Via SEC Comment Submission Form: https://www.sec.gov/cgi-bin/ruling-comments

November 19, 2018

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 Swaps Participants and Capital Requirements for Broker-Dealers, File Number S7-08-12 (83 Fed. Reg. 53,007, Oct. 19, 2018)

Dear Secretary:

Better Markets, Inc. ("Better Markets")[1] appreciates the opportunity to comment on the proposal cited above ("Proposal" or "Release"). Unfortunately, the Proposal suffers from pervasive fatal flaws, both procedural and substantive, and is, therefore, a textbook example of deficient and arbitrary and capricious rulemaking. Moreover, Better Markets joins the International Swaps and Derivatives Association, Inc. ("ISDA"); Investment Company Institute (ICI); Managed Funds Association ("MFA"); U.S. Chamber of Commerce; Securities Industry and Financial Markets Association ("SIFMA"); and the International Institute of Bankers ("IIB") in requesting a longer comment period.[2]

As a matter of rulemaking process, the 30-day comment period is, on its face, grossly insufficient to provide the public with adequate notice or opportunity for meaningful input; the Commission has failed to consult with fellow regulators as required under the Dodd-Frank Act;

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 See infra n. 18.

and the Proposal does not adequately identify, explain, or justify the substance of the changes the Commission is considering.

As a matter of substance, the Proposal wrongly weakens some of the most critical regulatory safeguards protecting the American people and our markets, which Congress intended the Commission to apply and enforce in the derivatives markets.

Finally, the Proposal offers none of the statutorily required economic analysis, and it compounds this omission by soliciting comment on numerous economic factors—such as "costs" and "benefits"—that the Commission has no duty to consider in any of its rulemakings and, indeed, would threaten to override the policy choices made by Congress.

Suggesting a desire to adopt a preordained outcome comments be damned, the Commission is acting with unnecessary haste and indefensible brevity, advancing rushed, ill-considered, poorly justified, and ultimately dangerous de-regulatory measures that are sure to increase the likelihood and severity of another financial crisis. The Commission should withdraw this Proposal and re-issue it only after it cures all of the problems identified below. Moreover, the Commission must extend the comment period for at least 90 days.

BACKGROUND

In 2008, Wall Street's gigantic, leveraged, interconnected and complex financial firms precipitated the worst financial crisis since the stock market crash of 1929 and the ensuing Great Depression.[3] The crisis destroyed the jobs, savings, and homes of millions of Americans; caused untold human suffering; and annihilated $20 trillion of gross domestic product. Its effects are still being felt today.

Opaque and high-risk trading in the derivatives subject to the Securities and Exchange Commission's ("Commission") jurisdiction—securities-based swaps ("SBSs")—played a major role in igniting and inflaming the crisis. AIG offers a powerful illustration of the point. Its trading activities enabled the fraudulent subprime bubble to be supersized: by the end of 2007, AIG had written $527 billion of insurance (called "credit default swaps" or CDS) on collateral default obligations (CDOs) and other subprime mortgage related derivatives and structured products, among other toxic assets. Every time AIG sold a CDS, it enabled other reckless market participants (the buyers of the CDS) to keep packaging, selling, and distributing worthless toxic assets because they were able to shift their risk of loss to AIG. This in turn created artificial demand for subprime mortgages, which sustained the fee-based originate-to-distribute predatory mortgage mills long after they should have collapsed.

These activities not only turbo-charged the structuring and securitization of subprime loans that fueled the crisis but also created an immense concentration of risk that imperiled AIG's

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3 See BETTER MARKETS, THE COST OF THE CRISIS: $20 TRILLION AND COUNTING (2015), https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis_1.pdf.

existence. AIG's executives failed to set aside anywhere near a sufficient amount of capital or margin as reserves against this CDS insurance, and when residential mortgage-backed securities plummeted in value and counterparties lodged their claims, AIG was brought to the brink of collapse. Its massive losses were then shifted to taxpayers and the American public. AIG and the other market participants enriched themselves, their shareholders, and their executives at the expense of the American people, who were forced to provide AIG with an unlimited bail out, carrying an eventual price tag of over $180 billion.

Congress and the President responded to the crisis—and the risks posed by derivatives trading specifically—by enacting the sweeping financial reforms set forth in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").[4] The Dodd-Frank Act incorporated a comprehensive set of provisions designed to bring transparency, accountability, and oversight to the derivatives markets. Core components of that regime are capital, margin, and segregation requirements intended to minimize the risk that losses on derivatives transactions will once again imperil the financial condition of dealers and counterparties and ultimately destabilize the financial markets as they did in 2008. In short, strong capital, margin, and segregation requirements are a vital part of the statutory and regulatory bulwark against future financial crises.

The margin requirements are an especially important element of that framework, as they reduce systemic risk **and** promote central clearing of derivatives.[5] Hundreds of trillions of dollars of notional amounts in derivatives that are not eligible for clearing are held and transacted by market participants, presenting the same types of liquidity, market, credit, and other risks that exacerbated the 2008 crisis. Posting initial margin on derivatives with high-quality, stable, and liquid collateral better ensures that the default of any individual counterparty can be managed through an orderly close-out process, reducing leverage that amplifies losses and the contagion experienced in 2008. It incentivizes standardization and clearing as well, because margining uncleared derivatives reduces differences in the economic costs of clearing and not clearing derivatives (which otherwise masks externalities posed by uncleared derivatives).

The SEC was tasked with writing these rules for SBS transactions that are not subject to prudential regulation. As recounted in the Release, the Commission originally proposed capital, margin, and segregation rules for SBS dealers and major SBS participants in 2012, with related proposals issued thereafter in 2013 and 2014.[6] Unfortunately, those three proposals have languished for six years, and over that period, the regulatory context has changed dramatically:

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4 Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

5 In 2011, the Group of 20 (G20) called on the Basel Committee on Banking Supervision (BCBS), the International Organization for Securities Commissions ("IOSCO"), and other organizations to "develop for consultation standards on margining for non-centrally cleared OTC derivatives by June 2012." G20 CANNES SUMMIT FINAL DECLARATION, BUILDING OUR COMMON FUTURE: RENEWED COLLECTIVE ACTION FOR THE BENEFIT OF ALL (2011), https://www.oecd.org/g20/summits/cannes/Cannes%20Declaration%204%20November%202011.pdf.

6 See Release at 53,007-08.

The Commission, the Commodity Futures Trading Commission ("CFTC"), and the prudential regulators have finalized a vast array of swaps and SBS regulations.

Now, the Commission is not only re-opening comment on all facets of the three original proposals—themselves highly complex—but also seeking comment on a long list of new potential changes that, if adopted, would materially alter the Commission's approach to margin, capital, and segregation in these markets. Yet the Commission has made it difficult if not impossible for the public to offer comprehensive and meaningful comment. It has provided the bare minimum comment period of 30 days; it has omitted from the Proposal the actual text of the changes contemplated; and it has offered no economic analysis of the proposed changes or of the original proposals despite the now very different regulatory context. Moreover, the proposed changes described generally in the Proposal appear to be substantively flawed, as they would, in almost every instance, weaken the necessary capital, margin, and segregation requirements without a convincing justification or rationale.

SUMMARY OF COMMENTS

In fourteen deceptively short pages, containing little analysis or data and framed largely as a simple reopening of a prior comment period, the Commission is in fact re-proposing rules without doing so formally as required by law. Moreover, those re-proposals ignore Congressional intent and the lessons of the 2008 financial crisis. The flaws in the Proposal are both procedural and substantive, and they include the following:

- A 30-day comment period is woefully inadequate, given the complexities of the issues raised and the amount of material on which the Commission is seeking comment.

- The Commission has violated explicit provisions of the Dodd-Frank Act not only through its nearly historic rulemaking delay but also in its failure to consult with the prudential regulators and the CFTC.

- The Proposal fails to provide adequate notice of the content of the rule changes it is proposing or their basis and justification.

- Although an appropriately thorough substantive analysis is impossible given the time constraints attending a mere 30-day comment period, it would appear that with few exceptions, the proposed changes wrongfully and needlessly dilute capital, margin, and segregation requirements; increase systemic risk; and undermine the goals of the Dodd-Frank Act. At least some of the specific concerns are these:

  Capital

  - The Commission proposes eliminating regulatory backstops to ensure SBS dealers ("SBSD"s) will be required to maintain sufficient capital;

- The Commission proposes expanding a narrow exception to how much capital must be set aside related to uncleared swaps, intended to provide relief for commercial end-users, so that it would apply to **all counterparties** of SBSDs, significantly lowering capital requirements and increasing risk;

- For purposes of allowing SBSDs to avoid taking a capital charge, the Commission proposes allowing SBSDs required to segregate initial margin to essentially have unfettered control over that margin, functionally eliminating the margin requirement and eliminating customer protections; and

- The Commission proposes allowing SBSDs to avoid a capital charge for initial margin delivered to a counterparty if they meet certain conditions, but it fails to explain why these conditions are sufficiently risk-reducing to justify allowing SBSDs to hold less capital.

