November 19, 2018

Brent Fields
Secretary
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 Securities Industry and Financial Markets Association ("**SIFMA**") [1] appreciates this opportunity to provide the Securities and Exchange Commission (the "**Commission**" or "**SEC**") with comments in response to the above-captioned release (the "**October 2018 Release**") re-opening the comment period for the Commission's 2012 proposal (the "**2012 Proposal**") relating to capital, margin, and segregation requirements for security-based swap ("**SBS**") dealers ("**SBSDs**") and major SBS participants ("**MSBSPs**") and capital requirements for broker-dealers ("**BDs**"),[2] its 2013 proposal (the "**2013 Proposal**") relating to the cross-border application of those requirements,[3] and its

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1 SIFMA is the leading trade association for broker-dealers, investment banks, and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation, and business policy, affecting retail and institutional investors, equity and fixed income markets, and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

2 Capital, Margin, and Segregation Requirements for [SBSDs] and [MSBSPs] and Capital Requirements for [BDs], 77 Fed. Reg. 70214 (Nov. 23, 2012).

3 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. 30968 (May 23, 2013).

2014 supplement to the 2012 Proposal (the "**2014 Proposal**"[4] and, together with the 2012 Proposal and the 2013 Proposal, the "**Proposed Rules**").

We strongly support the Commission's decision to seek additional feedback on the Proposed Rules. Since the Commission released the 2012 Proposal, regulatory reform of the over-the-counter ("**OTC**") derivatives markets—in particular the global implementation of margin requirements for non-cleared derivatives—has led to significant changes in the SBS markets. As described in greater detail below, these changes would exacerbate the extent to which the Proposed Rules would, if left un-modified, impose undue costs and burdens on the competitive position of SBSDs that do not have a Prudential Regulator[5] ("**nonbank SBSDs**") who are U.S. domiciled versus bank SBSDs and foreign SBSDs.

The modifications to the Proposed Rules described in the October 2018 Release would generally help to ameliorate these disadvantages by improving the alignment of the Commission's capital and margin requirements with the new global margin framework. Those modifications would also increase the risk-sensitivity of those requirements. We generally support the October 2018 Release's modifications, subject to certain changes and clarifications discussed below.

Those modifications will not be sufficient, however, to address the problems caused by inconsistencies between the Proposed Rules and the capital, margin, and segregation requirements adopted by other regulators. In particular, there are several aspects of the Proposed Rules that the October 2018 Release does not propose to modify, but which would pose significant problems if adopted as proposed. These aspects include the proposed methodology for calculating minimum net capital requirements, proposed liquidity stress testing requirements, and proposed omnibus segregation requirements, among others. We address these issues below.

It also is concerning that the Commission has not, at this time, published a full re-proposal of the Proposed Rules. Without reviewing the proposed modifications described in the October 2018 Release in context, it is not possible to assess them fully. For example, some of the modifications relate to other revisions to the Proposed Rules not described in the release. Also, some of the modifications (such as new capital charges for swaps in addition to SBS, or increased capital charges for transactions with commercial end users) would materially increase costs, but have not been subject to any cost-benefit analysis. Moreover, the cost-benefit analysis conducted by the Commission in 2012 is simply out of date, as it did not, and could not, take into account the subsequent, fundamental changes to the SBS market noted above. When the Commodity Futures

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4 Recordkeeping and Reporting Requirements for [SBSDs], [MSBSPs], and [BDs;] Capital Rule for Certain [SBSDs], 79 Fed. Reg. 25193 (May 2, 2014).

5 In this letter, the "**Prudential Regulators**" are the Board of Governors of the Federal Reserve System (the "**Federal Reserve Board**"), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation ("**FDIC**"), the Federal Housing Finance Agency, and the Farm Credit Administration.

Trading Commission (the "**CFTC**") and the Prudential Regulators substantially revised their proposed margin rules in response to comments and the release of the WGMR framework (as defined below), they published complete re-proposals of their rules.[6] We encourage the Commission to take the same approach.

The October 2018 Release's 30-day comment period also is not sufficient to permit affected parties to consider the release fully and respond to all the Commission's requests for comment. In particular, the 30-day period has not provided enough time to conduct new quantitative analysis or suggest modified rule text. Accordingly, we anticipate the need to supplement this letter with additional submissions addressing matters that we did not have the time to address during this abbreviated comment period.

BACKGROUND

Changes to the SBS markets since 2012 fundamentally alter the Proposed Rules' potential costs, benefits, and effects on competition. Accordingly, before providing our specific further comments on the Proposed Rules, we highlight below two key regulatory and market developments that form the basis for those comments:

- ***Implementation of Global Margin Framework***. In September 2013, the Working Group on Margining Requirements ("**WGMR**") of the Basel Committee on Banking Supervision ("**Basel Committee**") and International Organization of Securities Commissions ("**IOSCO**") published a global framework (the "**WGMR framework**") for margining of non-cleared derivatives, including SBS.[7] In 2015, the Prudential Regulators and the CFTC adopted margin requirements that implement the WGMR framework.[8] A number of foreign regulators have adopted similar requirements. These requirements have, to varying extents, been in effect for over two years.

  Although the Prudential Regulators' and CFTC's margin requirements were adopted pursuant to the same statutory mandate that authorizes the Proposed Rules,[9] those requirements (and the WGMR framework generally) differ from the Proposed Rules in several significant

[6] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898 (Oct. 3, 2014) and Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348 (Sept. 24, 2014).

[7] Basel Committee and IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives (Sept. 2013, rev'd. Mar. 2015).

[8] *See* 80 Fed. Reg. 74840 (Nov. 30, 2015) (final Prudential Regulator rules) and 81 Fed. Reg. 636 (Jan. 6, 2015) (final CFTC rules).

[9] *See* Section 15F(e) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and Section 4s(e) of the Commodity Exchange Act ("**CEA**").

respects, including: (1) requirements for dealers to collect and post initial margin ("**IM**") from and to covered counterparties; (2) use of approved, risk-based models to compute IM requirements, including for equity-related swaps and SBS; (3) adoption of a $50 million IM threshold, applicable on a consolidated, group-to-group basis; (4) requirements for IM to be segregated in an account held by an independent, third-party custodian; and (5) application of IM requirements to transactions with a financial end user only if the financial end user's group-wide notional amount of OTC derivatives exceeds $8 billion.[10] Other operational and definitional differences exist, too.

These differences affect the Proposed Rules in several ways. First, these differences would create undesirable competitive disparities between U.S. nonbank SBSDs versus bank SBSDs and foreign SBSDS. Second, because U.S. nonbank SBSDs, their affiliates, and their counterparties generally have already put in place systems, procedures, and documentation designed to satisfy the WGMR framework, these differences would result in significantly greater implementation costs and disruption to these firms than would have been the case had the Commission's rules been implemented prior to or contemporaneously with the WGMR framework. These costs and disruption would also disadvantage U.S. nonbank SBSDs versus bank SBSDs and foreign SBSDs. Finally, U.S. nonbank SBSDs need to transact with other dealers and financial end users who themselves are subject to the WGMR framework. Thus, these differences would create regulatory conflicts that fragment the market and reduce liquidity and hedging opportunities.

- ***Limited SBS Dealing Activity by Full-Purpose BDs***. In the 2012 Proposal, the Commission observed that BDs did not, at the time, engage in a substantial business in SBS.[11] This fact should not be surprising. More than 20 years ago, the Commission adopted a limited purpose BD regulatory regime for OTC derivatives dealers ("**OTCDDs**") because the costs of SEC

10 Based on additional quantitative analysis, SIFMA and the International Swaps and Derivatives Association ("**ISDA**") have requested that regulators increase this amount to $100 billion and exclude physically settled foreign exchange ("**FX**") swaps and forwards from the calculation. *See* Letter from Scott O'Malia, Chief Executive Officer, ISDA, Kenneth E. Bentsen, Jr., President and Chief Executive Officer, SIFMA, Ananda Radhakrishnan, Vice President, Center for Bank Derivatives Policy, American Bankers Association, James Kemp, Managing Director, Global Foreign Exchange Division, Briget Polichene, Chief Executive Officer, Institute of International Bankers, to the Bank of International Settlements, dated Sept. 12, 2018 at 4. A recent report from the CFTC staff generally finds support for these recommendations. *See* Richard Haynes, Madison Lau, and Bruce Tuckman, *Initial Margin Phase 5,* (Oct. 24, 2018), available at https://www.cftc.gov/sites/default/files/About/Economic%20Analysis/Initial%20Margin%20Phase%205%20v5_ada.pdf.

11 2012 Proposal, 77 Fed. Reg. at 70228.

regulation as applied to BDs effecting transactions in OTC derivatives had made them completely non-competitive and caused firms instead to conduct these activities through banks, foreign affiliates, and separate, non-BD U.S. affiliates.[12]

The 2012 Proposal, however, was based on the expectations that (1) full-purpose BDs[13] would increase their SBS activities after the Dodd-Frank reforms were implemented[14] and (2) some nonbank SBSDs would be able to register as BDs in order to offer customers a wider range of services than a nonbank SBSD not registered as a BD ("**standalone SBSD**").[15] These expectations were two of the key reasons why the Proposed Rules were modeled on existing BD financial responsibility requirements.

