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November 19, 2018

Mr. Brent Fields
Secretary of the Commission
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Reopening of Comment Periods for Capital, Margin, and Segregation Requirements for Security-based Swap Dealers and Major Security-Based Swap Participants; and Capital Requirements for Broker-Dealers (Release No. 34-84409; File No. S7-08-12)

Dear Mr. Fields:

The Institute of International Bankers ("**IIB**") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**Commission**" or "**SEC**") on the above-captioned request for comment (the "**Reopened Proposal**") regarding proposed capital, margin, and segregation requirements for security-based swap ("**SBS**") dealers ("**SBSDs**") and major SBS participants ("**MSBSPs**") (the "**Proposed Rules**"). We support the Commission's efforts to seek additional feedback on the Proposed Rules, given the significant amount of time that has passed since they were originally released by the Commission in 2012-2014[1] and the intervening adoption and implementation of margin requirements by other regulatory authorities.

In this letter, we respectfully suggest several modifications to the Proposed Rules, which are designed to address issues associated with the cross-border application of the Proposed Rules. We also generally support the comments submitted by the Securities Industry and

[1] *See* Capital, Margin, and Segregation Requirements for [SBSDs] and [MSBSPs] and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70214 (Nov. 23, 2012) (the "**2012 Proposal**"); Cross-Border SBS Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of [SBSDs] and [MSBSPs], 78 Fed. Reg. 18083 (May 1, 2013) (the "**2013 Proposal**"); and Recordkeeping and Reporting Requirements for [SBSDs], [MSBSPs], and Broker-Dealers; Capital Rule for Certain [SBSDs], 79 Fed. Reg. 25193 (Apr. 17, 2014).

Financial Markets Association and the International Swaps and Derivatives Association relating to other aspects of the Proposed Rules.

I. Substituted Compliance

The 2013 Proposal would permit a foreign nonbank SBSD to substitute compliance with comparable home country capital and margin requirements for compliance with the Commission's capital and margin requirements.[2] The Reopened Proposal requests comment regarding whether, in making a substituted compliance determination, the Commission should assess whether the capital requirements of the foreign financial regulatory system are designed to help ensure the safety and soundness of registrants in a manner that is comparable to the proposed capital requirements for nonbank SBSDs.[3] In addition, the Commission requests comment regarding whether to require, as a condition to an affirmative substituted compliance determination, that a foreign nonbank SBSD maintain liquid assets in excess of unsubordinated liabilities (the "**liquid assets condition**").[4]

We understand that the liquid assets condition is designed to address the fact that foreign securities firms are typically subject to the same or similar capital requirements as banks, which are generally in line with the capital standards established by the Basel Committee on Banking Supervision ("**Basel Committee**"). Unlike the Commission's net capital rule for broker-dealers or the proposed capital rules for nonbank SBSDs, Basel capital standards do not apply a net liquid assets test that requires a firm to have an amount of liquid assets that exceeds the amount of the firm's unsubordinated liabilities.

Post-crisis changes to the overall Basel framework have, however, substantially enhanced the extent to which firms subject to Basel capital standards must also maintain a significant cushion of liquid assets. In particular, the Basel framework now includes liquidity coverage ratio ("**LCR**") requirements designed to ensure that a firm has an adequate stock of unencumbered high-quality liquid assets (consisting of cash or assets that can be converted into cash at little or no loss of value in private markets) to meet its liquidity needs for a 30-day liquidity stress scenario. LCR requirements thus address the same objective as the Commission's proposed liquid assets condition, which is to ensure that a firm maintains sufficient liquidity to meet its obligations to customers and other unsubordinated creditors.[5] These requirements are currently in effect or in the process of adoption and implementation in key foreign jurisdictions.[6] In these

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[2] *See* 2013 Proposal, 78 Fed. Reg. at 31090.

[3] *See* Reopened Proposal, 83 Fed. Reg. at 53018.

[4] *See id*.

[5] *See id.* at 53019.

