



Americans for Financial Reform
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February 22, 2012

Elizabeth M. Murphy, Secretary,
Securities and Exchange Commission,
100 F Street, NE., Washington, DC
20549-1090

Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security Based Swap Dealers And Capital Requirements For Broker Dealers (File No. S7-08-12; RIN 3235-AL12)

Dear Ms. Murphy:

Americans for Financial Reform (“AFR”) appreciates this opportunity to comment on the above-referenced Proposed Rules (the “Proposed Rules”) by the Securities and Exchange Commission (the “Commission”) proposing regulations that set out capital, margin, and segregation requirements for Security-Based Swap Dealers (“SBSDs”) and capital requirements for Broker Dealers.

AFR is a coalition of more than 250 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups along with prominent independent experts.

Comments

In 2010, following the collapse of Lehman Brothers, the Commission promised a thorough review of broker-dealer capital adequacy rules, with particular attention to the use of internal models.¹ These Proposed Rules appear to be the result of this review, and they are disappointing. Not only does this proposal fully retain the use of internal models for broker-dealers permitted alternative net capital (ANC) treatment, but the internal models approach is expanded to SBSBs. This flies in the face of the experience of the financial crisis and the lessons learned regarding the dangers of bank self-regulation.

The reliance on internal models in this proposal also represents a step away from the evolving practice of the prudential regulators in their Basel rules. AFR has joined other groups in criticizing the new Basel III proposed rules for a continued over-reliance on internal risk

¹ Mary Schapiro, Chairman, Securities and Exchange Commission, “[Testimony Concerning the Lehman Brothers’ Examiners Report](#)”, House Financial Services Committee, April 20, 2010.

modeling, particularly in the standardized approaches.² But the Basel proposed rules at least limit capital reductions created by internal modeling by setting a floor for the Advanced Approaches capital requirements at the Standardized Approaches capital levels. The Basel market risk proposal also requires the use of stressed value-at-risk models, additional capital charges for securitization positions, and an incremental risk add-on calculated over a one year time horizon. Finally, the Basel Committee is continuing to examine the potential abuses created by the use of internal modeling and the flaws of value-at-risk models.³ None of these steps appear to be required in this proposal (although the Commission does request comments on using some of the Basel market risk adjustments).

Beyond reducing the amount of capital required, the use of internal models will likely make capital and margin more pro-cyclical, as market data will show less risk during strong periods of the economic cycle and more during downturns. A standardized approach that uses assumptions that are durable through the economic cycle will address this issue. Since the purpose of regulation is to ensure that the public is not providing a bailout option in depressed periods of the economic cycle, standardized capital and margin requirements that are set to address tail risk during downturns are most appropriate.

Given the very serious concerns raised by a reliance on internal modeling, at a minimum AFR recommends the following:

- If internal models continue to be used, they should be ‘floored’ at the level set by standardized approaches.
- Standardized approaches should be set to provide strong through the cycle protection, both for broker-dealer capital and for margin used by SBSDs.
- The Commission should incorporate some form of the market risk adjustments proposed by the Basel Commission into any modeling permitted.
- Liquidity stress testing is a key element of this proposal. However, the essentially conceptual parameters for liquidity stress testing set out here are much too dependent on assumptions generated by the banks themselves and should be made much more specific. This issue is discussed further below.
- The Commission should continue with a review of the implications of the use of internal models.

² Americans for Financial Reform, “[Comment on Basel III Regulatory Capital Rules](#)”, October 22, 2012.

³ See Basel Committee on Banking Supervision, Consultative Document, “[Fundamental Review of the Trading Book](#)”, Bank of International Settlements, Publication 219, May, 2012; Basel Committee on Banking Supervision, Regulatory Consistency Analysis Program, “[Analysis of Risk-Weighted Assets for Market Risk](#)”, Bank of International Settlements, Publication 240, January 2013.

The Proposed Rules also do include an increase in the minimum required capital for ANC broker dealers. While this does not go as far as desirable given the use of internal models, it still represents a positive step that must be retained as proposed and not weakened in the final rule.

The Proposed Rules also of course lay out margin requirements for SBSDs. Besides the internal models issue, AFR has the following recommendations for these requirements:

- Initial as well as variation margin should be posted for swaps. This requirement complies with the recommendations set forth by the International Organization of Securities Commissions (IOSCO) and good market practice and should be retained.⁴
- Alternative B for rule 18a-3 (requiring full posting of initial and variation margin for inter-dealer transactions) should be adopted. Alternative A would permit inappropriate buildup of systemic risk for transactions within the financial system.
- Two-way posting of margin between customers and dealers should be required (i.e. banks and SBSDs should be required to post margin to customers, as well as vice versa).
- The amount of netting permitted in this proposal is much too generous. Netting should only be permitted between exactly offsetting positions, not positions that are potentially correlated due to e.g. long and short positions in the same broad industry.

The Commission should not be swayed by claims that the full margining of swaps transactions will make it difficult to use swaps for hedging purposes, or will shrink the size of the global security based swaps market. The use of uncollateralized or under-collateralized swaps does not reduce risk, it increases it, even if users claim these swaps are ‘hedged’. And to the degree the unregulated swaps market in place prior to the Dodd-Frank Act was overleveraged, it was also too large because full social costs of the market were not incorporated into user decisions.

A final recommendation concerns the mandate for liquidity stress testing in this proposal. Since liquidity pressures are a key failure mechanism for dealers, these requirements are obviously necessary and critical. However, as the Commission states in this proposal and has stated elsewhere, some form of liquidity stress testing is already routine in the market, and was widespread even prior to the financial crisis. Thus, the key issue is the elements required within a liquidity stress test.

In this respect, the essentially conceptual requirements laid out in these Proposed Rules (CFR 70253) are too broad and vague. These requirements have some value in that they identify many of the key broad areas for focus, but the almost complete lack of specificity leaves far too much

⁴ See Basel Committee on Banking Supervision, Board of the International Organization of Securities Commissions, Consultative Document, “[Margin Requirements For Non Centrally Cleared Derivatives](#)”, Bank of International Settlements, Publication 226, July 2012.

room for dealers to set their own parameters. This is especially the case for parameters involving secured funding, where the conceptual directives here appear to allow dealers to assume almost any scenario ranging from very little loss of secured funding to complete breakdowns in the repo markets (as occurred in the 2008 crisis). The Commission should work with the Office of Financial Research, the Federal Reserve, and the academic community to better define such key elements as the characteristics of ‘less liquid assets’ that may lose secured funding, the level of a ‘material net loss’ in secured funding, and the types of runs that could occur through customer exercise of contractual rights. In respect to customer exercise of contractual rights, it is also critical that any stress testing require dealers to include the possibility that customers may liquidate or novate derivatives exposures away from the dealer, and that this behavior may eliminate netting benefits of current derivatives holdings. This was a key failure mechanism for dealers during the financial crisis, in particular at Bear Stearns and Lehman.⁵

Thank you for the opportunity to comment on these Proposed Rules. Should you have any questions, please contact Marcus Stanley, AFR’s Policy Director, at (202) 466-3672 or marcus@ourfinancialsecurity.org.

⁵ Duffie, Darrell, How Big Banks Fail and What To Do About It, Princeton University Press, 2010.

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services

- Home Defender's League
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Council of Women's Organizations
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Urban League
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS

- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Affiliates

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA

- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M

- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin
- UNET

