circumstances where central clearing is encouraged for instruments that lack sufficient standardization, price transparency or liquidity to be risk managed effectively by clearing agencies. Applying punitive margin requirements for uncleared SBS will not help to overcome these obstacles to central clearing.

Moreover, establishing initial margin requirements for uncleared SBS for the purpose of promoting central clearing of SBS, and without regard for the impact on the market for uncleared SBS, fails to give due consideration to the significant benefits that non-standardized SBS have provided for many years. These products enable financial and other firms to more effectively hedge their actual risks without incurring exogenous basis risk. The ability to accomplish these results, in a cost-effective manner, is important. It avoids unnecessary (and actual) financial losses. It also more effectively dampens profit and loss volatility that, in turn, can directly increase an issuer's cost of capital or costs of operations. The imposition of these consequences should not be undertaken lightly and without a careful determination that the corresponding benefits warrant these adverse consequences.

B. SIFMA's Margin Proposal

For the reasons discussed above, we strongly urge the Commission to focus on establishing a robust, two-way variation margin regime, while continuing to evaluate, in consultation with interested constituencies, effective methodologies to further mitigate systemic risk without causing the adverse impacts that would result from initial margin collection requirements.

Requiring (on a phased-in basis) the daily exchange of variation margin between all financial entities (other than qualifying SPVs and affiliates, as noted below), with zero thresholds and subject only to low minimum transfer amounts, would largely address the most significant systemic risk and macro-prudential concerns associated with uncleared SBS. Under this regime, a SBSD should be required calculate its current exposure to its counterparty as of the end of each of its business days and call for variation margin (if and as required) at the beginning of its next business day. The SBSD should then be required to collect such variation margin from the counterparty by the close of the counterparty's business day. This timeframe is the shortest one under which a SBSD could collect daily variation margin, given the operational steps necessary to compute, request and collect collateral and possible time zone differences between the SBSD and its counterparty.[86]

To bolster this regime, we support improvements to the valuation infrastructure upon which variation margining depends, including requirements for regular portfolio reconciliation, dispute resolution and the reporting of material valuation disputes to supervisors. We also

---

[86] In this regard, we note that the Proposal's requirement that variation margin be collected by the SBSD by noon of each business day would not account for these operational steps or time zone differences.

support the Proposal's requirement that SBSDs implement risk management procedures and guidelines, including credit limits for all SBS counterparties and use of stress tests to monitor potential future exposure to a single counterparty and across all counterparties.[87] Such requirements will help minimize the risks the Commission seeks to avoid.

Across each of the dimensions identified above in Section II.A above, these variation margin requirements would have very significant systemic risk mitigation benefits, without the adverse consequences arising from initial margin requirements:

- The net liquidity impact of regular bilateral exchanges of variation margin is typically not material. This is because variation margin is by definition a net transfer of value and, as a corollary, is not typically subject to restrictions on re-hypothecation or re-use. Rather, variation margin payments can be used to fund other aspects of a collecting party's business, including funding variation margin payments for hedging transactions on the other side of the market.

- Variation margin requirements are likely to create desirable macro-prudential outcomes because they ensure that a counterparty will not be required to post a significant amount of collateral for its SBS when it is suffering significant liquidity strains, thereby preventing the type of destabilizing "runs" that were observed during the recent financial crisis. In this way, variation margin requirements prevent the build-up of leverage in good times and soften the systemic impact of subsequent deleveraging. Two-way variation margining on a net basis thus significantly mitigates the need for undesirable pro-cyclical conduct.

- Variation margin is designed to cover a SBSD's actual current exposure to a counterparty, *i.e.*, its net mark-to-market exposure at a point in time. Exchanging variation margin can be expected to mitigate systemic risk by reducing the contagion and spillover effects that result when a SBS counterparty defaults while owing a substantial amount to its counterparty on a current, mark-to-market basis.

With respect to initial margin, we believe that the best approach, at this time, would be to focus first on expanding and enhancing variation margin exchange practices, as described above. We are concerned that implementing initial margin requirements, even in the form envisioned by Alternative A, would give rise to the adverse consequences noted above before there is an opportunity to observe market dynamics, quantify predictable impacts, identify risks that are not addressed by a rigorous variation margin regime and consider all of the possible measures for reducing those risks.

In addition, we note that there is not yet a consensus within the regulatory community regarding the structure or content of initial margin requirements. Alternative A, which has been proposed solely by the Commission, differs significantly from Alternative B, which was also

[87] Proposal § 18a-3(e).

proposed by the CFTC and the Prudential Regulators, and both differ from the universal two-way exchange proposed by BCBS/IOSCO. Further, none of the proposals substantively address initial margin thresholds, if any. Adopting initial margin requirements before there is an international consensus on their structure and content would be extremely problematic. Some market participants would, following their fiduciary duty, conduct their activities so that applicable initial margin requirements suited their interests, whether that is collecting more collateral or posting less. Inconsistencies would narrow the range of counterparty pairs able to transact effectively with each other, thereby reducing liquidity. In the case of SBSDs specifically, a nonbank SBSD subject to margin requirements under Alternative A would be disadvantaged were it to transact with a bank SBSD subject to margin requirements under Alternative B, since it would be required to post initial margin but not required to collect it. As a practical matter, this is likely to deter transactions between nonbank and bank SBSDs, or force nonbank SBSDs to negotiate for the collection of initial margin and thereby lead to the *de facto* adoption of Alternative B.

- ***Recommendation:*** *For the above reasons, we view the implementation of rigorous variation margin requirements as a vital improvement that should be the principal and most immediate focus of the Commission and other regulators. In the meantime, whether market participants post initial margin should be a matter of bilateral negotiation, based on their own evaluation of the costs, risks, and prudential safety and soundness considerations.*

- ***Recommendation:*** *If the Commission decides to adopt initial margin requirements, SIFMA urges the Commission to adopt Alternative A, modified as described in Appendix 2 to this letter. We emphasize that the Commission should not adopt this regime unless there is first a consensus for the approach within the international regulatory community, since inconsistent margin requirements would undermine the benefits of this regime and produce other competitive market distortions. In particular, we note that, to avoid such distortions, any requirement to collect initial margin should apply in a consistent manner to bank and nonbank SBSDs that transact with each other and should allow for a broader use of models than would be permitted under the Proposal.*

C. Additional Comments Relating to Margin Requirements

As we have explained above, we believe strongly that mandatory initial margin requirements would not significantly increase systemic resiliency and could be destabilizing. In addition to this over-arching concern, we have offered below further comments relating to the Proposal's margin requirements.

1. <u>The Commission Should Harmonize its Exceptions to the Margin Collection Requirement</u>

(a) **<u>Commercial End Users</u>**

The Proposal includes an exception to the margin collection requirement for commercial end users.[88] As a result, SBSDs would not be required to collect initial or variation margin from commercial end users. Parties can, however, individually negotiate bilateral margin requirements, and SBSDs would be required to establish credit limits for commercial end user counterparties.[89]

We support the proposed exception to the margin collection requirements for commercial end users, since SBS with commercial end users do not generally pose the type of risks to the safety and soundness of SBSDs that would justify categorical application of margin requirements to them. However, we are concerned that the Commission would define "commercial end user" in a way that is inconsistent with the definition applicable under its own mandatory clearing requirements and with the Prudential Regulators' and CFTC's margin proposals.