[6] In addition, since the crisis, key foreign jurisdictions have bolstered their regulation of SBS in other areas. For example, in the European Union, capital requirements were enhanced in light of Basel III standards through

circumstances, applying the liquid assets condition would impose an additional, administratively burdensome liquidity requirement on firms already subject to reasonably designed home country liquidity requirements. Likewise, unlike substitute compliance determinations by the Commodity Futures Trading Commission ("**CFTC**"), which generally have not been contingent upon any similar threshold tests but rather deferred generally to home country examination and enforcement, imposing the liquid assets condition would administratively burden the Commission to audit against the condition.

In addition, other jurisdictions take a different approach to the resolution and recovery of securities firms than the United States. In particular, unlike in the United States, in some foreign jurisdictions, large securities firms are subject to the same resolution regime as banks.[7] In addition, some foreign jurisdictions permit securities firms to access central bank liquidity facilities.[8] Therefore, many foreign nonbank SBSDs, like foreign banks, will in periods of financial distress be able to continue operations without being exposed to the risk of asset fire sales to the same extent as U.S. broker-dealers. Because securities firms are thus more similar to banks outside the United States, it makes sense that they are subject to the same capital, liquidity, and margin requirements as banks. For the same reason, comparing foreign capital and margin requirements to the Commission's parallel requirements for domestic nonbank SBSDs will often not be appropriate; in many cases, the Prudential Regulators' capital and margin requirements for bank SBSDs will be a more appropriate point of comparison.

At the same time, imposing the liquid assets condition or rejecting substituted compliance for capital and margin requirements would adversely affect the risk management and operations of foreign nonbank SBSDs by forcing them to reconcile two materially different approaches to capital, liquidity, and margin requirements. Not only would affected firms have to overhaul their systems and documentation for compliance with these requirements, but they would simultaneously face significantly different costs of capital for the same sets of activities, creating competing regulatory incentives for how they fund or hedge themselves. They might also face conflicts in requirements relating to how or where they maintain collateral. Most foreign nonbank SBSDs would find simultaneous compliance with such different requirements practically impossible and therefore be compelled to withdraw from the U.S. market.

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adoption and implementation of the Capital Requirements Regulation and Capital Requirements Directive IV, post-trade mitigation measures (including margin requirements) have been implemented through the European Market Infrastructure Regulation, and pre-trade and post-trade transparency and conduct of business have been enhanced through the Markets in Financial Instruments Regulation and Markets in Financial Instruments Directive II.

[7] For example, the European Union's Bank Resolution and Recovery Directive applies to investment firms (*i.e.*, securities firms) required to maintain minimum capital of at least EUR 730,000.

[8] For example, in the United Kingdom, systemically important investment firms have access to liquidity facilities offered by the Bank of England.

The Reopened Proposal also requests comment regarding whether the Commission should consider a condition on substituted compliance that a foreign nonbank SBSD not have a disproportionate number of U.S. customers.[9] The purpose of this condition is not clear. If a foreign nonbank SBSD is subject to comparable home country requirements, as would be the case under the circumstances described above, then any such condition would not be necessary to protect U.S. customers, protect the U.S. financial system, or prevent evasion of U.S. requirements. But it would artificially impair the competitive position of foreign nonbank SBSDs and reduce the liquidity available to U.S. customers. It also would potentially be disruptive to the market, to the extent natural fluctuations in the U.S. versus non-U.S. mix of a foreign nonbank SBSD's business led to an inadvertent breach of the condition.

Accordingly, the liquid assets condition should not apply to a foreign nonbank SBSD that is subject to Basel-like capital and liquidity requirements. Nor should such a foreign nonbank SBSD face limits on the extent of its U.S. customer business. In addition, just as the CFTC permits foreign SDs to substitute compliance with margin requirements compliant with the requirements established under the Basel framework,[10] the Commission should generally permit foreign nonbank SBSDs to substitute compliance with Basel-compliant capital and liquidity requirements and margin requirements consistent with the framework established by the Working Group on Margining Requirements ("**WGMR**") of the Basel Committee and International Organization of Securities Commissions, notwithstanding differences between those requirements and the parallel requirements applicable to domestic nonbank SBSDs.

II. The Use of Risk-Based Models Approved by Other Regulators

The Reopened Proposal requests comment regarding an expansion of the circumstances where a nonbank SBSD could use approved models to compute credit risk charges to net capital.[11] It also requests comment regarding whether to permit a nonbank SBSD to use a standard industry model to compute initial margin requirements.[12] These requests for comment are relevant to IIB members who register U.S. subsidiaries as nonbank SBSDs, as well as foreign nonbank SBSDs that are not granted substituted compliance by the Commission.