These expectations generally have not come to pass, however. SBS dealing activity largely remains concentrated in U.S. and foreign banks, foreign dealers, OTCDDs, and standalone SBSDs.[16] If the Proposed Rules are adopted without change, the differences between those rules and the WGMR framework highlighted above would limit the ability of all U.S. nonbank SBSDs to conduct substantial SBS business. Not only would full-purpose BDs fail to increase their SBS business, but firms conducting SBS business out of OTCDDs and standalone SBSDs would need to move that business into banks and foreign dealers or exit the business.

OVERVIEW OF PROPOSED APPROACH

In light of the considerations summarized above, our comments below propose an approach that builds on the twenty years of experience that the Commission has had with OTCDDs. Under this approach, OTCDDs and standalone SBSDs would generally be able to transact in SBS on a level playing field with banks and foreign dealers, subject to certain modifications designed to take account of how OTCDDs and standalone SBSDs access

12 Release No. 34-40594 (Oct. 23, 1998), 63 Fed. Reg. 59362, 59363 (Nov. 3, 1998).

13 In this letter, we refer to "**full-purpose BDs**" to distinguish OTCDDs from other BDs.

14 2012 Proposal, 77 Fed. Reg. at 70228.

15 *Id.* at 70216.

16 To the extent that SBS activity has moved into full-purpose BDs, that activity has generally involved equity SBS conducted in connection with such BDs' prime brokerage business. Under our proposal, these equity SBS would be portfolio margined with cash market securities, listed options positions, OTC securities options and swaps and subject to similar financial responsibility requirements. To the extent that activity in non-equity SBS moves into full-purpose BDs, the modifications set forth in the October 2018 Release would generally be sufficient to help ensure appropriate consistency with the WGMR framework, subject to the considerations we note in parts II.B, II.C, and II.H below regarding IM thresholds, IM exceptions, and portfolio margining.

funding and liquidity. Full-purpose BDs that dually register as SBSDs ("**BD-SBSDs**"), meanwhile, would generally follow an approach modeled more closely on existing BD financial responsibility requirements, particularly with respect to the margin requirements for equity SBS and the segregation requirements for SBS collateral generally.

This approach would foster the ability for BD-SBSDs to offer SBS on an integrated basis with other securities-related services, which bank SBSDs, OTCDDs, and standalone SBSDs could not offer. Because these other SBSDs could not offer the same services, differences between the rules applicable to BD-SBSDs and the rules applicable to other types of SBSDs are less likely to foster competitive inequities.

Our proposed approach is also more consistent with the statute. Section 15F(e)(3)(D)(ii) of the Exchange Act requires that the Commission's capital and margin requirements for nonbank SBSDs, to the maximum extent practicable, be comparable to those established by the Prudential Regulators and CFTC. In addition, Section 3E of the Exchange Act establishes a segregation regime for SBS that, for non-cleared SBS, does not authorize the imposition of BD-like customer protection requirements. However, Section 15F(e)(3)(B) of the Exchange Act clarifies that Section 15F shall not limit, or be construed to limit, the Commission's authority to set financial responsibility rules for BDs. Accordingly, our proposed approach seeks to (1) establish maximum comparability among the capital and margin requirements adopted by the Commission, the CFTC, and the Prudential Regulators and (2) give full effect to Congress's intended segregation regime for non-cleared SBS while (3) regulating the SBS activity of BD-SBSDs in a manner consistent with their cash market securities activities.

In the table below, we have summarized our proposed approach to three core aspects of the Proposed Rules: (1) the formula for calculating the minimum net capital requirement for SBS activity; (2) the method for calculating IM amounts for non-cleared SBS; and (3) the segregation requirements for SBS collateral when held in a securities or SBS account. In addition, as described in part II.H below, we also support the ability of an SBSD to portfolio margin SBS in CFTC-regulated accounts under specified circumstances, as well as the ability to use certain cross-margining arrangements across different product categories.

Type of SBSD	Minimum Net Capital Formula	Method of Calculating IM for Non-Cleared SBS	Segregation Requirements for SBS Collateral
Full-Purpose BD-SBSD	"Alternative method" under existing SEC Rule 15c3-1, with SBS taken into account by including SBS-related debits in SEC Rule 15c3-3's customer reserve formula	Industry standard models permissible to calculate IM, *except* for equity SBS	Omnibus segregation under SEC Rule 15c3-3 *applies* to cleared *and* non-cleared SBS, with a *single* possession and control calculation and a *single* reserve account formula for all SBS positions, securities positions, and any other positions eligible for portfolio margining with them, subject to right of non-cleared SBS counterparties to elect individual segregation of IM for non-cleared SBS at independent third-party custodians
OTCDD or Standalone SBSD	2% of the sum of (1) the customer margin requirement for cleared SBS and (2) the total IM amount required to be collected for non-cleared SBS (thus *excluding* situations where the OTCDD or standalone SBSD is not required to collect IM)	Industry-standard models permissible to calculate all IM, *including* for equity SBS	Omnibus segregation under SEC Rule 18a-4 does *not* apply *unless* the OTCDD or standalone SBSD elects to clear SBS for customers and *only* then in respect of collateral for cleared SBS (and any other collateral commingled with such collateral) Absent commingling with collateral for cleared SBS, collateral for non-cleared SBS is *not* subject to segregation unless the counterparty elects individual segregation of IM for non-cleared SBS at an independent, third-party custodian

Type of SBSD	Minimum Net Capital Formula	Method of Calculating IM for Non-Cleared SBS	Segregation Requirements for SBS Collateral
Bank SBSD	As set forth in Basel-compliant capital standards reflected in Prudential Regulator capital rules	As set forth in WGMR-compliant margin standards reflected in Prudential Regulator margin rules, which generally permit use of industry-standard models to calculate IM for all types of SBS, *including* equity SBS	Omnibus segregation under SEC Rule 18a-4 does *not* apply *unless* the bank SBSD elects to clear SBS for customers and *only* then in respect of collateral for cleared SBS (and any other collateral commingled with such collateral), *subject to* coordination with FDIC to address bank insolvency considerations Absent commingling with collateral for cleared SBS, and subject to Prudential Regulator margin rules, collateral for non-cleared SBS is *not* subject to segregation unless the counterparty elects individual segregation of IM for non-cleared SBS at an independent, third-party custodian

Type of SBSD	**Minimum Net Capital Formula**	**Method of Calculating IM for Non-Cleared SBS**	**Segregation Requirements for SBS Collateral**
Foreign SBSD	Substituted compliance with Basel-like home country capital and liquidity requirements	Substituted compliance with WGMR-compliant home country margin requirements, which generally permit use of industry-standard models to calculate IM for all types of SBS, *including* equity SBS	Omnibus segregation under SEC Rule 18a-4 does *not* apply *unless* the foreign SBSD elects to clear SBS for *U.S.* customers and *only* then in respect of collateral for cleared SBS (and any other collateral commingled with such collateral), *subject to* coordination with the home country regulator as necessary to ensure consistency with home country segregation requirements and insolvency considerations Absent commingling with collateral for cleared SBS and subject to home country margin rules, collateral for non-cleared SBS is *not* subject to segregation unless a U.S. counterparty elects individual segregation of IM for non-cleared SBS at an independent, third-party custodian

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DISCUSSION

I. Capital Requirements

A. 8 Percent IM Rule

The 2012 Proposal would require a nonbank SBSD to maintain minimum net capital equal to the greater of a fixed dollar amount or a financial ratio.[17] For a standalone SBSD, the financial ratio would equal 8 percent of the firm's "risk margin amount," an amount generally equal to the amount of IM calculated by the firm for its cleared and non-cleared SBS (the "**8 Percent IM Rule**").[18] For a BD-SBSD, the financial ratio would equal the sum of the 8 Percent IM Rule and the financial ratio requirement applicable to the firm's non-SBS securities business under the BD net capital rule, which is generally 2% of the aggregate debit items in the customer reserve formula (*i.e.*, the amount of financing the BD has extended to customers).[19]

For purposes of the 8 Percent IM Rule, the 2012 Proposal would define "risk margin amount" to mean the sum of: (1) the greater of (a) the total margin required to be delivered by the nonbank SBSD with respect to SBS transactions cleared for SBS customers at a clearing agency or (b) the amount of deductions that would apply to the cleared SBS positions of the SBS customer pursuant to the applicable Commission capital rule, were the positions proprietary positions of the nonbank SBSD (the "**Cleared SBS Deduction Amount**"); and (2) the total IM amount calculated by the SBSD with respect to non-cleared SBS pursuant to the proposed new margin rule.

The October 2018 Release requests comment regarding (1) the amount of net capital that this 8 Percent IM Rule would require and (2) modifying the definition of "risk margin amount" to remove the Cleared SBS Deduction Amount.[20] Accordingly, our comments below address the 8 Percent IM Rule in general before turning to the Cleared SBS Deduction Amount.

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[17] The 2012 Proposal would apply a higher fixed dollar minimum net capital requirement, as well as higher tentative net capital and early warning requirements, to a BD-SBSD than a standalone SBSD. We recommend that the Commission treat an OTCDD that registers as an SBSD like a standalone SBSD for purposes of these requirements.

[18] 2012 Proposal § 15c3-1(c)(16); 2012 Proposal § 18a-1(c)(6).

[19] *See* 17 C.F.R. § 240.15c3-1(a).

[20] October 2018 Release, 83 Fed. Reg. at 53008-9.