Margin

- The Commission proposes expanding the number of SBSDs that can use internal models to calculate initial margin, without providing any explanation as to how the Commission would oversee the use of such models;

- The Commission proposes establishing a risk-based threshold below which an SBSD does not need to collect margin from a counterparty, lowering margin requirements and increasing risk;

- The Commission proposes not requiring that an SBSD collect initial margin to be collected when its counterparty is an SBSD, lowering margin requirements and increasing risk; and

- The Commission proposes allowing SBSDs to portfolio margin accounts, without explaining how the Commission would oversee portfolio margining models.

Segregation

- The Commission proposes lowering segregation and customer reserve requirements on certain entities for the sake of regulatory consistency, when it could instead increase the requirements and achieve the desired regulatory consistency while enhancing customer protection.

Further Delay

- The Commission proposes adopting a compliance date that would give SBSDs at least eighteen months to comply, which would mean that the likely earliest SBSDs would need to comply with these rules would be 2021.

- Finally, the Proposal fails to include any economic analysis whatsoever, leaving the public with no information about the anticipated economic impact of these proposed rule changes and at the same time inviting comment on irrelevant economic factors.

COMMENTS

I. THE PROPOSAL DOES NOT PROVIDE AN ADEQUATE COMMENT PERIOD, GIVEN THE BREADTH, COMPLEXITY, AND IMPORTANCE OF THE TOPICS ADDRESSED IN THE PROPOSAL.

The Administrative Procedure Act ("APA") requires federal agencies to provide to the public notice and an opportunity to comment on regulatory proposals.[7] In interpreting the APA's notice-and-comment requirements, the courts have repeatedly affirmed that "[t]he opportunity for comment must be a meaningful opportunity,"[8] meaning that agencies must provide "enough time with enough information to comment and for the agency to consider and respond to the comments."[9] The legislative history makes clear, too, that the APA's minimum statutory notice

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7 5 U.S.C. § 553(b). The APA directs federal agencies to give interested persons an opportunity to participate in rulemakings through the submission of written data, views, or arguments to be considered in the agency's deliberative process. 5 U.S.C. § 553(c). Rulemakings must provide sufficient factual detail on the legal basis, rationale, and supporting evidence for regulatory provisions such that interested parties are "fairly apprised" of content, the reasoning of the agency implementing them, and the manner in which such regulations foreseeably may affect their interests. See, e.g., Mid Continent Nail Corp. v. United States, 846 F.3d 1364, 1373-1374 (Fed. Cir. 2017); U.S. Telecom Ass'n v. F.C.C., 825 F.3d 674, 700 (D.C. Cir. 2016), citing Honeywell Int'l, Inc. v. E.P.A., 372 F.3d 441, 445 (D.C. Cir. 2004); Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin., 407 F.3d 1250, 1259-1260 (D.C. Cir. 2005); Fla. Power & Light Co. v. U.S., 846 F.2d 765, 771 (D.C. Cir. 1988).

8 Rural Cellular Ass'n v. F.C.C., 588 F.3d 1095, 1101 (D.C. Cir. 2009); see also, e.g., Am. Medical Ass'n v. Reno, 57 F.3d 1129, 1132-133 (D.C. Cir. 1995) (stating that the APA's notice-and-comment requirements "serve important purposes of agency accountability and reasoned decisionmaking" and "impose a significant duty on the agency" to "allow for meaningful and informed comment").

9 Prometheus Radio Project v. F.C.C., 652 F.3d 431, 450 (3d Cir. 2011); see also, e.g., Florida Power & Light Co. v. U.S., 846 F.2d 765, 771 (D.C. Cir. 1988) (affirming that the APA's notice provisions require agencies "not only [to] give adequate time for comments, but also must provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully"). In Prometheus, the Third Circuit Court of Appeals held that the Federal Communications Commission ("FCC") did not provide adequate notice of a rulemaking under the APA and noted that the FCC failed, in relevant part, to provide "sufficient time" for interested parties to submit responsive information to a request for comment by the agency's chairman. Although the court's holding turned on other grounds, its concern about the length of the public comment period is instructive in light of the procedural steps taken by the FCC. The FCC initially permitted a 90-day comment period and extended that period for an additional 60 days. In addition, the FCC commissioned 10 economic studies and held six public hearings before the FCC's chairman published a New York

requirements are not sufficient as to "[matters] of great import, or those where public submission of facts will be either useful to the agency or a protection to the public," in which case rulemakings must "naturally be accorded more elaborate public procedures."[10] The courts and Congress agree, in other words, that public comment periods must be commensurate with the length, complexity, and significance of rulemakings.

In addition, the courts have held that the sufficiency of the notice-and-comment process must be informed by the APA's purposes: (1) to ensure regulations are tested via exposure to diverse public comment; (2) to ensure fairness to affected parties; and (3) to give affected parties an opportunity to develop evidence in the record to support their objections to the rule and thereby enhance the quality of judicial review.[11] Noting that good process can affect the quality of rulemaking outcomes, the courts also have been guided by the principle that a fair opportunity to comment requires agencies to maintain "a flexible and open-minded attitude towards [their] own rules"[12] and seek requisite information for informed administrative decision-making.

Under these well-established legal principles, a mere 30-day comment period for the Proposal—the bare minimum under the APA—is woefully inadequate given the breadth, complexity, and importance of the issues raised in the Release. The Release seeks comment on an enormous range of proposals issued four to six years ago, all of which are complex and central to the SBS regulatory framework. In addition, it seeks comment on a variety of new proposals that potentially would interact with existing securities, derivatives, and banking laws and regulations in complex ways, with significant consequences for U.S. financial stability.

Times Op-Ed bringing attention to the proposal and setting an additional 28-day deadline for responses. See Prometheus, 652 F.3d at 453 (affirming that "[t]he APA requires that the public have a meaningful opportunity to submit data and written analyses regarding a proposed rulemaking" and stating "commenters did not have sufficient time to do so," although there was no challengeable agency action on elements of the rulemaking's procedural history).

10 H.R. Rep. No. 1980, 233, 259 (1946). Executive Order 12866, as amended, though not specifically applicable to the Commission, also includes a presumptive 60-day minimum public comment period and suggests further that formal rulemaking may be appropriate for "complex determinations." See Executive Order ("E.O.") 12,866, Sec. 6. Centralized Review of Regulations, 58 Fed. Reg. 190 (Oct. 4, 1993), as amended by E.O. 13258 and E.O. 13422 (2017).

11 Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin., 407 F.3d 1250, 1259 (D.C. Cir. 2005); see also, e.g., American Coke and Coal Chemicals Institute v. E.P.A., 452 F.3d 930, 938 (D.C. Cir. 2006); Envtl. Integrity Project v. E.P.A., 425 F.3d 992, 996 (D.C. Cir. 2005); Prometheus Radio Project v. F.C.C., 652 F.3d 431, 449 (3d Cir. 2011); Home Box Office, Inc. v. F.C.C., 567 F.2d 9, 35 (D.C. Cir. 1977) (stating that the APA's procedural requirements are intended to assist judicial review as well as to provide fair treatment for persons affected by a rule").

12 Fed. Express Corp. v. Mineta, 373 F.3d 112, 120 (D.C. Cir. 2004); McLouth Steel Products Corp. v. Thomas, 838 F.2d 1317, 1325 (D.C. Cir. 1988); see also, e.g., Rural Cellular Ass'n v. F.C.C., 588 F.3d 1095, 1101 (D.C. Cir. 2009) (stating that "[t]he opportunity for comment must be a meaningful opportunity" and that "to satisfy this requirement, an agency must . . . remain sufficiently open-minded").