We support the changes described in these requests for comment, as well as the ability of a nonbank SBSD to use approved models to compute market risk charges, as contemplated by

[9] Reopened Proposal, 83 Fed. Reg. at 53019.

[10] *See* 17 C.F.R. § 23.160(b); *See, also* Comparability Determination for the European Union: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 82 Fed. Reg. 48394 (Oct. 18, 2017) and Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 63376 (Sept. 15, 2016).

[11] Reopened Proposal, 83 Fed. Reg. at 53010-11.

[12] *Id.* at 53013.

the 2012 Proposal.[13] Because the standardized haircuts that a nonbank SBSD would otherwise have to use to compute its capital and initial margin requirements do not appropriately take into account offsetting risk exposures within a derivatives portfolio, thus resulting in capital and margin requirements that are grossly disproportional to risk, nonbank SBSDs will not be able to operate effectively or competitively unless then can use risk-based models.

We are concerned, however, that the Commission might lack the resources to review and approve models for all nonbank SBSDs without unduly delaying the effectiveness of capital and margin requirements. Nor, for the reason noted above, would it be feasible to put those requirements into effect before the Commission grants all pending model approvals. Doing so would effectively force firms who do not yet have Commission model approval out of the market.

In addition, nearly all nonbank SBSDs will be subject to consolidated group-wide supervision by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") or a comparable foreign regulator, and most will be dually registered with the CFTC as swap dealers or be affiliated with a registered swap dealer. Each such firm will typically already be operating in accordance with capital requirements, at the legal entity or group-wide level, that involve the use of models approved by another regulator. They also will have another regulator's approval to use an industry standard model to compute initial margin requirements. The quantitative and qualitative standards for such model approvals are generally similar to those proposed by the Commission.

In these circumstances, requiring these firms to undergo yet another model approval process would involve an unnecessarily duplicative use of regulatory resources. Such duplication would only be warranted if the Commission were to require modifications to firms' models or model-related governance relative to what other regulators have already required. However, if the Commission's model approval process resulted in such modifications, it would adversely affect group-wide risk management processes and lead to regulatory conflicts and competitive disparities. In the context of initial margin models in particular, such modifications would also cause an unwarranted uptick in margin disputes.

Therefore, to speed the implementation of capital and margin rules, limit unnecessary demands on the Commission's resources, and promote consistency across market participants and within consolidated holding groups, the Commission should permit a nonbank SBSD to use risk-based models to compute its capital and initial margin requirements if those models have been approved by another qualified regulator, such as the Federal Reserve, the CFTC, the National Futures Association, or a foreign consolidated supervisor or other foreign regulator that administers Basel-like capital requirements and WGMR-compliant margin requirements.

[13] 2012 Proposal, 77 Fed. Reg. at 70237-40.

III. Segregation Requirements

A. Cross-Border Application

The 2012 Proposal would subject SBSDs (both banks *and* nonbanks) to omnibus segregation requirements for SBS collateral modeled on the Commission's broker-dealer customer protection rule, subject to the ability of a non-cleared SBS counterparty to enter into a subordination agreement with the SBSD pursuant to which the counterparty would either waive segregation or elect individual segregation.[14] These requirements are designed to work in tandem with the special customer property distribution regimes of the Securities Investor Protection Act ("**SIPA**") and the stockbroker liquidation provisions of the U.S. Bankruptcy Code.[15] The 2013 Proposal would, in turn, apply these requirements to a foreign SBSD either in respect of its U.S.-facing SBS transactions, or both its U.S.- and non-U.S.-facing SBS transactions, depending on whether the SBSD is a registered broker-dealer, a U.S. branch of agency of a foreign bank, or neither, and whether the SBS transactions are cleared or non-cleared.[16] The 2013 Proposal also would require foreign SBSDs to make disclosures regarding the treatment of their customers' assets under applicable insolvency laws.[17] The Reopened Proposal requests comment regarding the cross-border application of these segregation requirements.[18]

We are concerned regarding the application of omnibus segregation requirements to foreign SBSDs that are not registered broker-dealers.[19] As described below, these requirements would impose significant costs, with little to no countervailing benefits. With respect to non-cleared SBS in particular, we believe that Congress's intended customer protection regime—requiring an SBSD to offer individual segregation of initial margin at a third-party custodian—provides a more effective, and a sufficient, approach to protecting customer collateral, given the institutional character of the SBS market.