1. The Commission Should Replace the 8 Percent IM Rule with a More Risk-Sensitive Alternative

We have two general concerns regarding the 8 Percent IM Rule: (1) its treatment of non-cleared SBS would result in capital requirements that do not accurately reflect an SBSD's risk or leverage; and (2) it would treat both cleared and non-cleared SBS in a different manner than economically similar non-SBS securities positions are treated by the BD net capital rule. We provided additional details regarding these concerns and others relating to the 8 Percent IM Rule in our prior comments to the Commission and the CFTC.[21]

a. The 8 Percent IM Rule Treats Non-Cleared SBS Inappropriately

The proposed treatment of non-cleared SBS under the 8 Percent IM Rule would pose several problems:

Double-Counting Credit Exposure. Unlike SBS cleared for customers, which generally would not result in capital charges for a nonbank SBSD,[22] non-cleared SBS are proprietary positions of a nonbank SBSD. Accordingly, non-cleared SBS already result in both market and credit risk capital charges. Subjecting non-cleared SBS to the 8 Percent IM Rule therefore double-counts a nonbank SBSD's potential future credit exposure to its non-cleared SBS counterparties. For example, assume a nonbank SBSD enters into a long equity SBS with a $100 million notional amount, the SBS has an IM requirement and market risk charge both equal to $15 million, and the SBSD does not collect IM from its counterparty or hedge the position. Under the Proposed Rules, the nonbank SBSD would take a $15 million market risk charge (to account for volatility of the position) and a $15 million credit risk charge (to account for its potential future credit exposure to its counterparty). In addition, the nonbank SBSD would need to factor the same $15 million potential future credit exposure amount into its 8 Percent IM Rule calculation, therefore resulting in an additional $1.2 million of required net capital—even though the SBSD had already taken a $15 million capital charge for its full potential future credit exposure to its counterparty.

Example 1: One SBS, with $100M notional and $15M IM Requirement ($0 Collected)					
Notional	**IM**	**Market Risk Charge**	**Credit Risk Charge**	**8% IM**	**Total Net Capital Needed**

[21] *See* Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, to the SEC, dated February 22, 2013 at 3-7; Letter from Mary Kay Scucci, Managing Director, SIFMA, to the CFTC, dated May 15, 2017 at 2-5.

[22] *See* part I.B below for our discussion of capital charges for SBS cleared for customers.

$100M	$15M	$15M	$15M	$1.2M	$31.2M

Discouraging Market Risk Hedging. Nonbank SBSDs often hedge their market risk exposure by entering into offsetting non-cleared positions with other counterparties. Because the 8 Percent IM Rule applies on a gross basis across counterparties, it would discourage this risk-mitigating activity by assessing an incremental capital requirement on the hedging transaction. Using the example described above, assume that the nonbank SBSD hedges its long equity SBS with a mirror, but otherwise identical, short equity SBS with a second counterparty. This second SBS would eliminate the $15 million market risk charge, but the SBSD would incur an additional $15 million credit risk charge *and* need to factor that $15 million again into its 8 Percent IM Rule calculation, resulting in a total of $16.2 million of additional capital required for the second SBS. This additional capital requirement would more than outweigh the reduction in market risk capital charges from the hedge. Notably, in this example, even if both of the SBSD's counterparties default, they could not both owe money to the SBSD on these positions because the positions are on opposite sides of the market.

Example 2: Two offsetting SBS, each with $100M notional and $15M IM Requirement ($0 Collected)						
Transaction	**Notional**	**IM**	**Credit Risk Charge**	**Market Risk Charge**	**8% IM**	**Total Net Capital Needed**
Long Equity SBS	$100M	$15M	$15M	$15M	$1.2M	$31.2M
Short Equity SBS	$100M	$15M	$15M	$15M	$1.2M	$31.2M
Total	$200M	$30M	$30M	0	$2.4	$32.4M

Failure to Recognize Margin as a Risk Mitigant. To mitigate its credit risk and reduce its capital costs, the nonbank SBSD in the examples above might collect IM from its counterparties. However, even if the SBSD collected $15 million from each counterparty—thus fully offsetting its aggregate $30 million in potential future credit exposure—the 8 Percent IM Rule would still require the SBSD to maintain $2.4 million in net capital against these fully hedged, fully collateralized positions. In other words, collecting IM from a counterparty, and so effectively eliminating the credit exposure, does not reduce the credit-exposure capital required amounts of the 8 Percent IM Rule.

Example 3: Two offsetting SBS, each with $100M notional and $15M IM Requirement ($15M Collected)						
Transaction	**Notional**	**IM**	**Credit Risk Charge**	**Market Risk Charge**	**8% IM**	**Total Net Capital Needed**
Long Equity SBS	$100M	$15M	$0	$15M	$1.2M	$31.2M
Short Equity SBS	$100M	$15M	$0	$15M	$1.2M	$31.2M
Total	$200M	$30M	$0	0	$2.4	$2.4M

b. The 8 Percent IM Rules Departs Inappropriately from the BD Net Capital Rule

Most large BDs, including those likely to dually register as SBSDs, elect the so-called "alternative method" under which such a firm's minimum net capital requirement equals 2% of the firm's aggregate debit items in the customer reserve formula (the "**2 Percent Customer Debit Rule**"). The 8 Percent IM Rule differs from the 2 Percent Customer Debit Rule in two key respects:

<u>Use of 8 Percent Multiplier, Instead of 2 Percent</u>. The 8 Percent IM Rule would effectively treat SBS-related exposures as four times riskier than the securities-related exposures subject to the 2 Percent Customer Debit Rule. For example, $100 million in margin posted by a BD to the Options Clearing Corporation to cover options cleared for a customer would result in a $2 million net capital requirement under the 2 Percent Customer Debit Rule, whereas the same amount of margin posted by an SBSD to a clearing agency for an SBS cleared for a customer would result in an $8 million net capital requirement under the 8 Percent IM Rule. This is true even if the options customer has a pair of options (a put and a call) that is economically indistinguishable from an SBS.

The Commission has not provided any data or analysis to support this higher net capital requirement for SBS and, indeed, there can be no economic rationale for doing so. Instead, it has primarily referenced the CFTC's net capital rule for futures commission merchants ("**FCMs**") and related CFTC proposals for swap dealers ("**SDs**").[23] However, the CFTC adopted the relevant part of the FCM capital rule based on an analysis in 2003 of FCMs' clearing business in the listed futures markets.[24] The 2003 listed futures market is not a proxy for the SBS market in 2018. The CFTC also has not since updated that

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[23] *See* 2012 Proposal, 77 Fed. Reg. at 70223.

[24] *See* Minimum Financial and Related Reporting Requirements for [FCMs] and Introducing Brokers, 68 Fed. Reg. 40835 (Jul. 9, 2003) Proposed Rule.

analysis to cover swaps. The Commission also references the use of an 8 percent multiplier in the Basel Committee's capital standards,[25] but those capital standards apply that multiplier to a firm's risk-weighted assets. Risk-weighted assets are the equivalent of the market and credit risk charges required by the Proposed Rules. But the 8 Percent IM Rule would be calculated against gross IM levels, not market and credit risk charges.

Coverage of Margin Exceptions. BD margin rules generally do not require a BD to collect margin from another BD,[26] and the 2 Percent Customer Debit Rule does not cover a BD's debit balances with other BDs.[27] This treatment makes sense because the 2 Percent Customer Debit Rule is, in many respects, a supplement to the Commission's BD customer protection rule. By tying a BD's minimum net capital to the extent of the BD's use of customer assets, the 2 Percent Customer Debit Rule helps ensure that a BD maintains a buffer of liquid assets above the amount of customer cash and securities it reserves for the benefit of customers. It also helps limit the extent to which a BD can obtain leverage through use of customer assets. The 2 Percent Customer Debit Rule thus logically supplements the capital charges applicable to a BD's proprietary positions; those charges cover the risks of those positions—thus addressing the risk of the BD's dealing business as principal—whereas the 2 Percent Customer Debit Rule helps address the BD's role as custodian of customer cash and securities.

In contrast, the 8 Percent IM Rule would cover situations in which a nonbank SBSD is not required to collect IM, such as in connection with legacy accounts, counterparties that elect individual segregation at a third-party custodian, and transactions with other SBSDs.[28] Covering these situations is not necessary to restrict the leverage available to a nonbank SBSD because these situations do not result in the SBSD receiving collateral that it can re-hypothecate to fund its business. Nor is covering these situations necessary to provide a buffer to cover the return of property owed to counterparties, as these counterparties will not provide collateral that the SBSD will be obligated to return.

These departures would lead to undesirable regulatory arbitrage between economically similar SBS and non-SBS securities transactions. They also would impede portfolio margining of these transactions by treating commingled debits for SBS and non-SBS securities transactions in two different ways.

25 2012 Proposal, 77 Fed. Reg. at 70223, n. 77.

26 *Id.* at 70267.

27 *See* Financial Responsibility Rules for [BDs], Release No. 34-70072 (Jul. 30, 2013), 78 Fed. Reg. 51824, 51831 (Aug. 21, 2013).

28 The Commission has an alternative under which a nonbank SBSD would not need to collect IM from another SBSD ("Alternative A"), and the October 2018 Release requests comments regarding whether to expand Alternative A to counterparties that are BDs, banks, FCMs, foreign banks, and foreign dealers. October 2018 Release, 83 Fed. Reg. at 53013-14.