The end-user exception for both mandatory clearing and margin requires, among other conditions, that the end-user is not "predominantly engaged in activities that are financial in nature as defined in the Bank Holding Company Act of 1956" ("**BHCA**") (the "**Predominantly Engaged Test**"). Market participants are currently uncertain about how to analyze whether an entity satisfies this standard because neither the Commission nor the Exchange Act specifies what "predominantly" means or whether the analysis is based on the consolidated assets and revenues of the relevant entity. Instead of clarifying this ambiguity, the Commission proposed a second, almost identical requirement as a result of which the margin exception would be applicable only to a commercial end user that "engages primarily in commercial activities that are not financial in nature" (the "**Engaged Primarily Test**"). Therefore, for the margin exception, not only will market participants have to determine whether an entity is "predominantly engaged" "in activities that are financial in nature as defined in the BHCA" but they will also have to determine whether that same entity is "engaged primarily" in "commercial activities that are not financial in nature." Adding to the ambiguity, in contrast to the Predominantly Engaged Test, there are no definitions or legal precedents to refer to for the Engaged Primarily Test.[90]

More specifically, it is unclear whether the Commission intends the test for 'primarily' to be the same as the test for 'predominantly' and, if primarily is a lower standard (*e.g.*, more than 50% instead of 85% or more), some commercial end users could qualify for the mandatory

[88] Proposal § 18a-3(c)(1)(iii)(A).

[89] Proposal § 18a-3(e).

[90] For the Predominantly Engage Test, although the Exchange Act does not clarify what it means to be "predominantly engaged" in a financial activity, the BHCA and Title I of Dodd-Frank add gloss to congressional intent for this test. *See* Dodd-Frank Section § 102(a)(6) and BHCA §§ 4(k), (n). There are no analogous statutory provisions, to our knowledge, that provide market participants with similar clarity about how to analyze the Engaged Primarily Test.

clearing exception but not the margin exception. There is no indication that this was Congress's intent and, to the contrary, Congress made clear its intention in Dodd-Frank that the Predominantly Engaged Test be the threshold for an end user to qualify as a commercial end user. The Proposal would thus impose margin requirements on commercial end users that do not satisfy the Engaged Primarily Test, resulting in increased liquidity pressures, pro-cyclicality and credit risks in the market, without any basis for concluding that Congress intended such a result. These entities are not systemically important and do not pose risks to the safety and soundness of SBSDs or the broader financial market. Furthermore, because the CFTC and Prudential Regulators only require the Predominantly Engaged Test, and not the Engaged Primarily Test, for their end user exception to margin requirements, nonbank SBSDs will be at a competitive disadvantage because they will be required to collect margin from certain end users when SDs and bank SBSDs do not.

➢ ***Recommendation:*** *The Commission should eliminate the Engaged Primarily Test to make the definition of commercial end user for the margin exception consistent with the definition for the mandatory clearing exception, and the margin proposals of other U.S. and international regulators.*

(b) **Foreign Sovereigns, Central Banks And Supranational Institutions**

BCBS/IOSCO expressed broad support for exceptions from margin requirements for uncleared derivatives in the case of sovereigns, central banks and supranational institutions.[91] However, the Commission did not propose a similar exception for uncleared SBS. We are very concerned that this inconsistency, if it is codified, would result in severe competitive disadvantages for nonbank SBSDs. Not only would nonbank SBSDs be uncompetitive relative to foreign SBSDs when trading with foreign sovereigns, central banks and supranational institutions, but also nonbank SBSDs' diminished competitive position is likely to extend to other local counterparties because local agencies, municipalities and corporations often follow the lead of their sovereign in determining the counterparties with whom they transact. Therefore, we urge the Commission to harmonize its approach to the margin requirements with respect to transactions with sovereigns, central banks and supranational institutions with the BCBS/IOSCO final recommendations.

➢ ***Recommendation:*** *The Commission should ensure that its treatment of sovereign entities is consistent with international standards.*

(c) **Affiliates**

The Proposal does not include an exception to the margin collection requirements for SBS transactions between affiliates. We recommend that variation margin requirements apply to an inter-affiliate transaction only when a SBSD is transacting with an unregulated/non-prudentially supervised affiliate.[92] As discussed above in Section I.C, we also urge the

[91] *See* Initial BCBS/IOSCO Consultation at 9 and Second BCBS/IOSCO Consultation at 9.

[92] If the Commission adopts initial margin requirements, it should not apply them to any inter-affiliate transaction.

Commission to permit firms a one-day grace period before a capital charge will apply to an undermargined account of an affiliate, provided that the undermargined account is held for an affiliate that is subject to U.S. or comparable non-U.S. prudential regulation.

Inter-affiliate SBS transactions enable improved hedging efficiencies and better facilitation of transactions with customers (*e.g.*, customers can transact with a single entity in their jurisdiction). Additionally, global financial entities typically centralize their market risk exposures through a series of back-to-back transactions. Centralizing this exposure allows firms to more effectively manage their risk by aggregating and netting portfolio and other risk offsets before hedging their exposure in the market. Imposing excessive margin requirements on inter-affiliate trades would frustrate these prudent risk-reducing techniques because the costs of allocating margin could outweigh the benefits gained from posting margin. Posting and collecting margin would also raise complicated cross-border operational issues and cost allocations and, in the case of segregated initial margin, would unnecessarily tie up substantial liquidity.

There are also other mitigants to the risks of inter-affiliate transactions that are less disruptive. In particular, SBSDs must hold capital against credit exposures to their affiliates. In addition, financial holding companies are subject to consolidated supervision and risk management requirements.

Nevertheless, where a SBSD has significant concentrations of current exposure to an unregulated affiliate, such exposure could pose a risk to third parties transacting with the SBSD without that risk being addressed through effective prudential supervision of the affiliate. Accordingly, we believe it would be appropriate to require the SBSD to collect variation margin from its unregulated affiliate in such circumstances.

➢ ***Recommendation:*** *The Commission should apply margin requirements to inter-affiliate transactions only when one of the affiliates is unregulated.*

(d) **Structured Finance or Securitization SPVs**

The Commission should adopt an exception from margin collection requirements in the case of SBS entered into with a structured finance or securitization SPV where the SBSD has rights as a secured creditor consistent with market practice for such SPVs. SBS with structured finance or securitization SPVs are subject to additional considerations not present in the context of transactions with other types of entities. In a typical structure, an SPV issues debt that is supported by a pool of assets that serves as collateral for the issued debt and obligations to other permitted creditors, and that usually over-collateralizes those exposures. Whether to hedge interest or foreign exchange risk, or to gain market- or credit-linked exposure, the SPV might enter into one or more derivatives. However, because the SPV is generally capitalized to the extent of its obligations, and does not have an operating business to generate free cash flow, nor the ability to raise additional capital, it is not able to post variation margin, much less initial margin, to its derivatives counterparties. Instead, a derivatives counterparty to the SPV has rights as a secured creditor, typically with payment rights senior to those of debt holders and other permitted creditors, or at the same level as certain payments on senior debt.

For SBS entered into by structured finance or securitization SPVs, the collateral arrangements may take the form most typical of securitizations generally, where there is a pledge of all or substantially all assets of the SPV to a trustee or collateral agent, and creditors are paid in accordance with a priority of payments. In some structures the SBS may be secured by a combination of cash assets of the SPV and a committed credit facility. In other cases, individual credit derivatives are "defeased" at the time of entry by dedicated assets in a separate securities account in which the derivatives counterparty has a first priority security interest and its recourse typically is limited to those assets. These arrangements generally have proven to be commercially effective methods for the SPV to structure its derivatives exposures and for a counterparty to manage its risk to the SPV. In contrast, subjecting the SPV to margin requirements would essentially prevent it from entering into any SBS at all. The imposition of an additional margin requirement in such cases would impose uneconomic costs upon the SPV and could increase the cost of capital and, indirectly, the cost of financing the underlying assets.

- ***Recommendation:*** *Where the alternative security arrangements prevailing in the marketplace, such as those described above, are in place, SBS with a structured finance or securitization SPV should be excluded from margin requirements. Furthermore, a SBSD's security interest in accordance with the SPV's governing documents should be considered a substitute for the collection of collateral and no capital charge for foregone margin should be required.*

2. Eligible Collateral

The Proposal would allow counterparties to deliver cash, securities and money market instruments, subject to specified conditions relating to liquidity and transferability, for initial and variation margin and would not limit eligible collateral to a narrow category of assets.[93] There are many factors that should be considered in determining what collateral should be accepted for each unique counterparty and trade and the Proposal provides counterparties with sufficient flexibility to make such determinations without negatively impacting the markets. Accordingly, we strongly support the Commission's approach to determining eligible collateral. SIFMA also supports the haircut methodologies in the Proposal and encourages the Commission to modify the haircut requirements in the future as necessary to maintain consistency with international standards.