As noted above, the proposed omnibus segregation requirements are designed to facilitate the return of customer property in accordance with SIPA and the stockbroker liquidation provisions of the U.S. Bankruptcy Code. But as the Commission itself explains, with respect to an SBSD that is a foreign bank with a U.S. branch or agency, the insolvency of the SBSD would

[14] *See* 2012 Proposal (Proposed 17 C.F.R. § 240.18a-4).

[15] *See* 2012 Proposal, 77 Fed. Reg. at 70274.

[16] *See* 2013 Proposal, 78 Fed. Reg. at 31018-22.

[17] *See id.* at 31022.

[18] Reopened Proposal, 83 Fed. Reg. at 53016.

[19] We also note that many of the following comments would apply equally to U.S. bank SBSDs, as they likewise are subject to resolution under U.S. banking regulations.

be subject to banking regulations, not SIPA or the stockbroker liquidation provisions of the U.S. Bankruptcy Code.[20] And with respect to all foreign SBSDs, primary insolvency proceedings are likely to be initiated outside the United States under non-U.S. law.

In each case, it is of questionable benefit to subject a foreign SBSD to SEC segregation requirements designed to facilitate liquidation under provisions of SIPA or the U.S. Bankruptcy Code that would not, or very likely would not, apply. Indeed, this approach might even harm customers to the extent the Commission's omnibus segregation requirements conflict with foreign segregation or insolvency laws and, to avoid such conflicts, customers are forced to subordinate their claims. Conflicts with U.S. law would also arise for customers transacting with foreign bank SBSDs because the Prudential Regulator margin rules applicable to such SBSDs require segregation of regulatory initial margin at a third-party custodian.

Additionally, applying segregation requirements modeled on U.S. broker-dealer customer protection requirements to SBSDs not subject to the same insolvency regime as U.S. broker-dealers is likely to confuse customers regarding how their assets will be treated in the SBSD's insolvency. That the Commission proposed to require disclosures regarding relevant insolvency laws is telling in this regard.

The costs of imposing omnibus segregation requirements on foreign SBSDs would also be significant, even where those requirements do not conflict with applicable U.S. or foreign laws. Foreign SBSDs would need to invest significant resources to build systems designed to perform the requisite possession or control and reserve account computations. In addition, because the segregation requirements are not designed with foreign SBSDs in mind, absent Commission action the requirements would impede the use of foreign custodians, investment of customer cash in foreign securities, or rehypothecation of customer assets to foreign clearing agencies or SBSDs not required to register with the Commission.

We further note that the generalized imposition of omnibus segregation requirements on collateral for non-cleared SBS does not seem consistent with Section 3E of the Securities Exchange Act of 1934 (the "**Exchange Act**"). Section 3E(f), which governs collateral for non-cleared SBS, solely provides for individual segregation when elected by an SBSD's counterparty. Omnibus segregation is only potentially contemplated in connection with collateral for cleared SBS under Sections 3E(b) and (c), and thus only where collateral for non-cleared SBS is commingled with collateral for cleared SBS should it be subject to omnibus segregation requirements.

In light of these considerations, in connection with foreign SBSDs, we recommend as follows:

[20] *See* 2013 Proposal, 78 Fed. Reg. at 31019, n. 521.

- In connection with collateral for cleared SBS (and collateral for non-cleared SBS that is commingled with collateral for cleared SBS), the Commission's segregation requirements should only apply to transactions with U.S. persons, and the foreign SBSD should be permitted to satisfy these requirements by substituting compliance with home country segregation requirements; and

- In connection with collateral for non-cleared SBS (to the extent not commingled with collateral for cleared SBS), omnibus segregation requirements should not apply at all, but rather the foreign SBSD should solely be required to offer its U.S. counterparties segregation of their initial margin at a third-party custodian pursuant to Section 3E(f), unless that initial margin is not already required to be segregated pursuant to rules of the Prudential Regulators or applicable foreign regulations.