We also note that the October 2012 Proposal would, for all alternative net capital ("**ANC**") BDs, whether or not registered as SBSDs, require minimum net capital equal to the sum of the 2 Percent Customer Debit Rule and the 8 Percent IM Rule. It is not clear why these requirements should be added together, rather than integrating capital requirements for SBS into the existing 2 Percent Customer Debit Rule.

Recommendation: The Commission should replace the 8 Percent IM Rule with minimum net capital requirements modeled on the 2 Percent Customer Debit Rule, as set out below:

- For a **full-purpose BD**, whether or not registered as an SBSD, remove the 8 Percent IM Rule and modify the existing customer reserve formula to include SBS-related credits and debits, thereby covering SBS with the existing 2 Percent Customer Debit Rule.

- For an **OTCDD** or **standalone SBSD**, replace the 8 Percent IM Rule with a minimum net capital requirement equal to two percent of the sum of:

  (1) the total margin required to be delivered by the OTCDD or nonbank SBSD with respect to SBS transactions cleared for SBS customers at a clearing agency and maintained in an SBS account; and

  (2) the total IM amount required to be collected by the OTCDD or nonbank SBSD under the Commission's margin rules with respect to non-cleared SBS (*i.e.*, excluding situations where the OTCDD or standalone SBSD is not required to collect IM).

The Commission could adopt these requirements pursuant to an interim final rule, which would allow it to solicit additional comments and conduct further analysis on the requirements, including quantitative analysis regarding the potential impact of higher multipliers and inclusion of additional exposures.

2. If Retained, the 8 Percent IM Rule Should Not Include the Cleared SBS Deduction Amount

The October 2018 Release requests comment on whether the input to the risk margin amount calculation for cleared SBS should be revised so that it is determined solely by reference to the clearing agency margin requirements, without regard to the Cleared SBS Deduction Amount.[29] We support this modification, which would also be reflected in the revised minimum net capital requirements that we recommend above.

The Cleared SBS Deduction Amount is not the proper mechanism to address any deficiency that the Commission finds in a clearing agency's calculation of IM

[29] October 2018 Release, 83 Fed. Reg. at 53009.

requirements. The Commission is the direct regulator of clearing agencies. It should address any concerns that clearing agency margin requirements do not adequately address risk through its role as clearing agency regulator. In addition, the Commission has separately proposed to impose net capital deductions in circumstances where clearing agency margin requirements are deficient; including the Cleared SBS Deduction Amount in the 8 Percent IM Rule calculation would result in another instance in which the 8 Percent IM Rule double-counts an SBSD's credit exposure.

Recommendation: Consistent with the October 2018 Release, the Commission should exclude the Cleared SBS Deduction Amount from the calculation of required minimum net capital under the 8 Percent IM Rule.

3. If Retained, the 8 Percent IM Rule Should Exclude SBS Portfolio Margined in a CFTC-Regulated Swaps or Futures Account

A BD that is dually registered as an FCM (a "**BD-FCM**") is required to calculate its minimum net capital requirement under both SEC Rule 15c3-1 and CFTC Rule 1.17.[30] Just as the "risk margin" calculation under CFTC Rule 1.17 is generally limited to positions maintained in a futures or cleared swaps account, so too does the denominator in the 2 Percent Customer Debits Rule calculation exclude positions that are maintained in an account subject to the CFTC's rules. In line with this approach, the Commission should make clear in amended SEC Rule 15c3-1 and final Rule 18a-1 that any SBS positions that are portfolio margined in a swaps or futures account are not included in the respective rule's calculation of required minimum net capital. As currently drafted, the definition of "risk margin amount" appears to encompass the IM amount for *all* cleared and non-cleared SBS, irrespective of whether the CFTC's net capital requirements already takes account of them. This could result in such positions being counted in both the Commission's net capital calculation and that set forth in Rule 1.17.[31] This issue would be exacerbated if the CFTC adopted its proposed capital rules for SDs and proposed revisions to the FCM net capital rule, which would expressly subject IM for SBS to a parallel 8 Percent IM Rule.[32]

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30 *See* 17 C.F.R. § 1.17.

31 As the Commission noted in the 2012 Release, CFTC Rule 1.17, like SEC Rule 15c3-1, requires BD-FCMs to maintain an amount of capital equal to the greater of the amounts required under the Commission's and CFTC's respective net capital rules. 2012 Proposal, 77 Fed. Reg. at 70248. The Commission should ensure that its final rules make clear that this same approach applies not only to BD-FCMs but also to standalone SBSDs and OTCDDs that are dually registered as FCMs.

32 Capital Requirements of [SDs] and Major Swap Participants, 81 Fed. Reg. at 91263- 91265 (Dec. 16, 2016).

Recommendation: Consistent with the Commission's existing net capital framework, the Commission should exclude from the 8 Percent IM Rule those SBS that are portfolio margined with swaps or futures in an account subject to the supervision of the CFTC.

B. Cleared SBS Capital Charges

In addition to incorporating the Cleared SBS Deduction Amount into the risk margin amount calculation, the 2012 Proposal would require a nonbank SBSD to take a 100% capital charge (the "**Cleared SBS Capital Charge**") equal to the excess of the Cleared SBS Deduction Amount over the amount of IM that a nonbank SBSD collects from a customer in respect of cleared SBS positions.[33] The October 2018 Release requests comment on whether to modify the Cleared SBS Capital Charge to include a risk-based threshold under which an SBSD need not take the charge. Specifically, the October 2018 Release asks whether no charge should be required to the extent (1) the difference between the Cleared SBS Deduction Amount and the amount of IM that a nonbank SBSD collects in respect of an account is less than (a) 1% of the nonbank SBSD's tentative net capital and (b) 10% of the counterparty's net worth and (2) the aggregate difference across all counterparties is less than 25% of the nonbank SBSD's tentative net capital.[34]

1. Direct Clearing Agency Regulation Is Preferable to Cleared SBS Capital Charges

As discussed above, direct regulation of a clearing agency is the logical means of addressing deficiencies in the clearing agency's margin requirements. Addressing these deficiencies through the Cleared SBS Capital Charge, rather than requiring clearing agencies to collect sufficient margin, would also provide unwanted incentives for customers to clear SBS through firms willing to incur the capital charge instead of collecting sufficient margin. This incentive would provide an advantage to the largest clearing firms possessing the greatest amounts of excess net capital, thereby exacerbating concentration in the market for clearing services. Additionally, considering firms with different proprietary market risk models may calculate different Cleared SBS Deduction Amounts, the Cleared SBS Capital Charge would foster inconsistency in the margin of the same cleared positions. Such inconsistency could create a race to the bottom, with customers electing to clear SBS at the firm that calculates the lowest Cleared SBS Deduction Amount.

2. The Cleared SBS Capital Charges Unduly Depart from the Commission's Existing CDS Portfolio Margin Exemption

Subsequent to the 2012 Proposal, the Commission adopted an exemption permitting a BD-FCM to portfolio margin single-name credit default swaps ("**CDS**") with

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[33] 2012 Proposal, 77 Fed. Reg. at 70245-46.

[34] October 2018 Release, 83 Fed. Reg. at 53009.

index CDS (the "**CDS Portfolio Margin Exemption**").[35] After consultation with several BD-FCMs seeking to rely on the CDS Portfolio Margin Exemption, Commission staff decided only to apply the Cleared SBS Capital Charge to those BD-FCMs to the extent that the difference between (a) the Cleared SBS Deduction Amount and (b) the amount of IM the clearing agency requires in respect of an account (plus any uncollected variation margin ("**VM**")), exceeded 1% of the BD-FCM's tentative net capital.[36]

In connection with the CDS Portfolio Margin Exemption, Commission staff did not also require the charge to apply based on a 10% counterparty net worth threshold or a 25% aggregate tentative net capital threshold. The October 2018 Release does not describe why the 1% counterparty-specific tentative net capital threshold that has applied under the CDS Portfolio Margin Exemption for over four years is now insufficient or why these additional thresholds are warranted.

3. A Ten Percent Counterparty Net Worth Threshold Would Not Be Practical, Desirable, or Necessary to Implement

A 10% threshold based on counterparty net worth would be extremely difficult, if not impossible, for a clearing firm to implement. Clearing firms do not have the systems or processes in place to track counterparty net worth in real time. Even if they did, their counterparties would generally not be able to provide such information. Many commercial and financial end users calculate their net worth in accordance with regular reporting cycles, rather than on a daily basis, and some end users (*e.g.*, those that do not have outside investors) do not regularly perform net worth calculations at all.[37] As a result, implementing a 10% counterparty net worth threshold would not only require clearing firms to develop new systems and procedures, but also force commercial and financial end users that wish to clear SBS to overhaul their accounting and reporting systems. The expense of such an overhaul would, in many instances, outweigh the benefit of being able to hedge through SBS, especially for smaller end users.

A 10% counterparty net worth threshold would also be difficult to implement consistently with U.S. and non-U.S. securities laws. Absent confidentiality agreements, issuers of publicly traded securities may only be able to provide information regarding net worth during certain periods. A 10% counterparty net worth threshold would thus effectively bar public issuers from the SBS markets during blackout or similar periods, unless their clearing firms entered into confidentiality agreements with them. But in the presence of such confidentiality agreements, securities laws would restrict the ability of clearing firms to engage in trades related to an issuer's securities if they have received

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35 *See* Release No. 34-68433 (Dec. 14, 2012).

36 *See, e.g.*, Letter from Michael A. Macchiaroli, Division of Trading and Markets, Commission, to Keith Bailey, Barclays Capital Inc. (June 7, 2013).