The Prudential Regulators and CFTC proposed the opposite approach by specifying a limited category of assets that could be used as margin for uncleared swaps and/or SBS, as applicable. This approach would potentially increase market participants' risk by requiring them to accept collateral that could, in many cases, be inappropriate to the relevant trade. It would also increase costs and liquidity pressures on market participants by increasing demand for and placing undue pressure on the supply of such collateral. A fixed set of eligible assets is additionally likely to be unresponsive to future market evolution and the idiosyncratic needs of counterparties with particular asset portfolios or counterparties in emerging markets.

---

[93] Proposal § 18a-3(c)(3).

We also note that proposed Rule 18a-3(4)(i) would require collateral to be in the physical possession or control of the SBSD for it to be eligible. However, the segregation requirements in proposed Rule 18a-4 would only require excess securities collateral to be in the SBSD's physical possession or control. Accordingly, we request that the Commission modify Rule 18a-3(4)(i) to clarify that only excess securities collateral (and not any other type of collateral) is subject to the possession or control requirement. Imposing a broader possession or control requirement could impose serious funding costs on SBSDs, for instance by requiring them to fund initial and variation margin payments for offsetting transactions through their own resources rather than through the collateral posted by SBS customers in accordance with proposed Rule 18a-4.

➢ ***Recommendation:*** *The Commission should adopt its proposed requirements regarding the scope of eligible collateral, except it should clarify that the requirement that the SBSD maintain possession and control of the collateral should apply only to "excess securities collateral" as defined in its proposed segregation rules.*

III. SEGREGATION REQUIREMENTS

A. Omnibus Segregation Requirements

The Proposal would require that a SBSD comply with omnibus segregation requirements for cleared and uncleared SBS modeled on Rule 15c3-3, unless the counterparty waives segregation or elects individual segregation.[94] Under this proposal, the SBSD must maintain possession or control of "excess securities collateral"[95] and a reserve account containing cash and qualified securities equal in value to the excess of SBS customer credits over debits.[96]

We generally support the Commission's decision to model the SBSD omnibus segregation requirements on Rule 15c3-3. We believe that using Rule 15c3-3 as a model is appropriate in light of the insolvency treatment of SBS customers under the Securities Investor Protection Act ("**SIPA**") and the U.S. Bankruptcy Code. It also is an important complement to the Commission's proposal to permit cash positions, options and single stock futures to be held in a SBS account as collateral for SBS positions.[97]

We also support the Commission's objective of accommodating the current practice of dealers in OTC derivatives to collect collateral from an OTC derivatives counterparty and concurrently deliver collateral to another dealer for an OTC derivatives transaction that hedges the transaction with the counterparty.[98] To accomplish this objective, the Proposal would define "excess securities collateral" to exclude securities or money market instruments posted to

---

[94] Proposal § 18a-4(b)-(c).

[95] Proposal § 18a-4(b).

[96] Proposal § 18a-4(c).

[97] *See* Proposing Release at footnote 537 and accompanying text (indicating that short cash positions, options and single stock futures may be held in a SBS account as collateral for SBS positions).

[98] Proposing Release at 70,278.

collateralize current exposure of the SBSD to the customer and securities and money market instruments held in a "qualified registered SBSD account" to the extent they are being used by the SBSD to meet a margin requirement of another SBSD resulting from an uncleared SBS hedging transaction to mitigate the risk of an uncleared SBS transaction with the customer.[99] In addition, the SBS reserve formula would include as debit items the debit balance in a SBS customer's account, including the net replacement value of uncleared SBS in favor of the SBSD, and margin related to uncleared SBS transactions in accounts carried for SBS customers held in a qualified registered SBSD account at another SBSD.[100]

There are, however, several technical questions and issues that need to be addressed for the proposed requirements to be made consistent with Rule 15c3-3 and to accommodate the funding and hedging practices of dealers in OTC derivatives. Some key examples include the following:

- It is not clear to us that the proposal to require a broker-dealer SBSD to conduct separate possession and control and reserve account calculations for securities, on the one hand, and SBS, on the other, is necessary given the common insolvency treatment of securities and SBS customers. Requiring separate calculations also stands likely to increase operational risk, potentially significantly.

- The Proposal would only provide exceptions from the segregation requirements for collateral posted by the SBSD to another SBSD as margin for an uncleared SBS transaction that hedges a customer-facing SBS transaction. However, the strategies used to hedge SBS do not always involve another SBS. Instead, SBSDs use other products such as cleared and uncleared swaps, cleared SBS and futures. SBSDs may also use SBS customer collateral to finance the purchase of cash positions that are designed to act as a hedge for the SBS. As proposed, SBSDs would be penalized for using these hedging strategies – they would not be able to use the initial margin received for a SBS to hedge their exposure to the SBS and would instead have to use their own assets – even though these strategies may be more cost-effective and/or otherwise commercially more appropriate under the circumstances.

- The Proposal would use the market values of securities and money market instruments, rather than their haircut values. This would necessitate a SBSD to use its own resources to fund margin requirements for transactions that hedge customer SBS transactions, to the extent of the haircuts for the securities and money market instruments it posts as margin for those hedging transactions.

- It is unclear how the exceptions from the definition for "excess securities collateral" and the debit items in the reserve formula are intended to apply to a customer that posted a combination of cash and securities to collateralize its SBS

[99] Proposal § 18a-4(b).

[100] Proposal § 18a-4a.

transactions. For example, if a customer has posted $5 worth of securities and $5 of cash as margin for a SBS, and then the SBS position moves $3 in the SBSD's favor (without any further collateral posted by the customer), is there a $3 decrease in both the possession and control and reserve account requirements, just the possession and control requirement or just the reserve account requirement?

- It also is unclear how cash, securities and money market instruments posted by a SBSD as variation margin are to be treated under the requirements. For instance, should variation margin posted by a SBSD be included as a debit item in the reserve formula, which would offset a credit item for net replacement value of uncleared SBS in favor of a customer?[101]

- Unlike Rule 15c3-3, which excludes broker-dealers from the "customer" definition, the proposed requirements would not exclude SBSDs from the analogous definition for SBS customers.

- The SBS customer definition would only include a person from whom or on whose behalf the SBSD has received or acquired or holds funds or other property for the account of the person with respect to a cleared or uncleared SBS transaction. Under this definition, it is unclear what the treatment should be for property remaining in the account of a SBS customer that is party to a portfolio margining arrangement in a circumstance in which all the SBS positions in the customer's account are temporarily closed out or expire before the customer enters into a new SBS transaction with the SBSD.[102]

- The use of a single reserve account formula for both broker-dealer and stand-alone SBSDs generates confusion regarding how some of the formula items are intended to apply for a stand-alone SBSD and the extent to which a stand-alone SBSD can offer portfolio margining. Moreover, how the proposed requirements are to apply to a portfolio margining account more generally is unclear.

- The Proposal would not impose restrictions, similar to the restriction in Rule 8c-1, on commingling of hypothecated customer securities.

---

[101] The absence of debit and credit balance definitions also raises issues in connection with the Proposal's margin requirements. For instance, the Proposal suggests that the mark-to-market value of uncleared SBS positions would be included, simultaneously, as (i) either a debit or credit balance (as applicable) and (ii) the amount of "equity" in the account *prior to* the addition of any credit balance and the deduction of any debit balance. Proposing Release at 70,260. This would mean that the mark-to-market value of uncleared SBS positions would be double counted in the calculation of the equity in a counterparty's account. Accordingly, we ask the Commission to clarify that the mark-to-market value of SBS positions would only be counted in the "equity" definition as part of the credit balance or the debit balance, as appropriate.