First, it asks for comment on "all aspects" of three of the most extensive and important rule proposals issued under Title VII of the Dodd-Frank Act. They include (1) the original 2012 proposal on capital, margin, and segregation requirements, spanning 142 pages, 77 Fed. Reg. 70,213; (2) the original 2013 proposal on the cross-border treatment of capital, margin, and segregation requirements, spanning 315 pages, 77 Fed. Reg. 30,967; and (3) the original 2014 proposal on additional capital requirements for nonbank SBS dealers, spanning 194 pages, 79 Fed. Reg. 25,193 (collectively, the "Three Proposals").[13] The Proposal also notes that the Commission has carefully considered all of the comment letters received in response to the Three Proposals and that the Commission is "reopening" the comment period, in part, in light of those comments.[14]

Second, the Proposal dramatically expands the scope of the requested comment by asking for input "in light of" the adoption of at least eight other major SBS rules over the past six years, including rules on clearing agency standards, cross-border regulation of SBS activities, reporting and dissemination of SBS information; SBS data repository registration and duties; registration of SBS dealers and major SBS participants; SBS transactions connected to non-U.S. person dealing activity; business conduct standards for SBS dealers and major SBS participants; trade acknowledgement and verification of SBS transactions; and access to data obtained by swap data repositories.[15] Furthermore, the Proposal notes that the prudential regulators and the CFTC have adopted or proposed a host of other rules under Title VII, all of which, it states, "are relevant" to the Three Proposals that are the subject of the request for comment.[16]

Finally, and perhaps most significantly, the Proposal seeks comment on no fewer than 14 specific, substantive possible modifications in the rule text of the Three Proposals. These possible changes encompass a broad range of issues, including methods of calculating capital requirements; appropriate capital charges; the use of margin models; possible exceptions to the duty to collect initial and variation margin; alternatives to margin segregation requirements; and substituted compliance. In addition, the Proposal seeks comment on the impact of pending rule proposals on SBS dealer and major SBS participant registration deadlines. The Proposal goes even further and solicits comment on the far-reaching question of the economic implications of the Three Proposals.

Thus, the Commission is seeking comment on an extensive array of important subjects and is further asking commenters to take into account a vast body of regulatory material: three major rule proposals on capital, margin, and segregation; the comment letters received on those three proposals; eight final Commission rules addressing SBS regulation; and the rules issued by the CFTC and the prudential regulators governing swaps regulation. Moreover, all of the issues on which the Proposal seeks comment are not only extensive and complex, but also vitally important. They make up an important part of the fundamentally new regulatory framework designed to limit systemic risk; to bring transparency, oversight, and accountability to the derivatives markets; and ultimately, to help prevent, delay, or mitigate any future financial crises.

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13 Release at 53,007-08.
14 Release at 53,008.
15 Id.
16 Id.

In fact, any subset of the requests for comment described above would warrant more than a 30-day comment period. Taken together, they are so wide-ranging, complex, and important, that they cannot possibly be adequately addressed in 30 days. The prior comment periods that the Commission established for the earlier Three Proposals drive home the point, as they were set at 60, 90, and 60 days respectively, with an additional 90 days in extensions or re-openings of the initial comment period.[17]

Nor is Better Markets alone in this view. At least two groups of industry commenters have urged the Commission to extend the comment period, citing the long passage of time since the initial proposals, the intervening regulatory and market developments, and the significant implications that the Proposal may have on SBS participants and the SBS markets.[18]

Finally, there is at this point no need to act in haste. The process has already dragged on for six years and there is no legitimate reason now suddenly to compromise the integrity of the rulemaking process or to threaten the quality of whatever final rule emerges in the interest of sheer speed. The comment period should be extended by 60 days, at a minimum.

II. THE COMMISSION HAS VIOLATED THE DODD-FRANK ACT IN ITS EXTENSIVE DELAY AS WELL AS ITS FAILURE TO CONSULT WITH THE PRUDENTIAL REGULATORS AND THE CFTC.

The Commission has flouted specific statutory requirements in the Dodd-Frank Act. For example, the delay of more than half a decade in finalizing capital, margin, and segregation rules violates a basic mandate in the statute. Section 764(e)(2)(B) clearly provides that the Commission

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17 See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70,214 (comment period of 60 days); Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 78 Fed Reg. 4365 (extension of 30 days); Reopening of Comment Periods for Certain Proposed Rulemaking Releases and Policy Statements Applicable to Security-Based Swaps, 78 Fed. Reg. 30,800 (reopening of comment period for 60 days); Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants,78 Fed. Reg. 30,968 (comment period of 90 days on the proposal addressing the cross-border application of capital, margin, and segregation requirements); Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, 79 Fed. Reg. 25,193 (comment period of 60 days).

18 See Letter from International Swaps and Derivatives Association, Inc., Investment Company Institute, Managed Funds Association and U.S. Chamber of Commerce, Center for Capital Markets Competitiveness (Oct. 24, 2018); Letter from Kyle Brandon, Managing Director, Head of Derivatives and Director of Research, Securities Industry and Financial Markets Association, and Briget Polichene, Chief Executive Officer, International Institute of Bankers (Oct. 25, 2018).

"**shall adopt rules . . . imposing both initial and variation margin requirements on all swaps that are not cleared.**" In the face of this non-discretionary rulemaking under the Dodd-Frank Act, the Commission was required to issue such regulations "**in final form**" not later than 360 days after the exactment of [the Dodd-Frank Act]."[19] That period of time expired in July 2011. The Commission therefore has been in violation of its Congressional mandate with respect to SBS margin and capital (as well as numerous other required SBS-related regulations) for more than seven years.

The Commission has also ignored another explicit statutory requirement applicable to the the Proposal. The Dodd-Frank Act directs the Commission, "[i]n prescribing margin requirements," to "consult on minimum capital requirements and minimum initial and variation margin requirements" with the prudential regulators and the CFTC and "to the **maximum** extent practicable, establish and maintain comparable . . . minimum initial and variation margin requirements . . . for SBSDs" and others. In addition, section 712(a)(2) provides that "[b]efore **commencing any rulemaking** regarding [SBSs], [SBSDs] . . . [and others] . . . the [Commission] **shall consult and coordinate to the extent possible** with the [CFTC] and the prudential regulators for the purposes of assuring regulatory consistency and combability, to the extent possible."

The Proposal, however, makes no mention of such consultations or efforts to harmonize margin requirements, while acknowledging that a number of proposed provisions substantially deviate from the prudential regulators' margin regulations—all without an explanation as to market or product characteristics that prevent the SEC from seeking **maximum** comparability, or comparability to the exacting standard of "the extent possible." In other words, the Commission makes no suggestion that comparable standards are not possible, or even inappropriate to the SBS markets. That, in itself, is a violation of the Dodd-Frank Act.

III. THE PROPOSAL FAILS TO PROVIDE ADEQUATE NOTICE OF THE PROPOSED RULE CHANGES GENERALLY DESCRIBED IN THE RELEASE, NOR DOES IT EXPLAIN THEIR BASIS OR JUSTIFICATION.

As discussed above, the APA requires not only an adequate comment period but also adequate notice of the content of any proposed changes an agency is considering. The Proposal violates this basic precept of administrative law by omitting the actual implementing language for the specific rule changes that the Commission is contemplating and on which it seeks comment. Instead, the Release only includes characterizations or descriptions of the rule changes under consideration.

This approach is unacceptable for two reasons. First, it creates a major obstacle for commenters, since the proposed rule changes are not set forth in the context of the entire set of rules in question. Second, it affords the Commission too much leeway to eventually finalize rule language that deviates materially from the descriptions and regulatory goals that are described in the Proposal. These defects render the notice inadequate.

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[19] Dodd-Frank Act § 712(a)(3).

In a related vein, the Proposal fails to provide an adequate basis, rationale, or justification for each change under consideration, as required under the APA. In fact, the Commission gives little justification for **any** of the risk-enhancing modifications it proposes. Far too often, in "support" of a proposed modification, the Commission cites a single comment letter received in response to the 2012 Proposal, and in some cases that comment only has a tangential relation to the Proposal. At times the commenter does not provide any meaningful justification for their suggestion. One is left with the impression that the Commission is intent on finalizing a rule that significantly weakens the 2012 Proposal in ways not even suggested by many industry commenters in the first round of comments, and that the Commission is now inviting the industry to submit comments on those areas it wants to weaken, to create the appearance that the risk-increasing rule the Commission wishes to adopt is based on some semblance of a concrete foundation. The industry will surely take the invitation.