B. Third-Party Custodial Accounts

The Reopened Proposal requests comment regarding conditions under which a nonbank SBSD could recognize collateral held at a third-party custodian as a mitigant to credit risk for purposes of calculating credit risk capital charges.[21] The Reopened Proposal also requests comment regarding whether to permit an SBSD to rehypothecate customer collateral to a third-party custodial account.[22] In each case, the custodian would need to be a "bank," as defined in Section 3(a)(6) of the Exchange Act.

This limitation would generally prevent the non-U.S. branches or offices of foreign banks from qualifying as custodians for purposes of these provisions. However, foreign banks frequently act as custodians of collateral for non-cleared SBS, especially in connection with foreign securities or currencies. In addition, the Commission has long recognized the use of foreign bank custodians by U.S. broker-dealers.[23] Accordingly, where the other conditions to these provisions are satisfied, the Commission should permit the use of a foreign bank as custodian.

IV. Compliance Timeline

Significant time and effort will be necessary for the Commission and SBSDs to implement the SBSD regulatory framework. With respect to the Proposed Rules, to the extent that SBSDs cannot rely on substituted compliance or rely on other regulators' model approvals, SBSDs will need time to comply with the administrative requirements of the Proposed Rules, such as applying for Commission approval of risk-based models. The Commission will likewise

[21] Reopened Proposal, 83 Fed. Reg. at 53011-12.

[22] *Id.* at 53016-17.

[23] *See, e.g.*, Exchange Act Release No. 34-10429 (Oct. 12, 1973).

need time to review models.[24] Even if the Commission adopts the streamlined approach to model approval that we recommend in this letter, many SBSDs will still need time to raise additional capital or change the allocation of capital within their corporate groups and to develop and implement robust compliance and reporting programs.

Additionally, foreign SBSDs will need to apply, and the Commission will need to consider applications, for substituted compliance. However, because any such application is required to include a certification and opinion regarding Commission access to books and records as set forth in SEC Rule 15Fb2-4,[25] and foreign SBSDs will not be able to provide that certification and opinion absent relief or clarification from the Commission,[26] foreign SBSDs cannot yet apply for substituted compliance. And, for the reasons set forth in Part I above, it will not be feasible for a foreign SBSD to register unless it can substitute compliance with home country capital and margin requirements.

In light of these considerations, we support a Registration Compliance Date that is eighteen months following the finalization of the Commission's core SBSD regulations *and* relevant substituted compliance determinations. If the Commission adopts our recommendations with respect to substituted compliance and use of models approved by other regulators, then it should be reasonable for capital requirements to apply at this time. In addition, if this date falls after the latest compliance date for initial margin requirements under the WGMR framework (currently September 1, 2020), then it should also be reasonable for margin requirements to apply at this time.

On the other hand, if the Commission does not adopt our recommendations regarding substituted compliance and use of models approved by other regulators, then a delay in application of capital and margin requirements would be necessary. Specifically, in such case, we recommend that the Commission's capital and margin requirements should not become effective until after a sufficient time for the Commission to approve all capital and margin model applications submitted by nonbank SBSDs that register by the Registration Compliance Date.

In addition, if the Registration Compliance Date were to occur before the latest compliance date for initial margin requirements under the WGMR framework, including as they might be extended, we recommend that the Commission's initial margin requirements be phased in along the same timeline as the parallel WGMR requirements.

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[24] In this regard, if the SEC has previously approved a model for use by one registrant, the SEC should automatically approve the use of that model by an affiliated registrant subject to the same consolidated risk management program as the affiliate for whom the model was previously approved.

[25] *See* 17 C.F.R. § 240.3a71-6(c).

[26] *See* IIB and SIFMA, "SEC-CFTC Harmonization: Key Issues under Title VII of the Dodd-Frank Act," *available at* *https://www.sec.gov/comments/s7-05-14/s70514-3938974-167037.pdf*.

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The Institute appreciates the opportunity to submit these comments in connection with the Reopened Proposal. Please do not hesitate to contact the undersigned at [redacted] with any questions or if we can be of assistance to the Commissions.

Sincerely,

Briget Polichene

Briget Polichene
Chief Executive Officer
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