[102] Similar issues are raised by the definition for the term "account" in the proposed margin rule. Proposal § 18a-3(b)(1).

- The Proposal would require a SBSD to perform its reserve account formula computation on a daily basis, rather than a weekly basis consistent with Rule 15c3-3. We urge the Commission to reconsider this position. Calculating the reserve account formula is an onerous process that is operationally intensive and requires a significant commitment of resources. However, SBSDs should be permitted to make an intervening daily calculation and deposit if necessary to reduce liquidity burdens caused by daily variation margin delivery requirements. We believe the Commission's existing framework is flexible enough to permit voluntary daily calculations and deposits. Indeed, under Rule 15c3-3, there are broker-dealers that make periodic daily calculations and deposits even though weekly computations and deposits are required. Accordingly, the Commission can achieve its objective of decreasing liquidity pressures on SBSDs while limiting operational burdens by requiring weekly, and permitting while not requiring daily, calculations and deposits.

- The Proposal would not permit SBS reserve account deposits to be held at a bank that is affiliated with a SBSD. We urge the Commission to reconsider this position, too. Currently, affiliated banks are commonly used as custodians for securities reserve accounts and for collateral held by SBSDs. Moreover, affiliated banks are subject to financial regulations that are the same as those applicable to unaffiliated banks. We therefore recommend that affiliated banks be treated in the same manner as unaffiliated banks for these purposes.

➢ ***Recommendation:*** *Before adopting omnibus segregation requirements, we urge the Commission to consult further with interested constituencies regarding the questions and issues noted above. SIFMA would be pleased to work with Commission staff to facilitate such a consultation.*

B. Individual Segregation Requirements

Section 3E(f)(1)(b) of the Exchange Act enables uncleared SBS counterparties of SBSDs to require their initial margin, but not variation margin, collateral to be held in a segregated account at an independent, third-party custodian. Under the Proposal, SBSDs would be required to notify their SBS counterparties in writing prior to the first uncleared SBS transaction (after the effective date of the Proposal) that the counterparty has the right to require individual segregation of its initial margin collateral. SIFMA supports these requirements but believes that clarification is needed to provide market participants with more certainty.

First, the Commission should confirm that initial margin can be segregated at a custodian that is an affiliate of a SBSD. In many cases, a customer's preferred custodian may in fact be an affiliate of the SBSD. In this regard, the statutory language only requires the custodian to be an independent third-party. A reasonable reading of this language would include an affiliate of a SBSD that is a separately incorporated entity. Such an affiliate would not be subject to the insolvency of the SBSD. Additionally, initial margin held at an affiliated custodian would be subject to the same protections afforded to initial margin held at a non-affiliate custodian.

We also support the Proposal's confirmation that SBSDs are required under the statute only to send a single notice informing existing or prospective SBS counterparties of their right to elect individual segregation, and that this requirement would become effective following the effective date of the Commission's final margin rules. Requiring this notice to be sent before the Commission adopts final rules would create uncertainty in the market about the nature of counterparties' respective rights and responsibilities.

The Proposal does not, however, clarify the individual at a customer to whom a SBSD must deliver the notice.[103] In this connection, we note that parties to uncleared SBS typically already agree to notice provisions as part of their relationship documentation. Accordingly, we request that the Commission clarify that the notice may be sent to the customer (or an investment manager that is authorized to act on behalf of a customer) in accordance with notice terms mutually agreed by the parties (or, absent such terms, to a person reasonably believed to be authorized to accept notices on behalf of a customer). Customers (or investment managers, as appropriate) would then be able to receive and direct notices to the appropriate decision-makers.

Once a customer has received the notice, it should be deemed to have elected not to require individual segregation until such time as it duly notifies the SBSD that it wishes to require segregation.[104] This clarification would prevent the market disruption that would result if the SBSD could not execute a new SBS with the customer without tracking and confirming the receipt of a notice acknowledgment and affirmative election by the customer.

Once a counterparty has elected individual segregation, the segregation requirement should not become effective until after the execution of custodial documentation satisfactory to the parties, provided that the parties are negotiating such documentation in good faith. This clarification would ensure that the parties can continue to enter into new SBS pending the execution of satisfactory custodial documentation, which can require a significant amount of time.[105]

After the custodial documentation is executed by the parties, the segregation requirement should apply only to uncleared SBS entered into after the customer made the election (including SBS entered into prior to the execution of the custodial documentation but after the election), unless otherwise agreed by the parties. The pricing and other terms of each SBS are dependent on many factors, including whether a counterparty elects individual segregation. Permitting counterparties to require individual segregation, on a retrospective basis with respect to preexisting SBS, would be tantamount to a unilateral post trade modification, without consideration, of the terms of the original trade, economically disadvantaging the affected SBSD. To the extent that the parties wish for segregation to apply to preexisting SBS, or to apply

---

[103] *Cf.* 75 Fed. Reg. 75,432 (Dec. 3, 2010) at § 23.601(c) (requiring delivery of the notice to the Chief Executive Officer or Chief Risk Officer of the customer).

[104] *Cf. Id.* at § 23.601(d) (prohibiting the execution of new swaps until the counterparty acknowledges receipt of the notice).

[105] Of course, existing custodial documentation should be sufficient for the segregation of initial margin for existing transactions.

segregation for only some, but not all, positions, then they could agree to modify the scope of segregation.

Finally, we believe that the ability for a customer to elect individual segregation should be sufficient to address concerns that customers may have regarding potential exposure to "fellow customer risk" under omnibus segregation arrangements. Thus, it would *not* be appropriate, in our view, for the Commission to adopt novel omnibus segregation requirements for SBS that have never before applied to the securities markets, such as a requirement for a SBSD to segregate individually the amount owed by it to each customer or a restriction on the extent to which customer credits, in the aggregate, can be used by a SBSD to fund customer debits. Placing such limitations on omnibus segregation would be inconsistent with Rule 15c3-3 and raise complex issues relating to the relative costs and benefits of such limitations, possible increased operational risk, obstacles to portfolio margining and the introduction of moral hazard for customers in their selection of SBSDs. At a minimum, it would be necessary for the Commission, for it to act in a manner consistent with the Administrative Procedure Act, to seek further public comments before adopting such a materially different omnibus segregation regime.

➢ ***Recommendation:*** *A SBSD should be required to send a single notice, in accordance with contractually agreed notice procedures, regarding its customer's right to elect individual segregation. The customer should be deemed to have elected not to require individual segregation until it duly notifies the SBSD that it wishes to require such segregation. Unless otherwise agreed, segregation should apply only to SBS entered into after the customer's election, and should not take effect until the parties have executed custodial documentation satisfactory to the parties.*

C. Segregation Requirements Applied to Bank SBSDs

Section 3E of the Exchange Act authorizes the Commission to impose segregation requirements on all SBSDs, not just nonbank SBSDs. The proposed segregation rules for SBS are largely based on the provisions of the broker-dealer segregation rules (Rule 15c3-3) applicable to broker-dealers. This proposal would not unduly burden broker-dealer SBSDs or ANC broker-dealers because these firms already have procedures and resources in place to implement proposed Rule 18a-4. This regime, and the proposed segregation rules, makes sense as applied to nonbank SBSDs because of the priority afforded to customers of nonbank SBSDs upon their insolvency.

Bank SBSDs, in contrast, are already subject to customer protection requirements by their primary regulators applicable to their custody of customer assets, and requiring them to comply with proposed Rule 18a-4 would be duplicative, burdensome and unnecessary. Rule 15c3-3 and proposed Rule 18a-4 are largely written to work in tandem with broker-dealer and SBSD insolvency laws providing customers with priority over other creditors, among other protections. However, banks are subject to a different insolvency regime that does not provide similar priority or protections to "customers." It is therefore unnecessary, from an insolvency policy perspective, to subject bank SBSDs to the same segregation requirements as nonbank SBSDs.