37 Net worth also has very different meanings as to different companies and industries (*e.g.*, different treatment of good will).

non-public net worth information regarding such securities. Such trades may be necessary for a clearing firm to hedge its risk to the particular customer. The implementation difficulties with a 10% counterparty net worth threshold would accordingly increase, rather than decrease, risk.

In addition to being practically impossible and legally challenging to implement, a 10% counterparty net worth threshold is not necessary to protect BDs and SBSDs. The 1% tentative net worth test is sufficient to identify when a BD's or nonbank SBSD's exposure to a particular counterparty reaches a point when it could have a material impact on the BD's or nonbank SBSD's financial stability. We note in this regard that the 1% threshold is already substantially lower than the 5% threshold applicable to counterparty concentration charges that ANC BDs are required to recognize when calculating credit risk charges related to derivatives under Appendix E to SEC Rule 15c3-1. In addition, this threshold applies to potential future exposure, rather than current exposure, and potential future exposure does not count as net capital in the first place. Under such circumstances, a 10% threshold, even if it could be implemented, would do little more to bolster the financial stability of the nonbank SBSD.

We further note that the CDS Portfolio Margin Exemption took a more flexible, qualitative approach to limiting exposure to particular counterparties based on an assessment of creditworthiness.[38] Similarly, Federal Reserve Board requirements relating to assessment of credit risk for capital purposes require an effective process to obtain and update in a timely manner relevant and material information about counterparties.[39] In line with these precedents, rather than imposing an unworkable 10% counterparty net worth threshold, the Commission should require a BD or nonbank SBSD to put in place a process to obtain and update information concerning the credit risk of its customers.

4. An Additional 25 Percent Aggregate Threshold Is Unnecessary

With respect to the 25% aggregate tentative net capital threshold, we note that the existing portfolio-wide concentration charge applicable to derivatives-related credit exposure of ANC BDs does not apply until aggregate uncollateralized current exposure

38 In particular, the risk management system of a BD-FCM relying on that exemption must consist of an internal credit risk model to assess the initial and ongoing credit risk of each individual counterparty. The monitoring of counterparty credit risk must include the prudent setting of exposure limits and mechanisms that would allow the BD-FCM to limit or reduce the exposure to counterparties. The exposure limits must be reviewed at least quarterly based on the BD-FCM's ongoing credit assessments of all of its counterparties. Positions should be valued conservatively in view of current market prices and the amount that might be realized upon liquidation. The BD-FCM must also have the ability to raise margin requirements or lower exposure limits based on changes in the counterparty's credit risk profile. The BD-FCM must raise margin requirements or limit counterparty exposure when positions or markets are excessively volatile. *See* Note 36, *supra*.

39 *See* 12 C.F.R. § 217.122(b)(2)(iii).

exceeds 50% of the ANC BD's tentative net capital.[40] The October 2018 Release does not explain why a lower, 25% tentative net capital threshold is necessary for cleared SBS. Nor does it explain why a portfolio concentration charge to cover uncollateralized potential future exposure is necessary at all, considering that the existing portfolio concentration charge only applies to uncollateralized current exposure. Unlike current exposure, potential future exposure is not an on-balance sheet asset that would otherwise count towards a firm's net capital.

Recommendation: Consistent with the CDS Portfolio Margin Exemption, the Commission should only impose the Cleared SBS Capital Charge to the extent it exceeds 1% of the nonbank SBSD's tentative net capital.

5. The Cleared SBS Capital Charge Should Not Apply to Swaps

The October 2018 Release does not expressly request comment regarding whether the Cleared SBS Capital Charge should be extended to cleared swaps. However, the rule language set out in the release would have that effect. Specifically, it would require a BD or nonbank SBSD to take a 100% capital charge equal to the excess of the amount of deductions the BD or nonbank SBSD would be required to take in respect of swaps cleared for a customer were such positions proprietary positions of the BD or nonbank SBSD (the "**Cleared Swap Deduction Amount**") over the amount of margin the BD or nonbank SBSD has collected from the customer in respect of the positions. As with the Cleared SBS Deduction Amount, the Cleared Swap Deduction Amount would need to be calculated using a Commission-approved methodology, rather than one approved by the CFTC.

Extending the application of the Cleared SBS Capital Charge in this way would interfere with the CFTC's comprehensive regulation of the cleared swaps market. The CFTC is the direct regulator of both FCMs and derivatives clearing organizations and has prescribed detailed regulations to ensure that the cleared swaps markets are safe and efficient. As discussed above, the Cleared SBS Capital Charge affects the behavior of clearing members and their customers by modifying their incentives. Accordingly, were the Commission to impose a similar charge with respect to swaps cleared by FCMs that are dually registered as BDs or SBSDs, it would undermine the CFTC's considered policy choices by changing the margin that FCMs collect, the prices FCMs charge, and the calculus of customers when choosing an FCM. These changes, moreover, would be on the basis of the Commission's approved methodologies for calculating margin requirements, rather than the CFTC's.

Recommendation: The Commission should not extend the application of the Cleared SBS Capital Charges to swaps cleared for customers. If it nonetheless does, it should calculate the Cleared Swap Deduction Amount using a CFTC-, rather than SEC-, approved methodology.

[40] 17 C.F.R. § 240.15c3-1e(c)(3).

C. Non-Cleared SBS Capital Charges

The 2012 Proposal would have required a nonbank SBSD to take a 100% capital charge for any VM or IM that the nonbank SBSD does not collect in respect of non-cleared SBS because of an exception under the Commission's margin rules for commercial end users, counterparties that elect to hold their IM at a third-party custodian, or legacy accounts.[41] As an alternative to the 100% deduction, ANC BDs and standalone SBSDs approved to use internal models would be permitted to take a credit risk charge in connection with non-cleared SBS with a commercial end user.[42]

The October 2018 Release appears to contemplate several changes to these proposals:

1. *Single Capital Charge for All Uncollected SBS IM*. It appears that the three 100% capital charges described above would be replaced by a single capital charge equal to the amount of IM for non-cleared SBS calculated by a BD or nonbank SBSD for a counterparty (the "**IM Requirement**") in accordance an SEC-approved methodology, less the margin value of collateral held in the account of the counterparty at the BD or nonbank SBSD.[43]

2. *Addition of a Capital Charge for Uncollected Swaps IM*. A similar capital charge would apply to the extent the IM Requirement—again calculated in accordance with an SEC-approved methodology, not a CFTC-approved methodology—exceeded the margin value of collateral held in the account of the counterparty at the BD or nonbank SBSD.[44]

3. *Conditional Relief for IM Held at Third-Party Custodians*. For purposes of computing these capital charges, a BD or nonbank SBSD could treat IM held by an independent, third-party custodian as collateral held in the account of the counterparty at the BD or nonbank SBSD if certain conditions were satisfied.[45]

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41 *See* 2012 Proposal, 77 Fed. Reg. at 70246-47.

42 *Id.* at 70240-44.

43 *See* October 2018 Release, 83 Fed. Reg. at 53012. As noted below, we do not think that this charge should apply to a BD that is not an SBSD.

44 *See id.*

45 *See id.*

4. _*Credit Risk Charges in Lieu of 100% Capital Deductions for Uncollected IM*_. An ANC BD or standalone SBSD approved to use internal models could, in lieu of the capital charge set forth above for uncollected IM for non-cleared SBS or swaps, calculate a credit risk capital charge using its approved models.[46]

5. _*10% Cap on Credit Risk Charges for Uncollected VM*_. The ability of an ANC BD or standalone SBSD approved to use internal models to calculate its credit risk capital charge for uncollected VM for non-cleared SBS or swaps with commercial end users would be limited to the extent such charges, in the aggregate, do not exceed 10% of the tentative net capital of the BD or SBSD.[47]

We discuss the latter four changes in turn below.

1. The Commission Should Not Expand its Capital Charges for Uncollected IM to Cover Non-Cleared Swaps

As amended by the October 2018 Release, SEC Rules 15c3-1(c)(2)(xv)(B) and 18a-1(c)(1)(ix) would require a BD or nonbank SBSD to deduct from net capital not only (1) the IM Requirement for non-cleared SBS, but also (2) the IM Requirement for non-cleared swaps, in each case to the extent the IM Requirement exceeds the margin value of collateral held in the account of the counterparty. To calculate the IM Requirement for both SBS and swaps, the nonbank SBSD would need to use a methodology approved by the Commission, even when the transaction is a swap and maintained in a swaps account.

Expanding the Commission's capital charges to cover non-cleared swaps would, in and of itself, interfere with policy choices made by the CFTC with respect to how it regulates the swap markets. For example, as discussed below, the CFTC (as well as the Prudential Regulators) adopted third-party segregation requirements for non-cleared swap IM, consistent with the WGMR framework. Imposing additional capital charges on a nonbank SBSD when it holds IM for non-cleared swaps at a third-party custodian in accordance with CFTC rules, unless the SBSD satisfied conditions not reflected in those CFTC rules, would undermine the ability of the CFTC to regulate the swap markets as it sees fit.

It would further undermine, and to a significant extent override, the CFTC's policy choices were the Commission to require nonbank SBSDs to use a Commission-approved methodology to calculate the IM Requirement for non-cleared swaps. Such a requirement would either (1) force nonbank SBSDs to collect the IM Requirement calculated using the Commission's approved methodologies (when it exceeds the amount calculated using the CFTC's approved methodology) or (2) punish nonbank SBSDs that calculate IM

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46 *Id.* at 53010-11.