These procedural infirmities are particularly troubling in light of their potential to affect the quality of administrative decision-making and policy outcomes relating to margin. Indeed, given the importance of margin and capital requirements to the stability of the U.S. financial system, Congress required specific statutory standards be met and specific procedural steps be taken to implement the margin and capital requirements. For example, section 764(e)(3) of the Dodd-Frank Act sets forth "standards for capital and margin" requirements, providing that margin requirements for SBSDs and others must (1) "help to ensure the safety and soundness of [SBSDs]" and others; and (2) be appropriate for the risk associated with non-cleared SBSs and others. These statutory standards are not discretionary, and the Commission should therefore be expected to at least analyze them in any rulemaking affecting margin and capital requirements (e.g., explaining how proposed regulations that affect margin and capital requirements, the methodologies for determining such requirements, and the nature of collateral posted between market participants help to ensure safety and soundness of SBSDs and are appropriately calibrated). No such mention of these standards or explanation of the manner in which the proposed regulations meet them is found in the Proposal. Therefore, the public cannot meaningfully comment on whether the Commission's proposal is consistent with the standards specified for margin requirements in section 764(e)(3) of the Dodd-Frank Act.

IV. EVEN A PRELIMINARY REVIEW OF THE PROPOSAL REVEALS THAT IT IS ARBITRARY AND CAPRICIOUS, AS IT WOULD RELAX IMPORTANT CAPITAL, MARGIN, AND SEGREGATION REQUIREMENTS APPLICABLE TO SBS TRANSACTIONS, THEREBY SUBSTANTIALLY INCREASING SYSTEMIC RISK, WITHOUT A LEGITIMATE BASIS.

In the Proposal, the Commission poses a number of specific questions regarding significant potential changes to the Three Proposals dating back to 2012-2014. If adopted, these changes would significantly reduce capital and margin requirements and decrease counterparty protections. The Commission's mandate under Dodd-Frank is to establish rules to mitigate the risk of another financial crisis; the Proposal strays from this guiding principle, instead potentially sowing the seeds of the next financial crisis.

A. <u>The Proposal would reduce capital requirements and increase risk, and the Commission fails to offer any basis for its capital proposals.</u>

The importance of capital was starkly demonstrated during the financial crisis when many entities were severely over-leveraged and maintained plainly insufficient amounts of capital to absorb losses. Congress recognized the importance of sufficient capital to the stability of individual firms, the financial markets, and the economy more generally. It therefore directed the Commission to establish capital requirements for SBSDs to help achieve these goals. Now, the Commission proposes, in several respects, to reduce the capital requirements relative to the original 2012 proposal, with virtually no explanation as to how the re-proposed, reduced capital requirements are consistent with the risk mitigation directive from Congress.

1. <u>The Commission's proposal to remove regulatory backstops to ensure adequate capital would increase risk.</u>

The 2012 Proposal would require, as part of their capital requirements, that SBSDs maintain 8% of their so-called "risk margin amount" as capital.[20] The 2012 Proposal defined "risk margin amount" as:

> (i) The greater of the total margin required to be delivered by the broker or dealer with respect to security-based swap transactions cleared for security-based swap customers at a clearing agency **or the amount of the deductions that would apply to the cleared security-based swap positions of the security-based swap customers pursuant to paragraph (c)(2)(vi)(O) of this section**; and (ii) The total margin amount calculated by the broker or dealer with respect to non-cleared security-based swaps pursuant to § 240.18a– 3(c)(1)(i)(B).[21]

In Question 1 of the Proposal, the Commission proposes, based on a single comment generally requesting capital relief for cleared SBS, to eliminate the possibility that the first component of the risk margin amount could be the amount of the "haircut" from capital the SBSD would be required to take based on the cleared positions of its customers.[22] As the Commission explained in 2012, the purpose of this "greater of" provision is "to ensure that the 8% margin factor requirement is based on, at a minimum, the standardized haircuts. These haircuts provide a uniform approach for all cleared SBS, whereas **margin** requirements for cleared SBS will vary over time and across different agencies."[23] In other words, the "greater of" provision creates a backstop to protect against the possibility that varying margin requirements across clearing

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[20] 2012 Proposal, 77 Fed. Reg. at 70,223-24.

[21] 2012 Proposal, 77 Fed. Reg. at 70,333 (to be codified at 17 C.F.R. § 240.18a-1(c)(6)) (emphasis added).

[22] Release at 53,008-09.

[23] 2012 Proposal, 77 Fed. Reg. at 70,223-24.

agencies and over time could be insufficient to reflect the true risk to an SBSD arising from its customers' positions.

The Commission proposes to remove this backstop but gives no indication as to the reason. Indeed, the Commission requests comment on what the minimum net capital amounts would be under the 2012 Proposal,[24] indicating that the Commission has no basis for its original approach, let alone any modification. In any event, the potential impact of the proposed rule will be to significantly reduce the capital held by SBSDs, increasing risk. The Commission should not finalize a rule that includes a revised definition of risk margin amount until it provides the public with relevant data, informs the public as to the basis for its proposed change, and gives the public a meaningful opportunity to comment in light of the data and the Commission's stated basis for the proposed modification.

A similar issue arises with respect to the proposal the Commission offers in Question 2. The 2012 proposal required that an SBSD take a capital charge equal to the difference between the amount of margin collected from customers for cleared SBS and the deduction from net worth the SBSD would have to take if the positions were proprietary position.[25] The Commission explained in 2012 that this requirement "is intended to ensure that there is a standard minimum coverage for exposure to cleared security-based swap counterparties apart from the individual clearing agency margin requirements, which could vary among clearing agencies and over time." In other words, similar to the rationale for the definition of risk margin amount in the 2012 Proposal, the Commission intended to provide a standardized backstop against losses—if the amount of margin collected were less than the Commission's standardized calculation of the riskiness of a position for purposes of SBSD capital requirements, SBSDs would need to set aside that amount of capital to protect against losses. Again, in response to one single comment letter, the Commission is now proposing to establish a "risk-based" exception to this required capital charge. This exception would allow an SBSD to be exempt from this charge where the difference between the agency margin amount and the proprietary position capital charge is: (1) less than 1% of the SBSD's tentative net capital; (2) less than 10% of the counterparty's net worth; and (3) such differences across all counterparties are less than 25% of the SBSD's tentative net capital.[26]

This would allow SBSDs to avoid taking a deduction from capital reflecting the difference between margin collected and the proprietary position capital haircut where the difference between those two amounts is as high as 25%. The obvious effect and intent of this proposal is to reduce capital requirements, increasing risk. Moreover, the single comment cited by the Commission provides little substantive justification, stating only that the 2012 Proposal "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."[27] There is no discussion or analysis of the potential increased risk that would come from eliminating or modifying the capital charge

24 Release at 53,009.
25 2012 Proposal, 77 Fed. Reg. at 70,245-46.
26 Release at 53,009.
27 Id.; Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Securities Industry and Financial Markets Association (Feb. 22, 2013).

requirement. Certainly the Commission should not adopt a final rule containing such a nakedly risk-intensifying modification based on a single paragraph of a single comment letter with little substance to support the change and no discussion of the inevitable increased risk that would result.[28] Here too, the Commission should not adopt this change until, at the very least, it provides a credible basis, addresses how the proposal would protect the markets and the public, and affords a meaningful opportunity to comment in light of such additional information.

2. The Commission's proposal to significantly reduce the amount of capital required to be set aside for uncollected margin would significantly increase risk.

The proposal contained in Question 3 is extremely risk-enhancing and dangerous. The 2012 Proposal generally requires that if an SBSD does not collect initial or variation margin from a counterparty because of an exception to the margin collection requirement, it must take a 100% capital charge ("100% Capital Charge") in the amount of the margin it would be required to collect but for the exception. However, the 2012 Proposal would allow SBSDs who are approved to use internal models to take a "credit risk charge" using a methodology established by the Commission in lieu of taking the 100% Capital Charge where the counterparty is a commercial end-user ("Credit Risk Charge Exception").[29] As the Commission noted at the time, "in most cases the credit risk charge is significantly less than a 100% deduction, since it is a percentage of the amount of the receivable that would otherwise be deducted in full."[30] In other words, when an SBSD takes the Credit Risk Charge Exception, it increases risk by allowing the SBSD to set aside as capital only a portion of the risk to which it is exposed due to uncollateralized SBS.

Now, based on the thinnest of reeds, the Commission proposes to broaden the ability of SBSDs to take the Credit Risk Charge Exception by allowing an SBSD to take it for **all counterparties.**[31] What is the basis for this strikingly broad expansion of an already risky reduction to capital requirements? All the Commission offers in the Proposal is that "[c]ommenters requested that nonbank SBSDs be permitted to apply the credit risk charge to other types of counterparties."[32] The Commission then cites a single comment letter, from several multilateral development banks ("MDBs"), including the World Bank and International Finance Corporation.[33] In that letter ("MDB Letter"), the MDBs argue that a Commission rule requiring

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28 Better Markets recognizes that the Commission's proposal does not completely eliminate this provision, as requested by the commenter. Nevertheless, even though eliminating the provision was proposed only by a single commenter in response to the 2012 Proposal, now that the Commission has highlighted this provision, surely many industry commenters will be urging the Commission to eliminate the provision as proposed in 2012, or eliminate it entirely. While the Commission should not modify the provision at all, if it does it is imperative that it resist the invitation of industry to further weaken it or eliminate it.