The Commission should instead adopt an approach similar to the one taken by the Treasury Department for the segregation rules applicable to banks that are government securities dealers.[106] Specifically, the Treasury Department provides an exemption to the government securities dealer customer protection requirements for banks that meet certain conditions and are subject to the "rules and standards of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation [or] the Office of Thrift Supervision governing the holding of government securities in a fiduciary capacity by depository institutions."[107]

- ***Recommendation:*** *A SBSD that has a Prudential Regulator, as provided in Section 1a(39) of the CEA, should not be subject to the proposed segregation requirements, except the proposed requirements implementing the Dodd-Frank statutory requirement that a SBSD offer individual segregation to its uncleared SBS counterparties. This approach would avoid an unnecessary burden on bank SBSDs who are already subject to adequate customer protection requirements.*

IV. PHASED IMPLEMENTATION

Implementing rigorous, two-way daily exchange of variation margin as proposed in Section II.B of this letter will take time. While market participants are aware of the Commission's intention to impose margin requirements for SBS transactions, there remain many unanswered questions about the general contours of these future requirements, not to mention the specific details. Market participants will be unable to negotiate revised collateral agreements, enhance valuation methodologies and modify operational systems until there is sufficient certainty about the requirements in the final margin rules for SBS transactions. To facilitate the implementation of these adjustments in an orderly manner, we suggest that the Commission provide 24 months from the publication of final rules until two-way daily variation margining is required for uncleared SBS between financial entities (other than qualifying SPVs and affiliates), with a 12-month phase-in period for uncleared SBS between SBSDs.[108]

In addition, the Commission has previously recognized the importance of appropriately sequencing the compliance dates for requirements under Title VII of Dodd-Frank in light of the interdependencies for those requirements.[109] In the instant case, there is a significant dependency of capital requirements on margin requirements. In particular, the Proposal would apply capital deductions for under-margined accounts. If the margin and capital rules were implemented simultaneously, SBSDs would likely be unable to restructure counterparty

---

[106] *See* 17 C.F.R. Part 450.

[107] 17 C.F.R. § 450.3.

[108] As discussed in Appendix 2, if the Commission does adopt mandatory initial margin requirements, the requirements should be phased in following the later of (a) 2 years after the adoption of mandatory variation margin requirements or (b) 6 months following the adoption of a mandatory clearing requirement for the relevant asset class or counterparty type.

[109] *See* SEC Release No. 34-67177 (June 11, 2012), 77 Fed. Reg. 35,625 (June 14, 2012).

relationships quickly enough to collect sufficient margin as required by the Commission, which would result in very significant capital deductions for a temporary period. Such temporary capital deductions are unnecessary, since they reflect a change in regulation rather than a change in the underlying economics of the business.

In addition, many nonbank SBSDs are subsidiaries of holding companies that are managing the implementation of the Basel III Standards. For such firms, there is an interdependency between revisions to the Basel Accords and capital requirements for SBSD subsidiaries. In this regard, the Banking Agencies have proposed a rule that would gradually phase-in the Basel III minimum capital requirements between 2014 and 2015, with full compliance with all Basel III requirements not mandatory until 2019.[110] That timetable was itself based on anticipated adoption of those requirements by the end of 2012; to date, the Banking Agencies have not finalized those requirements.

We note that the proposed three-plus year period for implementation of Basel III minimum capital requirements generally reflects an appropriate benchmark for an implementation period for the Proposal's capital requirements. Moreover, to comply with Basel III, firms will need to consider how most efficiently to raise additional capital and/or dispose of some of their assets or businesses. Similar decisions will also need to be made to prepare for compliance with the Proposal's capital requirements. Requiring firms to go through this process multiple times would be unduly disruptive.

In light of these considerations, we respectfully request a phase-in period for the Proposal's capital rules (other than the application of Basel 2.5) extending until two years from the effective date of the margin requirements in the Proposal, and in any event until the phase-in of Basel III's minimum capital requirements. Such a phase-in would provide adequate time for all market participants to renegotiate documentation and for SBSDs to begin collecting regulatory margin on all new positions, thereby avoiding market disruptions resulting from temporary capital deductions as the market adjusts to the new regimes. It would also provide market participants with the time necessary to backload transactions that are not currently, but that become, clearable. At the same time, it would avoid a sudden implementation of SBSD capital requirements that may disrupt the transition to new Basel III capital requirements at the holding company level.

➢ ***Recommendation:*** *The Commission should provide 24 months from the publication of final rules until two-way daily variation margining is required for uncleared SBS between financial entities (other than qualifying SPVs and affiliates), with a 12-month phase-in period for uncleared SBS between SBSDs.*

➢ ***Recommendation:*** *The Proposal's capital rules (other than the application of Basel 2.5) should not take effect until the later of two years from the effective date of the Proposal's margin requirements or the effective date for Basel III's minimum capital requirements.*

[110] 77 Fed. Reg. 52,792 (Aug. 30, 2012).

*   *   *

We appreciate the Commission's consideration of our comments on the Proposal. As it considers our comments and those of others, we emphasize the extent to which it is critical for the Commission to work closely with the CFTC, the Prudential Regulators and BCBS/IOSCO in conducting a detailed empirical analysis of the costs and benefits of these rules and establishing consistent requirements across all types of affected firms and jurisdictions. Capital, margin and segregation requirements for SBS are among the most consequential requirements that the Commission will adopt under Dodd-Frank. They will play a significant role in determining how firms structure their OTC derivatives business overall and the competitive dynamics of the entire OTC derivatives market. As described above, we believe that significant modifications to the Proposal are necessary to prevent adverse market-wide consequences and better achieve the objectives of Dodd-Frank.

We would be pleased to provide further information or assistance at the request of the Commission or its staff. Please do not hesitate to contact the undersigned, or Giovanni P. Prezioso (+1 202 974 1650), Edward J. Rosen (+1 212 225 2820) or Colin D. Lloyd (+1 212 225 2809) of Cleary Gottlieb Steen & Hamilton LLP, outside counsel to SIFMA, if you should have any questions with regard to the foregoing.

Respectfully submitted,

Kenneth E. Bentsen, Jr.
Executive Vice President
Public Policy and Advocacy

cc: Elisse B. Walter, Chairman
Luis A. Aguilar, Commissioner
Troy A. Paredes, Commissioner
Daniel M. Gallagher, Commissioner

John Ramsay, Acting Director
Michael Macchiaroli, Associate Director
Division of Trading and Markets

Craig M. Lewis, Director and Chief Economist
Division of Risk, Strategy and Financial Innovation

Appendix 1: Summary of Requirements for Dually Registered OTC Derivatives Dealers/SBSDs

The below chart summarizes a proposed approach under which an OTC derivatives dealer could register as a SBSD.

Requirement	Proposal
Scope of Activities	The entity could engage in the following activities: • Dealing in eligible OTC securities derivatives (including SBS, forwards and options) • Issuing and reacquiring securities issued by the entity (*e.g.*, warrants and structured notes) • Ancillary, non-dealing cash and portfolio management securities activities • Non-securities activities (*e.g.*, interest rate swaps, commodity swaps, futures, etc.) in accordance with any applicable regulations
Registration	The entity would register using Form SBSE-BD, with conforming changes to reflect its status as an OTC derivatives dealer
Capital	The entity would apply the higher of the OTC derivatives dealer or SBSD minimum capital requirement and could use approved models for credit and market risk charges
Margin	With appropriate disclosure to customers and Commission approval, the entity could portfolio margin all eligible OTC securities derivatives together

Customer protection/segregation	With appropriate disclosure to customers and Commission approval, proposed Rule 18a-4 could apply to all eligible OTC securities derivatives
Insolvency	The entity would be exempt from SIPA, but subject to stockbroker liquidation provisions of the Bankruptcy Code for any customer that does not waive segregation
Sales practice/business conduct/associated persons	The entity would not be required to join FINRA. Dodd-Frank business conduct rules would apply to SBS. Securities and SBS transactions would be conducted through registered personnel of an affiliated full-purpose broker-dealer subject to FINRA rules (with relevant exemptions from those rules for SBS), unless (a) the counterparty is a broker-dealer, a bank acting in a dealer capacity or an affiliate, (b) for ancillary portfolio management transactions in foreign securities, a broker-dealer or bank acting as agent for the entity or (c) for contacts with a foreign counterparty, the contacts are conducted by an associated person of a an affiliated foreign broker-dealer that is registered under local law
Confirmations and other documentation requirements	Rule 10b-10 would apply to securities, except SBS, and proposed Rule 15Fi-1 would apply to SBS. Other SBS documentation rules, if any, would also apply
Books and records	Rules 17a-3, 17a-4, 17a-5, 17a-11, 17a-12 and any new SBSD recordkeeping rules would apply to the entity

Appendix 2: Modified Version of Alternative A

If the Commission determines to adopt initial margin requirements, SIFMA urges the Commission to adopt Alternative A, modified as described below. We emphasize that the Commission should not adopt this regime unless there is first a consensus for the approach with the international regulatory community, since inconsistent margin requirements would undermine the benefits of this regime and produce other competitive market distortions.