47 *Id.*

Requirements solely using the CFTC's methodology. In either case, to the extent the Commission's methodology calculates a higher IM Requirement, the Commission would effectively force BDs and nonbank SBSDs and their respective counterparties to incorporate that methodology into the economics of each non-cleared swap, whether directly by adjusting margin requirements or indirectly by increasing the transaction's costs.

The extra charges imposed by the Commission with respect to non-cleared swaps would create a significant disincentive to dually registering an SD as an SBSD (an "**SD-SBSD**"); on the other hand, bifurcating swap and SBS activity into two separate entities would reduce opportunities for netting, increase credit risk, and make hedging and funding activities less efficient. Similar issues would arise if an SD-SBSD faced 100% capital charges for failing to collect VM from a non-cleared swap counterparty not required to post VM under the CFTC's margin rules.

The charges would also interfere with Congress's decision regarding when to impose margin requirements on non-cleared swaps. As amended in the October 2018 Release, SEC Rules 15c3-1(c)(2)(xv)(B) and 18a-1(c)(1)(ix) would require a nonbank SBSD to take a capital charge for uncollected IM in respect of non-cleared swaps, regardless of whether the BD or SBSD is dually registered as an SD. Imposing such capital charges on a BD or SBSD that is not an SD would be especially inappropriate. BDs and SBSDs that are not dually registered as SDs are not required to collect IM under the CFTC's margin rules. That limitation reflects not only the CFTC's determination that such collection of margin is not necessary, but also Congress's decision to limit the application of Dodd-Frank's swaps margin rules to SDs, major swap participants, and their counterparties. Were the Commission to impose a capital charge on BDs or SBSDs that are not SDs, it would undermine Congress's decision by incorporating the costs of IM into non-cleared swaps between non-SDs. Such costs would impede the BD or SBSD from engaging in transactions that Congress wanted non-SDs to execute, such as transactions that allow the BD or SBSD to hedge its exposures or *de minimis*, ancillary swap dealing.

Recommendation: The Commission should not expand its capital charges for uncollected IM to cover non-cleared swaps. If the Commission nonetheless does, it should (1) only do so for a BD or SBSD that is dually registered as an SD and (2) permit such BD or SBSD to calculate the IM Requirement using a CFTC-approved methodology.

2. The Commission Should Recognize Collateral Held at Third-Party Custodians

The October 2018 Release asks whether IM maintained at an independent, third-party custodian should be treated as collateral held in the account of the counterparty at a BD or nonbank SBSD if: (1) the custodian is a "bank," as defined in the Exchange Act; (2) the BD or nonbank SBSD enters into an agreement with the custodian and counterparty that provides the BD or nonbank SBSD with the same control over the collateral as would be the case if the BD or nonbank SBSD controlled the collateral directly; and (3) an opinion of counsel deems the agreement enforceable (the "**Custodial Conditions**").[48]

With respect to (2), the October 2018 Release requests comment on whether the custody agreement should satisfy the following conditions (the "**Control Conditions**"):

> (1) Provide that the collateral will be released promptly and directed in accordance with the instructions of the BD or nonbank SBSD upon the receipt of an effective notice from the BD or nonbank SBSD;
>
> (2) provide that, when the counterparty provides an effective notice to access the collateral, the BD or 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 BD or nonbank SBSD over an effective notice from the counterparty, as well as priority to the BD's or nonbank SBSD's instruction about how to transfer the collateral in the event the custodian terminates the account control agreement.[49]

We appreciate the Commission's efforts to balance its objective of ensuring prompt access to collateral by a BD or nonbank SBSD with Congress's requirement that SBSDs offer segregation of IM at an independent, third-party custodian.[50] As described below, however, the approach set forth in the October 2018 Release would still unduly interfere with the congressionally mandated right to segregation. It also would conflict with the implementation of the WGMR framework by the Prudential Regulators and the CFTC.

a. The Commission Should Not Adopt the Second and Third Control Conditions

Third-party segregation is a widely utilized mechanism to protect both pledgors and secured parties. In addition to swaps and SBS market participants, repurchase agreement and securities lending counterparties frequently use third-party custodial arrangements to protect both the buyer/lender and seller/borrower. Well-established commercial law rules and practice ensure that, under such arrangements, the secured party is able to access and liquidate the custodied assets promptly upon the pledgor's default and apply the proceeds to the pledgor's obligations.

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48 October 2018 Release, 83 Fed. Reg. at 53012.

49 *Id*.

50 *See* Exchange Act Section 3E(f).

In view of the protections that third-party custody arrangements afford to secured parties and pledgors, the margin rules adopted by the CFTC and Prudential Regulators pursuant to Dodd-Frank and the WGMR framework require that bank and nonbank SDs and, in the case of the Prudential Regulators, bank SBSDs, both (1) segregate IM collected pursuant to their respective non-cleared swaps margin rules at an independent, third-party custodian and (2) require that the IM the SDs and SBSDs post pursuant to the rules be segregated at an independent, third-party custodian.[51] As the CFTC stated: "[T]he ultimate purpose of the custody agreement is two-fold: (1) That the [IM] be available to a counterparty when its counterparty defaults and a loss is realized that exceeds the amount of [VM] that has been collected as of the time of default; and (2) [IM] be returned to the posting party after its swap obligations have been fully discharged."[52]

Following the promulgation of the CFTC's and Prudential Regulators' margin rules, SDs and SBSDs worked with their counterparties to put in place custodial arrangements that satisfy those rules. Consistent with the first Control Condition, these arrangements provide the SD or SBSD with the right to access the IM if the SD or SBSD provides the custodian with a certification that an event of default has occurred with respect to the counterparty.

Some custodial arrangements also include a two-day "cooling off" period that, consistent with the second Control Condition, delays the ability of the pledgor to access its collateral. However, many custodial agreements do not include such a provision due to its limited utility. A cooling off period generally serves to allow the secured party to proceed to court to obtain a temporary restraining order blocking the pledgor from withdrawing the collateral.

Also, many custodial agreements do not include a requirement that the collateral only be released to the pledgor when an agreed-upon event has occurred, as the second Control Condition would require. The reasons for this are two-fold. First, custodians are not well-placed to determine whether an event of default has occurred and are very unwilling to agree to any such obligation, since it creates significant liability exposure. Second, such a requirement may actually serve to harm the secured party. Under Article 8 of the Uniform Commercial Code, the most effective and simplest way for a secured party to perfect its security interest in assets like IM maintained at a third-party custodian is by obtaining "control." In order to obtain control in the context of a third-party custodial account of the sort contemplated here, the custodian must have agreed that it will comply with the entitlement orders originated by the secured party without the further consent of the pledgor. A requirement that the IM will not be released until a prior agreed-upon condition among the three parties has occurred could be viewed as curtailing the

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[51] *See*, e.g., 12 C.F.R § __.7; 17 C.F.R. § 23.157(a).

[52] Margin Requirements for Uncleared Swaps for [SDs] and Major Swap Participants, 81 Fed. Reg. 636, 670 (Jan. 6, 2016).

custodian's obligation to follow the orders of the secured party in a way that raises questions regarding the secured party's control for purposes of Article 8.

Custodial arrangements also do not generally give priority to the SBSD's or SD's notice over the counterparty's, as the third Control Condition would require. This is because many counterparties require the SBSDs and SDs they face to incorporate into the custodial arrangement governing the margin posted by the SBSD or SD the same terms that govern the margin posted by the counterparty. As a result, were an SBSD or SD to demand that its notice be given priority when the SBSD or SD acts as secured party, it would likewise have to give the counterparty's notice priority when the counterparty acts as secured party. Such a provision is undesirable since it could frustrate the ability of SBSDs or SDs to recover the margin they posted quickly in the event of the counterparty's insolvency and provide a way for the counterparty to access the collateral inappropriately.

Rather than provide the secured party's notice with priority, SBSDs and SDs have generally agreed with their counterparties that, in order for either party to access the collateral, the party must provide a certification to the custodian that an event of default or other circumstance entitling it to the collateral has occurred. The penalties associated with a false certification, coupled with the general awareness that custodians will frequently be reluctant to release collateral in dubious contexts, has been regarded, both in the swaps and securities financing contexts, to provide sufficient protection to both the pledgor and the secured party. Additionally, the risk faced by the SBSD or SD when acting as secured party is somewhat limited, since custodial arrangements generally only permit a pledgor to withdraw an amount of collateral that exceeds the amount of margin it is required to post to the secured party.