29 Id.

30 Id.

31 Release at 53,010.

32 Id.

33 Id. at 53,010n.30.

that SBSDs collect margin from MDBs would conflict with the privileges and immunities to which MDBs are entitled. The MDBs also argue that they should not be subject to margin requirements because they have exceptionally low risk profiles.[34] In light of these unique considerations, the MDBs urged the Commission to "make it clear that the authorization for certain entities to use internal models and apply credit risk-based charges for uncollateralized receivables on OTC derivatives also applies to exposures **to MDBs**."[35] In other words, the MDBs did not request that the Credit Risk Charge Exception be expanded to any type of counterparty other than MDBs. Their request was specific to MDBs.

Despite the inherently limited nature of the MDBs' request, which was based on the unique characteristics of MDBs and accordingly requested a modification only as to MDBs, the Commission seeks to blow a hole in the 2012 Proposal's capital requirements. Whatever the merits of the MDBs very narrow and specific request, the MDB Letter does not purport to advocate, or offer justification for, the expansion of the Credit Risk Charge Exception to all counterparties. Such a sweeping reduction in SBSD capital requirements is plainly unreasonable.

As noted above, in Question 8, the Commission proposes to eliminate the requirement that an SBSD collect initial margin when its counterparty is an SBSD. In other words, for an SBS between two SBSDs, the combination of the proposals contained in Questions 5 and 8 would allow **no collection of initial margin** to protect against the exposure created by the SBS and would allow the SBSDs to hold plainly insufficient capital. The Commission makes these proposals despite the fact that insufficient margin and capital were two of the triggers of the financial crisis. So, under the guise of reopening the comment period of the capital and margin rules, and with little explanation, these two provisions of the Proposal would, **by rule, allow SBSDs to operate in the very manner that brought the financial system to the brink of collapse and led to the worst recession since the 1930s**. The Commission should abandon this approach; at the very least, it must provide a credible justification and provide the public with a meaningful opportunity to comment in light of the basis put forward by the Commission.

3. <u>The Commission's proposal to allow SBSDs to avoid a capital charge for segregated margin by essentially asserting complete control over segregated margin appears to violate Dodd-Frank's segregation requirements.</u>

The 2012 Proposal would require that SBSDs take a capital charge where a counterparty requires that initial margin be segregated at a third-party custodian.[36] This requirement makes sense since such segregated margin, by definition, does not belong to the SBSD—the funds must be segregated "for the benefit of the counterparty… in a segregated account separate from the assets" of the SBSD.[37]

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34 MDB Letter at 5-7, https://www.sec.gov/comments/s7-08-12/s70812-39.pdf.
35 MDB Letter at 10 (emphasis added).
36 2012 Proposal, 77 Fed. Reg. at 70,247-48.
37 <u>Id</u>.; 15 U.S.C. § 78c-5(f)(1)(B).

In Question 4, the Commission now proposes, in response to comments expressing concerns that the proposed capital charge would discourage the use of segregation and increase costs,[38] to allow SBSDs to avoid the capital charge for segregated initial margin if: (1) the custodian is a bank; (2) the bank, SBSD, and the SBSD's counterparty enter an agreement that "provides the SBSD with the same control over the collateral as would be the case if the nonbank SBSD *controlled the collateral directly*;" and (3) an opinion of counsel deems the agreement enforceable.[39] The Commission further states that it is considering issuing guidance on when such an agreement would be sufficient to allow an SBSD to escape the capital charge requirement, and that such guidance would explain that the agreement should:

> (1) Provide that the collateral will be released promptly and directed in accordance with the instructions of the nonbank SBSD upon the receipt of an effective notice from the nonbank SBSD; (2) provide that when the counterparty provides an effective notice to access the collateral the nonbank SBSD will have sufficient time to challenge the notice in good faith and that the collateral will not be released until a prior agreed-upon condition among the three parties has occurred; and (3) give priority to an effective notice from the nonbank SBSD over an effective notice from the counterparty, as well as priority to the nonbank SBSD's instruction about how to transfer the collateral in the event the custodian terminates the account control agreement.[40]

Effectively, such an agreement would appear to give complete control over the "segregated" margin to the SBSD.

It **may** be the case that SBSDs should not be required to take a capital charge for "segregated" margin over which they have complete control. However, the mechanism through which the Commission intends to allow SBSDs to avoid this capital charge raises concerns: it seems that margin covered by an agreement meeting these requirements is no longer "segregated" in any meaningful sense, but is instead under the joint ownership of the SBSD and its counterparty. It is not clear how such an arrangement would not violate the plain language of the Dodd-Frank Act that initial margin for uncleared SBS be segregated "for the benefit of the counterparty." The Commission offers no explanation. The Commission should not allow SBSDs to violate the requirements of the Dodd-Frank Act intended to provide counterparty protections just so they can avoid a capital charge.

4. <u>The Commission offers no reasoning for its proposal to allow SBSDs to avoid a deduction from net worth the value of initial margin delivered to a counterparty.</u>

The 2012 Proposal would require that SBSDs deduct from net worth the value of initial margin delivered to a counterparty when computing net capital.[41] In Question 5, in response to a letter from several industry groups sent to the Commission in June 2018 making suggestions for

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38 Release at 53,011.
39 <u>Id.</u> (emphasis added).
40 <u>Id.</u>
41 2012 Proposal, 77 Fed. Reg. at 70,267.

how the Commission could fashion its SBSD rules to harmonize them with the rules for swap dealers promulgated by the CFTC, the Commission proposes to offer SBSDs an exception from this requirement where:

> (1) The initial margin requirement is funded by a fully executed written loan agreement with an affiliate of the broker-dealer; (2) the loan agreement provides that the lender waives re-payment of the loan until the initial margin is returned to the broker-dealer; and (3) the broker-dealer's liability to the lender can be fully satisfied by delivering the collateral serving as initial margin to the lender.[42]

The effect of this provision would be to reduce the amount of capital SBSDs are required to hold, increasing risk. The Commission does not explain why these particular conditions would be sufficiently risk-reducing to excuse SBSDs from taking this reduction in net worth. The newly proposed exception is styled after relief granted in a no-action letter that Commission staff issued to FINRA in 2016, relating to the capital treatment of margin collateral posted by broker-dealers to counterparties for non-cleared swaps.[43] Commission staff apparently issued this letter in response to an "informal" inquiry from FINRA. Unfortunately, that letter does not explain the basis for the relief it grants, and because it is a response to "informal" questions from FINRA, it is unclear how FINRA justified the relief it sought. Accordingly, nowhere in the record is there any sort of justification or analysis supporting this proposal or explaining why it is appropriate.

The Commission should not finalize an exception that allows SBSDs to hold less capital, and thus become more risky, unless and until it provides the public with a compelling basis for the proposed exception that goes beyond a passing reference in a recent industry request letter[44] and unexplained relief granted to broker-dealers in 2016. And, the Commission must afford the public a meaningful opportunity to comment in light of the basis it puts forth.

B. <u>The Commission's proposed changes in margin requirements will unnecessarily increase risk and are unsupported by any reasoned basis.</u>

1. <u>The SEC's proposal to permit use of a standard industry margin models provides too little information concerning the parameters that would be required for such models and the process for SBSDs to approve, establish, maintain, review, and validate margin models.</u>

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42 Release at 53,012.

43 Letter from Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, Commission, to Kris Dailey, Vice President, Risk Oversight and Regulation, FINRA (Aug. 19, 2016), https://www.sec.gov/divisions/marketreg/mr-noaction/2016/finra-081916-15c3-1.pdf.

44 As far as Better Markets can tell, the only reference to this relief in the letter the Commission cites is the following: "The SEC should also allow SBS dealers to rely on relief previously granted to broker-dealers posting initial margin in connection with swaps." <u>See</u> Letter from Institute of International Bankers and Securities Industry and Financial Markets Association (June 21, 2018), https://www.sec.gov/comments/s7-05-14/s70514-3938974-167037.pdf.

For reasons discussed above, it is difficult to provide meaningful responses to the questions the Commission asks in the Proposal because the Commission fails to explain and justify the contemplated changes. However, Question 6 of the Proposal presents a unique challenge because the public cannot even unambiguously identify the proposed regulatory text, much less its potential implications.