I. Benefits of Alternative A Relative to Alternative B

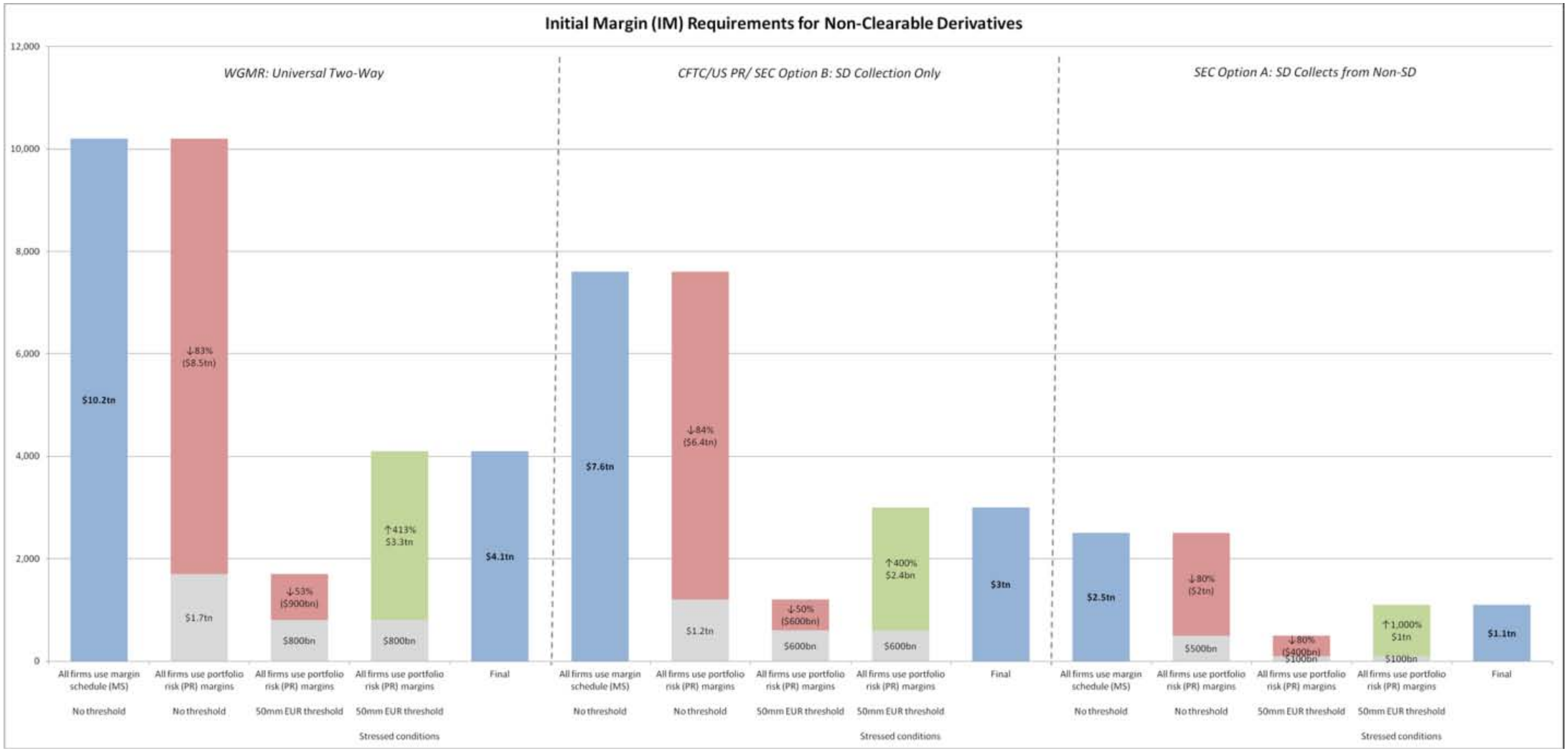
Adopting Alternative A, rather than Alternative B or the BCBS/IOSCO proposal, would significantly reduce the quantum of initial margin required to be collected. To illustrate this, we have prepared the chart on the following page, which compares the levels of initial margin that would be required to be collected under the BCBS/IOSCO Consultations, Alternative B and Alternative A, assuming that each proposal were adopted universally by each relevant regulatory authority.[111]

As the chart indicates, Alternative A is estimated to reduce the liquidity impact of initial margin requirements by roughly three to four times. At the same time, it would still assure that SBSDs obtain collateral to mitigate their potential future exposure to financial end users. If the Commission were to adopt an initial margin requirement, Alternative A would provide the most "bang for the buck."

Alternative A would also eliminate the potential for initial margin requirements to increase net credit risk to SBSDs because it would eliminate the scenarios under which SBSDs would be required to participate in a two-way exchange of initial margin. Financial end users would still, however, be exposed to SBSDs for the return of initial margin. In this regard, we note that there are important policy considerations on which the Commission could conclude that mitigating SBSDs' potential future exposure to their counterparties outweighs the possible adverse effects on those counterparties. These include principally that (i) the interconnected nature of SBSDs means that mitigating losses to them is more likely, all else equal, to prevent cascading losses throughout the financial system and (ii) SBSDs, unlike financial entities, will be subject to capital requirements that are designed to prevent their insolvency. Additionally, under the Proposal, SBSDs would be subject to segregation requirements that are designed to safeguard initial margin posted to them. It was clearly also Congress's objective that margin requirements be established for the safety and soundness of SBSD's and not for other purposes or market constituencies.

[111] As noted above, these estimates were prepared by SIFMA prior to the release of BCBS/IOSCO QIS results as part of the Second BCBS/IOSCO Consultation. While we are still studying those results, we have observed a number of respects in which they might under-estimate the impact of initial margin requirements. *See* Note 5, *supra*.

Figure 1. Comparison of Initial Margin Requirements



II. Proposed Modifications to Alternative A

Set forth below are modifications to an initial margin regime based on Alternative A that we urge the Commission to adopt if it decides to mandate the collection of initial margin by SBSDs. As discussed above, the imposition of a mandatory initial margin regime would be detrimental to liquidity and increase pro-cyclicality. The modifications described below would reduce the scale of these issues.