Lastly, most custodial arrangements do not give priority to the secured party's instruction about how to transfer the collateral in the event the custodian terminates the account control agreement. Rather, custodial agreements generally only allow the custodian to terminate a custodial arrangement with a substantial notice period. During this notice period, the parties can submit a joint instruction for the custodian to transfer the margin to an account at another custodian. If the custodian does not receive the instruction by the end of the notice period, it will file an interpleader action to receive a court instruction as to where to deposit the margin. This arrangement provides sufficient protection to both the secured party and the pledgor. An arrangement that gives the secured party absolute authority to dictate the disposition of margin on a custodian's termination would be unworkable since the cooperation of both the pledgor and the secured party is needed to establish a replacement custodial arrangement.[53]

In light of these considerations, applying the second and third Control Conditions would cause nonbank SBSDs to face a significant competitive disadvantage relative to

[53] It could also raise concerns under the Investment Company Act of 1940 when the counterparty is a registered investment company. Similar concerns might also be raised for pension plans and other investors subject to regulations limiting their ability to custody assets with a counterparty.

bank SBSDs, who could continue to be able to use market-standard custodial arrangements. In addition, a nonbank SBSD's counterparties would not be able exercise their congressionally-granted right to third-party segregation without entering into one-sided custody arrangements that favor nonbank SBSDs. Alternatively, such counterparties might insist on certain reciprocal rights, as noted above, which would in turn harm nonbank SBSDs. Especially significant issues would arise in connection with custody arrangements that comply with applicable CFTC or Prudential Regulator rules and were entered into before finalization of the Commission's capital requirements for nonbank SBSDs. It is highly unlikely that a nonbank SBSD's counterparties and custodians will agree to modify these existing arrangements in non-market standard ways.[54]

Recommendation: The Commission should not adopt the second and third Control Conditions. If the Commission nonetheless does impose such conditions, it should only impose them on margin collected under the Commission's margin rules, and should not apply them to custody arrangements entered into in order to comply with the CFTC's or Prudential Regulators' margin rules.

b. The Commission Should Expand the Range of Permissible Custodians

The Custodial Conditions would limit eligible custodians to "banks" as defined by the Exchange Act. This definition generally encompasses only U.S. banks and U.S. branches and agencies of foreign banks.[55] However, a wider range of entities currently act as custodians in the non-cleared SBS market. For example, within the U.S., clearing agencies, such as The Depository Trust Company, can also act as custodians. Outside the U.S., foreign banks and securities depositories also act as custodians, especially for foreign securities and currencies. The Commission has previously recognized these entities as permissible custodians (*i.e.*, good "control locations") for securities held by U.S. broker-dealers.

Recommendation: The Commission should permit nonbank SBSDs to recognize IM segregated at U.S. securities depositories and clearing agencies, foreign banks, and foreign securities depositories, as held for the account of the counterparty.

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54 The CFTC's rules are relevant to the proposed Control Conditions because the conditions would apply to recognition of IM for non-cleared swaps in connection with the expanded capital charges described in the October 2018 Release. The Prudential Regulators' rules are relevant because IM posted by bank SDs and bank SBSDs to nonbank SBSDs must satisfy those rules' segregation requirements.

55 *See* Exchange Act Section 3(a)(6).

c. The Commission Should Permit Alternatives to Satisfying Opinion Requirements

In order to implement the CFTC's and Prudential Regulators' margin rules, SDs and SBSDs have obtained opinions from U.S. and non-U.S. counsel that the custodial arrangements under which IM is segregated are legal, valid, binding, and enforceable and that the SDs and SBSDs will be able to access the IM in the event of the counterparty's insolvency. However, such opinions were not common prior to the adoption of the WGMR framework, and market participants generally do not obtain opinions regarding custodial arrangements that are outside the scope of the margin rules. Due to the general reluctance of outside counsel to provide opinions regarding pre-existing arrangements, it would be very difficult for BDs or nonbank SBSDs to obtain such opinions now.

As an alternative to the opinion requirement, the Commission should adopt the standard that the U.S. banking regulators require firms to meet to recognize financial collateral posted in connection with an OTC derivative. That standard requires, among other things, that the institution have a well-founded basis to conclude that the collateral arrangement is legal, valid, binding, and enforceable and that it will be able to access the collateral in the event of its counterparty's insolvency.[56] Allowing BDs and nonbank SBSDs to treat segregated IM as held for the account of the counterparty if the BD or SBSD satisfies this well-founded basis test would serve to align the capital treatment of such arrangements under the Commission's rules with the treatment under the requirements applicable to bank SBSDs (and most non-U.S. institutions), which would reduce competitive disparities and opportunities for regulatory arbitrage.

Recommendation: In lieu of the opinion requirement for BDs and nonbank SBSDs to recognize segregated IM as held for the account of the counterparty, a BD or nonbank SBSD should be permitted to recognize IM so long as it has a well-founded basis to conclude that the collateral arrangement is legal, valid, binding, and enforceable and that it will be able to access the collateral in the event of its counterparty's insolvency.[57]

d. Certain Technical and Conforming Changes

The October 2018 Release would only permit the recognition of IM held at an independent third-party custodian if the counterparty has elected segregation pursuant to Section 3E(f) of the Exchange Act (for non-cleared SBS) or Section 4s(l) of the CEA. However, as noted above, the margin rules adopted by the CFTC and Prudential Regulators (for non-cleared swaps) pursuant to Section 4s(e) of the CEA or Section 15F(e) of the Exchange Act also require segregation of IM at a third-party custodian. In addition, foreign

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56 *See, e.g.*, 12 C.F.R. § 3.3(c), § 3.34(b).

57 If the Commission nonetheless requires nonbank SBSDs to obtain formal opinions, it should make clear that industry opinions regarding classes of agreements satisfy the Commission's requirement.

regulators' margin rules could also require such segregation. Accordingly, we recommend including a reference to other applicable laws in addition to Section 3E(f) and Section 4s(l).

Recommendation: In addition to IM segregated pursuant to Section 3E(f) of the Exchange Act or Section 4s(l) of the CEA, the Commission should permit BDs and nonbank SBSDs to recognize any IM that is segregated in accordance with the Prudential Regulators' or CFTC's margin rules or any other applicable law to be treated as held for the account of the counterparty, as long as it satisfies the Custodial Conditions.

The credit risk charge methodology set forth in Appendix E to SEC Rule 15c3-1 and proposed SEC Rule 18a-1(d), which would be relevant to the credit risk charges for uncollected IM described below, require that, in order for a BD or nonbank SBSD to apply collateral as a mitigant to the BD's or SBSD's credit exposure, the BD or SBSD must maintain physical possession or sole control over the collateral and the collateral may be liquidated promptly without intervention by the other party. Similarly, in order for collateral to count towards satisfaction of margin requirements, proposed SEC Rule 18a-4(b)(4) requires that the collateral be subject to the physical possession or control of an SBSD and may be liquidated promptly by the SBSD without intervention by either party. The Commission should make conforming changes to these provisions to make clear that that collateral held at an independent, third-party custodian in a manner consistent with the Custodial Conditions satisfies these requirements.

Recommendation: The Commission should make conforming changes to Appendix E to SEC Rule 15c3-1, SEC Rule 18a1-(d), and SEC Rule 18a-4(b)(4) to clarify that segregated IM that satisfies the Custodial Conditions may be used to offset credit exposure for net capital purposes and to satisfy margin requirements.

3. The Commission Should Expand the Ability to Take Credit Risk Charges for Uncollected IM

As noted above, the October 2018 Release requests comment regarding whether an ANC BD or standalone SBSD approved to use internal models should, in lieu of the capital charge set forth above for uncollected IM for non-cleared SBS or swaps, be permitted to calculate a credit risk capital charge using its approved models.[58] This charge would equal the potential future credit exposure computed by the ANC BD or standalone SBSD using its approved internal model, multiplied by 8%, and then multiplied by either 20%, 50%, or 150%, depending on the credit risk weight factor applicable to the counterparty.

We support this expanded ability to use models to compute credit risk charges. Such use of models is consistent with Basel capital standards and thus would help to satisfy the statutory requirement that the Commission's capital rules, to the maximum extent

[58] October 2018 Release, 83 Fed. Reg. at 53010-11.

practicable, be comparable to the Prudential Regulators' capital rules.[59] Perhaps more significantly, such use of models is also consistent with the manner in which the broker-dealer net capital rule currently applies to ANC BDs.

We further consider it appropriate to multiply any credit risk charge for uncollected IM—whether calculated using a model or a standardized approach—times 8% and a 20%, 50%, or 150% credit risk weight factor. Uncollected IM solely constitutes an off-balance sheet exposure of a BD or SBSD because the realization of any losses is contingent on the counterparty's default and an adverse change in the value of the SBS or swap. As a result, uncollected IM is not an asset of a BD or SBSD that would otherwise count as net capital absent a deduction. The capital charge for uncollected IM thus acts as a risk-based adjustment, not a liquidity-based adjustment. Accordingly, it is appropriate to weight that risk to reflect its contingent nature.

Recommendation: All BDs and nonbank SBSDs, whether or not approved to use internal models, should be permitted to weight their credit risk charges for uncollected IM by 8% and a credit risk weight factor. These credit risk charges should apply in connection with all the IM exceptions applicable under the rules, including the exceptions we described in part II.C below and IM that an SBSD does not collect during the phase-in of IM requirements.

4. Credit Risk Charges for Uncollected VM

The 2012 Proposal would permit an ANC BD or standalone SBSD approved to use internal models to use those internal models to compute credit risk charges to net capital in lieu of 100 percent deductions for uncollected VM from commercial end users.[60] The October 2018 Release requests comment regarding whether to limit this ability to use internal models to the extent such deductions for uncollected VM, in the aggregate, do not exceed 10% of the tentative net capital of the BD or SBSD.[61]

a. The Ability to Use Models to Calculate Credit Risk Charges for Uncollected VM Should Cover All Applicable VM Exceptions

Capital charges for uncollected VM would apply to both non-cleared SBS and non-cleared swaps. Accordingly, to be effective, the ability to use internal models to

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59 Exchange Act Section 15F(e)(3)(D)(ii).

60 2012 Proposal, 77 Fed. Reg. at 70240-44. As noted below, we do not think the limitations on use of credit risk charges reflected in the 2012 Proposal or the October 2018 Release should apply to a BD that is not an SBSD (for limits pertaining to SBS) or SD (for limits pertaining to swaps).