For example, the Commission characterizes proposed internal model provisions in SEC Rule 18a-3 as a "potential **modification** to paragraph (d)(2)**(i)**." However, there is no subparagraph (i) to modify. Accordingly, it is unclear whether the Commission intends to replace the 2012 proposed paragraph (d)(2) in its entirety with the preamble language set forth in the Proposal, or whether the Commission instead intends to **supplement** the 2012 proposed paragraph (d)(2) with new and more broadly applicable model-approval language. The effects of those differing interpretations could be significant. Either way, as a matter of administrative law, the public cannot be left to divine what the Commission may have intended to propose.

Ordinarily, the public might consider the economic analysis of such provisions in considering its intended effects and potential regulatory outcomes. Here, again, no such analysis is provided. Moreover, the new proposed language includes limited requirements for model confidence levels, margin periods of risk, correlations, and risk factors—each significant determinants of model outputs—with **zero discussion** concerning, for example, (1) the importance of the particular restrictions proposed; (2) the reasons for choosing these limited parameters or model characteristics; and (3) alternatives to such restrictions (e.g., as proposed by the prudential regulators and CFTC in their margin requirements). Without any discussion at all of these critical elements of the Proposal, meaningful public comment, again, is not possible. Again, the Commission has failed to abide by the most fundamental principle of administrative law: to explain the basis and rationale for the Proposal.

The Commission does state that the purpose of the new provision would be "to provide flexibility to nonbank SBSDs to apply to the Commission for authorization to use a proprietary or other model to compute initial margin, and, with respect to an industry standard model, to increase transparency and decrease margin disputes among counterparties." Although it is evident that such a provision could provide SBSDs margining "flexibility," it is not at all clear **how** it would do so. The 2012 Proposal would not preclude the use of a uniform initial margin model, at least for those SBSDs approved to use internal models to compute net capital. We can only speculate therefore that the primary, **but unstated**, effect of the proposal provision may be broadening the universe of SBSDs authorized to use internal margining models to include those not approved to compute net capital using internal models.[45] If that is the purpose of the modification, the Commission should have (1) said so explicitly; (2) provided the basis for the Commission's determination that it is appropriate to allow all SBSDs to use a model to compute initial margin, along with relevant evidence; and (3) provided the public with a meaningful opportunity to comment in an informed manner. Meaningful public comment would require some estimate of (1) the number of non-ANC

[45] Better Markets reiterates its recommendation that the Commission should not allow certain market participants to calculate their own risk weightings for regulatory capital, as the 2012 Proposal would.

BDs the Commission would expect to benefit from the model approval provision, and the potential implications for such firms; and (2) the number of ANC BDs that conceivably could be required either to seek model approvals under the Proposal or rely upon the standard schedules. Again, no economic analysis or data is provided that would enable this type of informed public comment, and the purported purposes of the provision—"to increase transparency and decrease margin disputes among counterparties"—are not discussed at all.

From a broader policy perspective, we are especially concerned by this departure from administrative norms in a rulemaking relating to model risk management, validation, implementation, and documentation, given a long history of internal models failing to sufficiently account for the risks they are intended to measure. ISDA—a dealer trade association with a duty to act in the interests of its members—presently operates the standard industry margin model used to meet the initial margin requirements under the prudential and CFTC regulations. Without additional information from the Commission on what it intends to require for risk management, compliance, and other purposes, there is simply no means by which Better Markets and the public can comment on the appropriateness of the internal model "modification." The standards for approving and maintaining such models must at least be discussed (as such standards can range from exacting to the equivalent of self-regulation by the industry having incentives to minimize margin requirements). No such effort to explain the legal authority, basis, rationale, and evidentiary support for the skeletal Proposal is made, nor is there an effort to address the problematic incentives of permitting industry self-policing of margin requirements.

2. The SEC's proposal to permit use of a risk-based, unsecured threshold is insufficiently explained and supported to allow meaningful public comment.

Question 7 raises a number of issues that similarly do not permit meaningful public comment. The Commission proposes to establish a risk-based threshold below which an SBSD need not collect margin from a specific counterparty.[46] It also appears to reject the "fixed-dollar threshold" approach adopted by the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the CFTC, noting that such a threshold could be "too large . . . and, therefore, not adequately address the risk," or "too small and, therefore, overcompensate for risk." However, the Commission's analysis for establishing such an alternative risk-based threshold stops there and fails to account for the seemingly obvious rebuttal that a risk-based threshold, while having certain advantages, also can be "too large" or "too small" depending on the risk measurement used.

For example, the Commission's potential modifications to paragraph (c)(1)(iii)(E) of Rule 18a-3—again, provided in an unusual manner for administrative releases and without the context of regulatory language—appear to state that SBSDs would be permitted to elect not to collect required margin to the extent it does not exceed the lesser of: (1) 1 percent of the SBSD's tentative net capital; or (2) ten percent of the net worth of the counterparty. But the Commission provides zero evidentiary support, or even qualitative analysis, to support the specific percentages cited.

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[46] Release at 53,013.

Moreover, the Commission does not explain its views on why a counterparty-specific unsecured threshold (e.g., the $50 million aggregate credit exposure resulting from all uncleared swaps and uncleared derivatives between a swap entity or any of its affiliates and a counterparty or any of its affiliates) should be rejected in favor of a measure that would relate to a percentage of the non-bank SBSD's tentative net capital, which captures counterparty exposures only indirectly, or the counterparty's overall net worth unrelated to a specific counterparty relationship. Without **some** explanation of that reasoning or **some** analysis supporting a specific threshold, the public is left to untangle the policy equivalent of a ball of Christmas lights in determining not only what the Commission proposes but also whether it is comparable, better than, or simply different than the threshold concept favored by U.S. and international regulators. That burden should fall on the Commission, not the public.

In short, the Commission provides no basis for its proposed risk-based thresholds, nor does it provide any rationale for why yet another exception to the margin collection requirement is warranted. Margin requirements are essential to reducing risk in derivatives transactions, which is an overriding purpose of Title VII of the Dodd-Frank Act. The public cannot be certain about the potential risk impacts of the Commission's newest margin proposal. But it is certain that the Commission should not establish exceptions to margin regulations that **enhance**, rather than reduce risk, and certainly it should not do so where, as here, it has given no justification or basis for its risk-enhancing proposal.

3. The SEC's proposed interdealer exemption from margin requirements is insufficiently explained and supported to provide a meaningful opportunity for public comment.

The Commission acknowledges the dearth of information available to support its proposal in certain respects. For example, it requests comments and data to "assist in the quantification of the economic impacts of Alternatives A and B" from the 2012 proposal." The 2012 Proposal proposed two alternative approaches to an SBSD's obligation to collect initial margin from a counterparty that is another SBSD. Alternative A would not require that an SBSD collect initial margin where its counterparty is another SBSD.[47] Alternative B would require that an SBSD collect and segregate initial margin where its counterparty is an SBSD.[48] It is telling that seven years after the Commission's deadline for implementing the SBS regulatory framework, the Commission has only now determined that it should issue a call for pertinent data. But it is even more telling that it apparently seeks data on complex, nuanced policy concerns within an abbreviated 30-day comment period. The same challenges that have led the Commission to request data **after seven years of consideration**—despite having thousands of employees with technical knowledge and administrative expertise, and access to confidential supervisory information—apply with far greater force to the data challenges faced by the public in seeking to provide meaningful comment on the same set of issues.

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[47] 2012 Proposal, 77 Fed. Reg. at 70,267-68.

[48] Id.

The Commission frames its questions in terms of potential means for mitigating the acknowledged risks in adopting Alternative A—an exemption for dealer-to-dealer transactions from margin requirements. The Commission notes "the likelihood" that "increased use of leverage, the potential for a nonbank SBSD to fail, and the potential that a default by a nonbank SBSD could translate to defaults of counterparty SBSDs" would be **higher** under Alternative A (the interdealer exemption) but then proceeds to ask whether capital requirements would appropriately address that higher risk potential and even whether **margin requirements themselves actually increase risk due to procyclicality**. These weighty public policy concerns—even with the specious arguments made by industry—cannot be responsibly addressed without the due consideration denied by the Commission's abbreviated comment period. But the important take-away is this: The Commission, in a re-proposal of a six-year old rulemaking that itself is now seven years passed a congressional deadline for final action, not only acknowledges that it has insufficient information to finalize the Alternative A proposal but also proposes new provisions with acknowledged risk implications for the U.S. financial system without even attempting the economic analysis required by the Securities Exchange Act (as discussed below).