A. Permissible Calculation Methodologies

Under the Proposal, a nonbank SBSD would be required to use a standardized method drawn from Rule 15c3-1's market risk haircuts to compute the initial margin requirement for equity SBS, which would mean applying the methodology set forth in Appendix A of Rule 15c3-1.[112] For other SBS, nonbank SBSDs that are approved to use internal models for computing capital charges would be permitted to use those internal models to compute initial margin requirements.[113] Other nonbank SBSDs would, in turn, be required to use the standardized method for those SBS.[114]

We strongly support the proposal to permit nonbank SBSDs that are approved to use internal models for computing capital charges to use those internal models to compute initial margin requirements. Because of the complementary relationship between margin and capital, it is critical for there to be consistency between the calculation methodologies for margin and capital requirements. In this regard, we also urge the Commission to provisionally approve the use of internal models approved by other regulators (including qualifying foreign regulators) for the purpose of initial margin requirements, just as we have proposed that the Commission do for purposes of capital requirements.[115]

Moreover, the Prudential Regulators and the BCBS-IOSCO Consultation would each permit the use of approved models to compute initial margin requirements. Consequently, extending that approach to nonbank SBSDs would help foster consistency both domestically and internationally and ensure a level playing field for nonbank SBSDs competing with bank SBSDs and foreign SBSDs.

For similar reasons, however, we oppose the proposal to require the use of the standardized method for computing initial margin for equity SBS. So requiring would create discrepancies between capital and margin requirements and make nonbank SBSDs uncompetitive with bank SBSDs and foreign SBSDs for equity SBS. Moreover, we are concerned that applying the methodology set forth in Appendix A to Rule 15c3-1 would result in initial margin requirements that are substantially less sensitive to the economic risks of a SBS portfolio than a VaR-based model.

---

[112] Proposal § 18a-3(d).

[113] Proposal § 18a-3(d)(2).

[114] Proposal § 18a-3(d)(1).

[115] *See* Section I.B.2, *supra*.

In particular, although Appendix A's methodology yields results similar to VaR for a SBS portfolio that is only directionally long, it significantly overstates risk for a market-neutral portfolio. For instance, a long-only, diversified U.S. equities portfolio of $100 million in notional size would result in a $15 million initial margin requirement under Appendix A and a $10 million initial margin requirement under VaR. In contrast, a market-neutral, diversified U.S. equities portfolio with $100 million in long positions and $100 million in short positions would result in a $30 million initial margin requirement under Appendix A and a $2 million initial margin requirement under VaR. Thus, for such a market-neutral portfolio, Appendix A would overstate risk by more than 15 times relative to VaR.

- ***Recommendation:*** *For computing the margin amount for equity SBS, a nonbank SBSD should be permitted to use either the Appendix A methodology or approved internal models.*

B. Modifications to Mitigate Pro-Cyclicality

Even with these virtues relative to Alternative B, Alternative A has the potential to exacerbate pro-cyclicality, as SBSDs simultaneously adjust the assumptions underlying their initial margin models during increased volatility market environments to require their financial end user counterparties to post significant amounts of additional collateral. As noted above, one way to mitigate this effect might be to adopt standardized (and stable) initial margin requirements. Nonetheless, doing so would significantly increase the adverse liquidity and credit impact of the resulting higher collateral requirements.

Thus, adopting a mandatory initial margin regime requires the Commission and other regulators to identify a framework that would facilitate a risk-sensitive, empirically based method for computing initial margin while at the same time mitigating, to the greatest extent feasible, the potential for initial margin requirements to increase during periods of market stress. If they adopt mandatory initial margin requirements, we strongly urge the Commission and its counterparts to consider ways in which they might satisfy these two principles.

By way of example, the Commission could require that internal margin models use a static historical VaR approach. Under this approach, the initial margin level would be set at a level based on the actual losses observed during a specified historical time period, with the period chosen to include a variety of stressed market environments. If actual historical data is used rather than a current hypothetical distribution of losses, and the historical observation period is kept static, it would not be necessary to vary the level of initial margin based on dynamic volatility conditions. If, following a future period of market stress, the Commission wished to update the historical observation period, it could time the update in a manner that would not exacerbate volatility during that period.

- ***Recommendation:*** *The Commission should seek to apply parameters to internal margin models that limit the potential for pro-cyclical effects, such as requiring that such models use a static historical VaR approach.*

C. Initial Margin Thresholds

Initial margin thresholds can be a useful means for reducing the aggregate liquidity impact of mandatory initial margin requirements while still protecting a SBSD from large uncollateralized potential future exposures to counterparties.[116] Accordingly, if the Commission adopts mandatory initial margin requirements, then we recommend that it permit an initial margin threshold. Because initial margin thresholds are not proposed or discussed in the Proposal, we urge the Commission to seek comment from the industry before adopting one of several possible approaches for setting initial margin thresholds.

- ***Recommendation:*** *If the Commission adopts mandatory initial margin requirements, it should permit an initial margin threshold. The Commission should seek comment before adopting its framework for initial margin thresholds.*

D. Legacy Account Exception

The Proposal contains an exception from the initial margin collection requirement for a legacy SBS account, which would be defined as an account that holds no SBS entered into after the effective date of the margin rules and that only is used to hold SBS entered into prior to the effective date of those rules and collateral for those SBS. We request that the Commission confirm that this exception would apply to accounts that contain positions that were originally entered into by the customer prior to the effective date, but which were novated to the SBSD after such date. Such clarification is necessary to address the possibility that initial margin requirements for nonbank SBSDs may go into effect before the time at which bank SBSDs are required by Section 716 of Dodd-Frank to "push out" many of their SBS activities to nonbank affiliates. Nonbank SBSDs likely will not be in a position to negotiate for the ability to collect initial margin for transactions novated to them due to Section 716. At the same time, novating such transactions will facilitate the ability for firms to manage their SBS portfolios in a single legal entity.

- ***Recommendation:*** *The Commission should clarify that the margin exception for legacy SBS accounts would apply to accounts that contain positions that were originally entered into by the customer before the effective date for the margin rules, but which were novated to the SBSD after such date.*

E. Portfolio Margining and Cross-Margining

As the Commission has observed, calculating margin requirements on a portfolio basis offers many benefits, including greater efficiencies as a result of the recognition of off-setting positions and better alignment of costs and overall portfolio risk.[117] Portfolio margining alleviates excessive margin calls, improves cash flows and liquidity and reduces the impact of individual position volatility. The Commission has made great progress in the area of portfolio

[116] Thresholds do not, however, address the pro-cyclicality effect discussed above.

[117] SEC, Exemptive Order and Request for Comment, Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps (Dec. 14, 2012), http://www.sec.gov/rules/exorders/2012/34-68433.pdf.

margining. However, there is more work to be done to provide market participants with the ability to use portfolio margining for all risk-offsetting products.

For the reasons discussed above, we support the Commission's efforts to allow parties to use portfolio margining. Specifically, we support the proposal to allow omnibus segregation and portfolio margining of initial margin held for cleared and uncleared SBS. We also commend the Commission's recent order permitting the commingling and portfolio margining of cleared CDS, which include both swaps and SBS, in a segregated account established and maintained in accordance with Section 4d(f) of the CEA.[118] This is a valuable step in overcoming the gap between functionally equivalent products that are subject to different regulatory and insolvency regimes.

There are, however, other risk-offsetting products that should be included in the Commission's portfolio margining regime. For example, market participants offset the risk of both cleared <u>and</u> uncleared CDS SBS with cleared <u>and</u> uncleared index CDS. SBSDs that use internal models to calculate initial margin for these products have the capabilities to calibrate margin on a portfolio basis. However, regulatory and legal barriers prevent them from doing so and obtaining the benefits of portfolio margining.

In particular, we acknowledge that there are challenges to the comprehensive portfolio margining of Commission- and CFTC-regulated products as a result of different insolvency and customer protection regimes. Broker-dealers and SBSDs are subject to the Commission's customer protection rules that include, for broker-dealer SBSDs, access to Securities Investor Protection Corporation insurance for customers whereas, for swap dealers and FCMs, the CFTC does not have an equivalent customer protection regime.