Nor should the Commission, as suggested in Question 8.b, apply the exception to an **even broader** class of counterparties. Either approach would violate the spirit, and potentially the letter, of the Dodd-Frank Act. Enacted in response to a crisis caused in large part because swaps counterparties did not maintain adequate capital and margin in relation to their swaps exposures, the Dodd-Frank Act **directs** the Commission to impose margin requirements on SBSDs.[49] The purpose of margin requirements is to "offset the greater risk to the security-based swap dealer…and the financial system arising from the use of" uncleared SBS. The Dodd-Frank Act further requires that margin requirements "shall help ensure the safety and soundness" of SBSDs.[50] Allowing SBSDs to be exposed to other SBSDs, and possibly boundless other counterparties, without protection from loss, is clearly contrary to the purpose of the Dodd-Frank Act. If the Commission chooses that policy direction, it must do so consistent with the procedural requirements of the APA and the Dodd-Frank Act noted above.

Moreover, this proposal, disguised as a question, illustrates the fatally flawed nature of the Commission's approach to finalizing these rules. The Commission, as noted, asks for "comment and supporting data that would assist in the quantification of the economic impacts of Alternatives A and B."[51] Specifically, the Commission imprecisely asks whether the "proposed capital requirements" would reduce the likelihood of SBSD failure if the Commission adopted Alternative A. But which "proposed capital requirements?" The capital requirements originally proposed by the Commission in 2012? Or the radically reduced capital requirements in the Proposal? As explained above in response to Question 3, under the rules the Commission proposed in 2012, SBSDs would be required to take a 100% capital charge in the amount of margin not collected from counterparties because of an exception from the margin collection requirement, with one narrow exception where the counterparty is a commercial end-user. Under that regime, the risk

49 15 U.S.C. § 78o-10(2)(B)(1).

50 15 U.S.C. § 78o-10(3)(A).

51 Release at 53,014.

implications of exempting SBSDs from collecting margin from a counterparty that is another SBSD would be very different than the risk implications of an interdealer transaction without such capital treatment.[52] However, under the guise of reopening the comment period, the Commission appears bent on radically weakening the previously proposed capital regime by expanding the scope of the Credit Risk Charge Exception to include **all counterparties** an SBSD does not collect margin from, while at the same time proposing that SBSDs should not need to collect margin from SBSD counterparties (and possibly others).

Again, as explained above, we can only speculate that this means that for SBS between two SBSDs, the Commission invites the SBSDs to have **no margin** to cover future exposures and a plainly insufficient amount of capital to absorb potential losses arising from their exposure. But this is speculation because the Commission has not explained itself. Moreover, by the sleight of hand of purporting only to be reopening the comment period and requesting additional comment, the Commission conceals what is the true import of these proposals. And in this question it completes the subterfuge by suggesting that capital requirements might limit the risk of creating further exceptions to the margin collection requirement, **without explaining that it is also proposing to significantly reduce those capital requirements.** The Commission may not modify the 2012 Proposal in a way that appears, on its face, to provide the ingredients for another financial crisis; even less valid is such an attempt through the guise of reopening the comment period and with a release that muddies the waters regarding the Commission's true intent and provides no reasonable basis for the Commission's radical departure from the guiding principles of Dodd-Frank.

C. The Commission should not weaken segregation requirements that provide important counterparty protections.

1. In considering changes to the cross-border treatment of segregation requirements, the Commission should adhere to principals of a strong and clear cross-border approach that prevents evasion of Dodd-Frank.

With respect to Questions 10.b, regarding whether there should be more clarity regarding cross-border application of segregation requirements, and 10.c, regarding cross-border application of segregation requirements to certain entities, Better Markets reiterates the recommendations and comments previously submitted in response to the 2013 Cross-Border Proposal. As to those questions, Better Markets previously emphasized the following points:

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[52] Better Markets notes that the commenter cited by the Commission as supporting Alternative A arguesd that initial margin should not be required because "[i]mplementation of the SEC's proposed capital requirements will result in significant capital requirements for SBSDs." Letter from Robert Pickel, Chief Executive Officer, International Swaps and Derivatives Association (Jan. 23, 2013), https://www.sec.gov/comments/s7-08-12/s70812-17.pdf. In other words, this commenter justified not requiring initial margin by pointing to the very capital requirements the Commission proposes to eviscerate.

- **First, the SEC has extensive authority to regulate cross-border activity and a duty to do so.** The Commission's statutory duty is to apply Title VII not only to entities within the jurisdiction of the U.S., but also as necessary or appropriate to prevent evasion of Title VII, wherever it may occur. The Commission should maximize the effectiveness of its cross-border regulation.

- **Second, the 2013 Cross-Border Proposal is too long, convoluted, and unclear.** As a result, it discourages meaningful comment; virtually guarantees that cross-border regulation will be riddled with loopholes; and promises a regime that will prove very difficult for the SEC to implement, oversee, and enforce. To remedy these problems, the SEC must streamline and strengthen the content of the Proposal.

2. <u>Instead of reducing certain segregation and customer reserve requirements to achieve regulatory consistency, the Commission should consider raising them to achieve regulatory consistency.</u>

In several questions in the Proposal, the Commission suggests reducing segregation and customer reserve requirements for certain entities, so that such requirements are similar to the regulatory requirements for similarly situated entities. Regulatory consistency is not, in and of itself, sufficient reason to adopt proposals that increase risk, and in any event, regulatory consistency can also be achieved by enhancing, rather than reducing, customer protection requirements. Several examples stand out.

In Question 11, the Commission proposes, based on a single comment, amending the broker-dealer customer protection rule[53] to allow broker-dealers not registered as SBSDs to deduct from their required customer reserve amount margin that is posted at a clearing agency.[54] The 2012 Proposal would allow SBSDs to take such a deduction. The Commission states that the "purpose would be to permit broker-dealers that are not registered as SBSDs but that engage in security-based swap activities to use segregation requirements that parallel those in proposed Rule 18a–4 and which are tailored to security-based swaps" and "to locate in Rule 15c3–3 the security-based swap segregation requirements for entities registered as a broker-dealer and SBSD."[55] The result would be that broker-dealers not registered as SBSDs would be able to reduce the amount of customer reserves they are required to hold. Instead of amending the broker-dealer customer protection rule to require lower reserves, the Commission should consider not allowing SBSDs to take this deduction. In other words, the Commission should consider eliminating the "clearing agency" exemption to the calculation of the customer reserve amount for SBSDs, rather than providing the exemption to broker-dealers. This would achieve the desired consistency while increasing customer protection.

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53 17 C.F.R. § 240.15c3-3.
54 Release 53,016.
55 <u>Id.</u>

In Question 12, the Commission proposes to modify the treatment of "excess securities collateral," i.e. securities and money market instruments not being used to collateralize the SBSD's current exposure to its customer, and the manner in which an SBSD is allowed to use excess securities collateral to post margin to a bank SBSD counterparty.[56] Specifically, the Commission proposes to allow an SBSD to post excess securities collateral to a bank SBSD in connection with a transaction that is undertaken to hedge a non-cleared SBS with the SBSD's customer.[57] It appears that one reason for this modification is to allow SBSDs to deduct the amount posted to a bank SBSD from its required customer reserve amount. Apparently, this is necessary because the prudential regulators require that any margin posted to bank SBSDs from an SBSD must be held with a third-party custodian. Such margin would not meet the requirements of the 2012 Proposal for the deduction, because the 2012 Proposal only allows the deduction if the margin is held by the counterparty bank SBSD.[58] This change would make the treatment of excess securities collateral posted to bank SBSDs similar to the treatment when posted to non-bank SBSDs. However, as with Question 11, the Commission should consider achieving the desired consistency by eliminating the ability to take this deduction, which would increase customer protection. The Commission should not allow SBSDs to increase customer risk by concentrating customer reserves in a single bank. In other words, The Commission should consider eliminating the ability for an SBSD to take a deduction from its required customer reserve amount for initial margin delivered to an SBSD, rather than modifying the treatment of "excess securities collateral" in a way that would reduce customer protection.

Further, the 2012 Proposal would require an SBSD, when calculating whether it is maintaining sufficient customer reserves, to deduct from the calculation of its current customer reserves the amount of funds held in a customer reserve account at a single bank to the extent the amount exceeds 10% of the equity capital of the bank as reported in its most recent call report.[59] The purpose of this is to recognize that where an SBSD's customer reserve funds are concentrated at a single bank, there is added risk to the SBSD and its customers if the bank encounters financial difficulties.[60] At the same time, the 10% figure was consistent with a proposed rule amending Rule 15c3-3 that would apply an analogous requirement to broker-dealers.[61] Since then the broker-dealer rule has been finalized, but with a higher figure of 15% of the bank's net worth.[62] The Commission proposes modifying the rule proposed in 2012 to reflect the 15% figure, for the sake of consistency with the broker-dealer rule.[63]

While regulatory consistency may be desirable, it cannot be the Commission's sole or predominant consideration. The Commission is still charged with reducing risk to SBSDs and

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56 Id.
57 Id.
58 2012 Proposal, 77 Fed. Reg. 70,278-82.
59 Id. at 70,285.
60 Id.
61 Release at 53,018.
62 Id.
63 Id.

their customers, yet raising this threshold to 15% of a single bank's net worth would increase those risks. The Commission should not do so, at a minimum until it provides, if possible, a substantive analysis explaining why raising this threshold would not lead to undue risk for SBSDs and their customers, along with a meaningful opportunity to comment in response to the Commission's analysis.

The Commission also proposes that "the fifteen percent…threshold" should "not apply if the SBSD is a bank and maintains the security-based swap customer reserve account itself rather than at an affiliated or non-affiliated bank."[64] By way of explanation, the Commission states that the "purpose of this exception would be to accommodate a bank SBSD that holds the customer reserve account directly."[65] But nowhere does the Commission explain why this accommodation is desirable or how it advances the purposes of the Dodd-Frank Act. Nor can Better Markets discern any reason why the counterparties of a bank SBSD that holds customer reserve accounts itself should be more exposed to this concentration risk than counterparties of SBSDs that hold customer reserve accounts at an affiliated or unaffiliated bank. And, ironically for a proposal that purports to be promoting regulatory consistency, adopting this provision would promote regulatory fragmentation at the same time that it places counterparties at greater risk. The Commission should not adopt this rule; at the very least, however, the Commission must provide some basis for this proposal and allow the public to provide comments in response to the basis the Commission puts forward.

D. The Commission should adopt a strong cross-border regime that is designed to prevent evasion.

In Question 14, the Commission proposes to modify the substituted compliance regime outlined in the 2013 Cross-Border Proposal. Better Markets reiterates the recommendations and comments it submitted in response to the 2013 Cross-Border Proposal. Specifically:

- **The 2013 Cross-Border Proposal does not provide an adequate legal or policy justification for allowing substituted compliance, and if permitted at all, it must be substantially narrowed and subjected to much stronger criteria.** The Proposal does nothing further to justify the substituted compliance approach. If the Commission nevertheless adopts such an approach, substituted compliance should not be allowed in transactions with U.S. persons or transactions occurring within the United States. In particular, substituted compliance should not be permitted as to External Business Conduct Standards for transactions with U.S. persons.

- **In addition, even where permitted, substituted compliance should be subject to more rigorous tests and a more public process.** The Commission must abandon the regulatory outcomes test and must ensure that the foreign regulation is comparable in substance, form, over time, and as enforced. The Commission should not simply outsource the protection of

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64 Id.

65 Id.

U.S. taxpayers to EU bank regulators, which badly failed foreign depositors, taxpayers, and treasuries. Finally, the process for making a substituted compliance determination must be more transparent.

E. After six years of delay, the Commission should not provide SBSDs with a year and a half to come into compliance with SBSD rules.

When it adopted final rules regarding registration of SBSDs, the Commission provided a compliance date for requirements with SBSD rules of six months from the publication in the Federal Register of the later of: (1) SBSD margin and capital rules; (2) SBSD recordkeeping and reporting rules; (3) SBSD business conduct rules; or (4) rules regarding allowing an AP of an SBSD who is statutorily disqualified to effect or be involved in effecting SBSs on the SBSDs behalf.[66] The Commission proposes to **triple** this six month window to **eighteen months**.

It has been eight years since the Dodd-Frank Act was passed, and over six years since the 2012 Proposal. And yet, the Commission now proposes to delay the compliance deadline for its body of SBS rules for another **year and a half** after publication of the last of these long-delayed rules in the Federal Register. In the Commission's most recent rulemaking agenda, it lists the expected finalization date for the remaining three relevant SBS rules as September 2019.[67] That would put the compliance date at March **2021,** over a decade after passage of Dodd-Frank. The Commission should not extend the compliance date as proposed.

V. THE PROPOSAL FAILS TO OFFER ANY ANALYSIS SHOWING THE ECONOMIC IMPACT THE COMMISSION EXPECTS THE PROPOSAL TO HAVE, INCLUDING ITS LIKELY IMPACT ON INVESTORS, SYSTEMIC STABILITY, CRISIS PREVENTION, OR THE THREE ECONOMIC FACTORS SET FORTH IN THE SECURITIES LAWS.

The Commission has a duty to consider the impact that its rules will have on a variety of factors, derived from the underlying statutory purposes and goals the Commission was established to serve. The Commission was originally created for the purpose of implementing the securities laws, and its primary duty is to achieve the legislative objectives of those laws. Those objectives are, first and foremost, protecting investors from fraud, abuse, and manipulation in the securities markets.

The Proposal is also part of a new regulatory framework established by the Dodd-Frank Act to regulate the derivatives markets. Therefore, the legislative purposes underlying that staute

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66 Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, 80 Fed. Reg. 48,963 (Aug. 14, 2015).

67 https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235&Image58.x=49&Image58.y=12&Image58=Submit.

also shape and inform the Commission's duty to assess the economic impact of its proposals. That assessment must give proper weight to the overriding goals that Congress intended to achieve. Those goals were to preserve and protect the stability of our financial system, to prevent another financial collapse and economic crisis, and to avoid the economic costs, hardships, and human suffering that would inevitably accompany it.

Finally, the securities laws also require the Commission to consider three specific economic factors when promulgating rules. Sections 3(f) and 23(a)(2) of the Exchange Act set forth the Commission's statutory requirement to "consider" a rule's impact on several listed economic factors.[68] Specifically, Section 3(f) provides as follows:

> **(f) Consideration of promotion of efficiency, competition, and capital formation**
>
> Whenever pursuant to this chapter the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, **in addition to the protection of investors**, whether the action will promote efficiency, competition, and capital formation.

Section 23(a)(2) similarly requires the Commission to "consider among other matters the impact any such rule or regulation would have on competition," and to refrain from adopting the rule if it "would impose a burden on competition not necessary or appropriate in furtherance of the purposes of [the statute]."

Thus, when promulgating rules, the Commission must assess their likely impact on all of the factors set forth above: the protection of investors; systemic stability and crisis prevention; and efficiency, competition, and capital formation. Yet the Proposal nowhere includes such an analysis. Rather, it simply seeks comment from the public on the "economic implications" of the Proposal. And even that request is misguided, for it neglects to ask for comment on the most important and germane economic impacts of the Rule, including the degree to which it will affect investor protection and systemic stability. At the same time, it focuses unduly on fashioning an analysis of the costs and benefits of the Proposals—something that the SEC is not legally required to conduct.[69] In short, the Proposal is devoid of any meaningful economic analysis, while soliciting comment on largely irrelevant economic factors that the Commission has no duty to address.

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[68] 15 U.S.C. §§ 78c(f), 78w(a)(2).

[69] Better Markets has set forth a comprehensive analysis regarding the scope of the Commission's duties under the securities laws in BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 39-44 (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf; see also Whitman v. American Trucking Ass'n., Inc., 531 U.S. 457, 471 (2001) (holding the duty to conduct cost-benefit analysis is a matter for Congress to decide, and holding that the statute under consideration "unambiguously bars cost considerations"); American Textile Mfrs. Inst., Inc. v. Donovan, 452 U.S. 490, 510-512

CONCLUSION

We hope our comments are helpful.

Sincerely,

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& n. 30 (1981) (stating that "Congress uses specific language when intending that an agency engage in cost-benefit analysis" and citing numerous statutory examples); Nat'l Ass'n of Manufacturers v. SEC, 748 F. 3d 359 (D.C. Cir. 2014) (agency is not required to conduct a rigorous, quantitative economic analysis unless the statute explicitly directs it to do so); Nat'l Ass'n of Home Builders v. E.P.A., 682 F.3d 1032, 1039 (D.C. Cir. 2012) (statutes in which agencies must "consider" the "economic" impact or "costs" do not require cost-benefit analysis); Cent. Ariz. Water Conservation Dist. v. E.P.A., 990 F.2d 1531, 1542 n.10 (9th Cir. 1993) (language in 42 U.S.C. § 7491(g)(1) requiring "consideration" does not require a cost-benefit analysis); Sec'y of Agric. v. Cent. Roig Ref. Co., 338 U.S. 604, 611 (1950) (when statutorily mandated **considerations** are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty).

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