Nevertheless, we believe portfolio margining can be achieved notwithstanding these challenges. In particular, the Commission and the CFTC have repeatedly recognized, through cross-margining orders, portfolio margining arrangements under which a securities counterparty subordinates itself to securities customers and has its positions carried in a commodities account (*i.e.*, a futures or, more recently, cleared swap account). Dodd-Frank also contemplates portfolio margining of futures positions in a securities account,[119] and the Commission's recent cross-margining order, noted above, contemplates portfolio margining of cleared swap positions in a securities account.[120]

Additionally, market participants have developed arrangements for cross-margining cleared and uncleared derivatives. Under these arrangements, the total initial margin would be calculated based on the risks of both cleared and uncleared derivative portfolios. Although this will result in a lower total initial margin requirement, it will more accurately reflect the risk of default on a portfolio basis. The clearing organization would receive the full amount of initial margin to which it is entitled and the uncleared derivative counterparty would receive the remainder. In an event of default, the clearing organization and clearing broker would be paid in

[118] *Id.*

[119] *See* CEA Section 4d(h).

[120] *See* Note 117, *supra*.

full with the initial margin they hold and any excess margin would be available (subject to the prior claims of the clearing organization, clearing brokers and customers) to satisfy the claim of the uncleared derivative counterparty. These arrangements have been in place for years to establish cross-margining between futures contracts and OTC derivatives, and have proven to be an effective mechanism for calibrating margin requirements to reflect accurately the overall risk presented by a counterparty's portfolio. Similar arrangements are also commonly used in other areas, such as to cross-margin derivatives and correlated cash positions (margin loans and short positions in prime brokerage arrangements), listed options, repo and/or securities lending positions.

Notably, these cross-margining arrangements generally should not result in a significant shortfall in customer property, if any, in the insolvency of the clearing broker or the dealer. By design, the amount of customer property available to customers of the clearing broker would not be diminished at all as a result of the arrangement. The dealer, in turn, would still be responsible for collecting the full amount of variation margin due on the uncleared portfolio, without offsetting that amount based on positions in the cleared portfolio. As a result, subject to intraday movements, no customers of the dealer would have negative equity in their accounts.[121] Therefore, to the extent that the amount of initial margin required to be delivered by the customer was reduced because of the cross-margining arrangement, that reduction would simply be reflected by a reduction in the customer's claim against the pool of customer property. This is no different from a case in which the dealer collects more initial margin from some customers than others based on its evaluation of the relative creditworthiness of those customers.

- ***Recommendation:*** *The Commission should build on existing precedent by working with the CFTC to facilitate the expansion of portfolio- and cross-margining arrangements. Set forth below are sample scenarios under which we propose the Commission and the CFTC, through rulemakings or cross-margining orders (as appropriate), should facilitate portfolio margining arrangements.*

[121] To the extent that the Commission has concerns about the possibility that a dealer might not collect sufficient initial margin to cover intraday movements, it could address that concern through its evaluation and approval of the dealer's initial margin model, in particular the extent of offsets that the model allows vis-à-vis the customer's cleared portfolio.

Scenario	Applicable Customer Protection and Insolvency Regime	Portfolio Margin Recommendation
(1) Eligible contract participant ("**ECP**") customer has SBS and OTC securities options positions with (i) a dual broker-dealer-SBSD or (ii) a dual OTC derivatives dealer-SBSD	• Dual Broker-Dealer-SBSD. An ECP's SBS and OTC securities options are currently subject to functionally equivalent customer protection regimes pursuant to proposed Rule 18a-4 and Rule 15c3-3, respectively. Upon a dual broker-dealer-SBSD's insolvency, SBS and OTC securities options would both be subject to resolution under SIPA. • OTC Derivatives Dealer-SBSD. Currently, OTC securities options would not be subject to either Rule 15c3-3 or proposed Rule 18a-4. SBS would, however, be subject to proposed Rule 18a-4. Upon an OTC Derivatives Dealer-SBSD's insolvency, customers' rights for both SBS and OTC securities options would be governed by the stockbroker liquidation provisions of the Bankruptcy Code.	We urge the Commission to allow OTC securities options to be held in a Rule 18a-4 SBS account at a dual broker-dealer-SBSD or OTC derivatives dealer-SBSD, with margining determined via an approved VaR or TIMS model. Subjecting OTC securities options to proposed Rule 18a-4 aligns it with the customer protections applicable to SBS, thereby eliminating the key legal impediments to portfolio margining.

(2) A SBS counterparty of a dual SD-SBSD waives segregation requirements for its SBS positions and contractually agrees to be subordinate to customers. The counterparty has an uncleared swap account with the SD.	• SBSD. Proposed Rule 18a-4 would provide customer protections for the SBS positions; however, the counterparty waived segregation and agreed to be subordinate to other customers, thereby making the customer protection rules inapplicable. Upon insolvency of a SBSD, a dual broker-dealer-SBSD's SBS counterparties' rights will be governed by SIPA and a stand-alone SBSD's counterparties' rights will be governed by the stockbroker liquidation provisions of the Bankruptcy Code. However, in both cases, the counterparty has waived customer status. • SD. The CFTC does not have customer protection rules equivalent to Rule 15c3-3 or proposed Rule 18a-4. An SD's insolvency is governed by the Bankruptcy Code.	SIFMA proposes that the SBS positions can be carried in an uncleared swap account of an SD-SBSD, with portfolio margining using an approved VaR model. The electing counterparty should also contractually agree to be subject to the CFTC's regulations and the insolvency regime applicable to CFTC-regulated entities. Under this scenario, the SBS counterparty's positions are no longer subject to the Commission's customer protection regime and the legal impediments to portfolio margining are eliminated.

(3) A SBSD counterparty elects segregation at an independent, third-party custodian and is subordinate to customers.	The Commission's reserve account and possession and control requirements are inapplicable to initial margin held at a third-party custodian. Upon a SBSD's insolvency, the customer would receive all of its collateral from the custodian and would have an unsecured claim against the SBSD's estate for any amount it is owed.	The Commission should allow customers to have their SBS positions held in a third-party segregated uncleared swap account held pursuant to Section 4s(l) of the CEA. Upon a SBSD's insolvency, the counterparty would not have a customer claim for initial margin held in the third-party account.
(4) An uncleared SBS customer also has cleared SBS and cleared swap positions with the SBSD or its affiliate.	• Either Rule 15c3-3 (for a dual broker-dealer-SBSD) or 18a-4 (for a standalone SBSD) would apply to the cleared and uncleared SBS positions. Upon insolvency of a SBSD, a dual broker-dealer-SBSD's SBS counterparties' rights will be governed by SIPA and a stand-alone SBSD's counterparties' rights will be governed by the stockbroker liquidation provisions of the Bankruptcy Code. • Section 4d of the CEA and Part 22 of the CFTC's rules would apply to collateral held for cleared swap positions. Upon an insolvency of an FCM, swap customers' rights will be governed by the commodity broker liquidation provisions of the Bankruptcy Code and Part 190 of the CFTC's Rules.	SIFMA encourages the Commission to allow SBSDs to determine the level of initial margin to collect for uncleared SBS (and swap) positions taking into account collateral provided by the customer for its cleared positions, provided that the SBSD has an enforceable second lien on the cleared positions allowing it to foreclose on the collateral remaining after claims by the clearing organization, FCM/broker-dealer and cleared swap/SBS customers.

F. Phased Implementation of Initial Margin Requirements

An appropriate phase-in for initial margin requirements is necessary to provide market participants with adequate time to adopt necessary operating procedures to implement margin requirements, negotiate or re-negotiate relevant agreements and enhance valuation methodologies and for the market to prepare for the drain on liquidity resulting from initial margin requirements. It also is needed to provide regulators with better empirical data on which to define and calibrate initial margin requirements and levels.

- ***Recommendation:*** *If the Commission does adopt mandatory initial margin requirements, the requirements should be phased in following the later of (a) 2 years after the adoption of mandatory variation margin requirements or (b) 6 months following the adoption of a mandatory clearing requirement for the relevant asset class or counterparty type.*[122]

[122] We note that BCBS/IOSCO have proposed to phase in initial margin requirements over 2015-2019 by prioritizing counterparty pairs based on each party's level of uncleared derivatives activity. *See* Second BCBS/IOSCO Consultation at p. 22. We are still evaluating this proposal.