61 October 2018 Release, 83 Fed. Reg. at 53010-11.

compute these capital charges must apply to the full range of counterparties not required to post VM, and legacy transactions not subject to VM rules.

Under Section 4s(e)(4) of the CEA and the CFTC's margin rules for non-cleared swaps, a counterparty is not required to post VM if it (1) is not a financial entity, (2) uses swaps to hedge or mitigate commercial risk and, (3) notifies the CFTC how it generally meets its financial obligations.[62] In addition, the CFTC does not require a counterparty to post VM if it is not a "financial end user."[63] However, the credit risk model provision set forth in the October 2018 Release would only cover the first exception.

The CFTC explained that it excluded non-financial end users from the scope of its margin rules because it found that such entities generally engage in swaps for hedging purposes and pose less risk to SDs than financial end users. Additionally, consistent with the WGMR framework, the CFTC sought to ensure that its margin rules did not apply to sovereign entities, multilateral development banks, and the Bank for International Settlements (collectively, "**Sovereigns**") and effected this by excluding such entities from the "financial end user" definition. Requiring Sovereigns to satisfy the CEA's commercial end-user exception requirements could have posed challenges for such entities because Sovereigns often use derivatives to effect monetary policy or other governmental functions, not necessarily to "hedge commercial risk."

Requiring ANC BDs and standalone SBSDs to take a 100% capital charge for each dollar of VM they do not collect from a non-financial end user under a swap would effectively undermine the CFTC's efforts, since doing so would place economic pressure on such firms to collect VM from, or pass on the disproportionate capital charges to, Sovereigns and other non-financial end users. Increased charges and margin requirements would also create competitive disparities between bank and nonbank SBSDs, since, like the CFTC, the Prudential Regulators do not require bank SDs (or SBSDs) to collect margin from Sovereigns or other non-financial end users.

<u>Recommendation</u>: To avoid undermining the CFTC's decision to not impose VM requirements on Sovereigns and other non-financial end users or for legacy transactions, the Commission should permit ANC BDs and nonbank SBSDs approved to use internal models to take credit risk charges in lieu of 100% capital deductions for VM uncollected from such entities and legacy transactions not subject to VM rules.

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[62] *See* 7 U.S.C. 2(h)(7)(A); 7 U.S.C. 6s(e)(4); 17 C.F.R. § 23.150(b).

[63] 17 C.F.R. § 23.153.

b. The Commission Should Rely on Existing Concentration Charges Instead of the 10 Percent Tentative Net Capital Limitation

To address concentration risk associated with uncollected VM, the 2012 Proposal would leverage the existing charges in Appendix E to SEC Rule 15c3-1. Appendix E requires ANC BDs to take (1) a counterparty concentration charge to the extent its uncollateralized current exposure to a particular counterparty in respect of OTC derivatives transactions exceeds 5% of the ANC BD's tentative net capital[64] and (2) a portfolio concentration charge to the extent its uncollateralized current exposure in respect of OTC derivatives transactions across all counterparties exceeds 50% of its tentative net capital. The 2012 Proposal would apply these same provisions to an ANC BD or standalone SBSD approved to use internal models in respect of uncollected VM for non-cleared SBS.

The October 2018 Release, however, requests comment on whether the Commission should limit the amount of uncollected VM in respect of which an ANC BD or models-approved standalone SBSD takes credit risk charges in lieu of 100% capital charges to 10% of the BD's or SBSD's tentative net capital.[65] Such a limitation would be a drastic departure, both in magnitude and approach, from Appendix E's risk-tailored framework. As discussed above, Appendix E addresses concentration risk through specific charges that increase as the size and severity of the concentration risk increase. Specifically, as an ANC BD's uncollateralized current exposure to a particular counterparty increases beyond 5% of the BD's tentative net capital, the BD is required to increase its buffer against loss. The amount of those increases depends on the creditworthiness of the counterparty, with 5% charges being required for counterparties that present the least credit risk and 50% charges being required for counterparties with the greatest risk. As a backstop to these charges, Appendix E additionally requires an ANC BD to take an additional 100% credit risk charge to the extent its uncollateralized current exposure to all counterparties exceeds 50% of its tentative net capital.

The October 2018 Release's 10% net capital limitation would dispatch (or, if added to Appendix E and proposed Rule 18a-1(e), undermine[66]) Appendix E's risk-tailored approach with a flat cap one-fifth the size of the analogous threshold under Appendix E, without any analysis or data supporting the change from the status quo or the 2012 Proposal.

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[64] As described below, the amount of this concentration charge depends on the credit risk weight of the counterparty.

[65] October 2018 Release, 83 Fed. Reg. at 53010-11.

[66] We assume that this new charge would not apply in addition to existing counterparty concentration and portfolio concentration charges, since such application would result in charges in excess of 100% of exposure.

Managing this much lower 10% threshold would be especially difficult for standalone SBSDs approved to use internal models. Such SBSDs will typically have much lower amounts of tentative net capital than ANC BDs, due to the smaller range of businesses engaged in by them. Subjecting such SBSDs to a 10% threshold would likely limit their ability to transact with commercial end users, thereby reducing the liquidity available to this important market segment.

The 10% cap would also undermine the amendments that Congress made to the Exchange Act and CEA in Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015 ("**TRIPRA**").[67] TRIPRA exempts from the scope of Dodd-Frank's margin rules those non-cleared SBS and swaps with counterparties that qualify for an exception from Dodd-Frank's mandatory clearing requirement.[68] Were the Commission to impose a 10% net capital limitation on the amount of VM nonbank SBSDs may elect not to collect without incurring a capital charge, it would force BDs and nonbank SBSDs either to collect VM in direct contravention of Congress's expressed intent or charge commercial end users increased prices to compensate for the higher capital costs. In either case, such a cap would undercut Congress's clearly expressed desire to relieve commercial end users of the costs of posting VM.

For these reasons, the Commission should not override Appendix E's carefully risk-calibrated concentration framework with a requirement that ANC BDs and standalone SBSDs approved to use internal models limit to 10% of tentative net capital the amount of uncollected VM in respect of which such BDs and SBSDs take credit risk charges in lieu of 100% capital charges.

If the Commission nonetheless decides to depart from Appendix E's concentration charges, then it should replace (1) the 10% aggregate threshold with a 20% aggregate threshold and (2) the 10% counterparty net worth threshold with a counterparty-by-counterparty threshold equal to 1% of the ANC BD's or standalone SBSD's tentative net capital, consistent with the Cleared SBS Capital Charge. A 20% aggregate threshold is meant to be consistent with the early warning threshold currently imposed on OTCDDs.[69] Such a threshold would also be consistent with the early warning threshold that the 2014 Proposal proposes to apply to nonbank SBSDs.[70] And as noted above, a 10% counterparty net worth threshold is unworkable. These changes would help to ensure that BDs and SBSDs can continue to service a diversified group of commercial end users, instead of concentrating

[67] Pub. L. 114-1 (Jan. 12, 2015).

[68] *Id.* § 301.

[69] *See* 17 C.F.R. § 240.17a-11(c)(3).

[70] 2014 Proposal, 79 Fed. Reg. at 25317. This threshold would also be consistent with the October 2012 Proposal's setting of the early warning threshold for ANC BDs at $6 billion in tentative net capital, which would be 20% greater than the $5 billion minimum tentative net capital requirement. *See* October 2012 Proposal, 77 Fed. Reg. at 70228.

their transactions among a smaller group who can report their net worth, limited up to the smaller 10% threshold.

In any case, we also request that the Commission modify the capital charge applicable when an ANC BD or standalone SBSD approved to use internal models exceeds the relevant threshold to be a credit concentration charge, not a deduction for unsecured receivables. Otherwise, the consequence of the charge would be more severe than intended because it would reduce the BD's or SBSD's tentative net capital, not just its net capital.

Recommendation: The Commission should utilize the existing concentration charge framework set out in Appendix E of SEC Rule 15c3-1 to address concentration risk associated with uncollected VM. If it nonetheless departs from the Appendix E framework, it should replace (1) the proposed 10% aggregate threshold with a 20% aggregate threshold and (2) the 10% counterparty net worth threshold with a counterparty-by-counterparty threshold equal to 1% of the ANC BD's or SBSD's tentative net capital. In addition, in all instances, the Commission should treat the net capital charge as a credit concentration charge rather than a deduction for unsecured receivables.[71]

5. Use of Credit Risk Hedges

It is common for financial institutions to use hedging techniques, such as purchasing credit derivatives or risk participations, to mitigate the credit risk they face in connection with OTC derivatives. For example, an institution that faces credit risk to a swap counterparty might buy a risk participation from a bank obligating that bank, in the event the institution's swap counterparty defaults, to pay the institution the close-out amount of the swap, minus the amount recovered by the institution from its swap counterparty.

These hedges effectively involve the institution substituting the credit risk of its hedge counterparty (*e.g.*, the bank in the preceding example) for the credit risk of its original derivatives counterparty. When a nonbank SBSD enters into such a credit risk hedging transaction that is an SBS, the nonbank SBSD will be subject to margin and capital requirements in respect of that transaction. As a consequence of those requirements, the nonbank SBSD will generally be required to collect margin from the hedge counterparty. Accordingly, if both the original derivatives counterparty and the hedge counterparty default, the nonbank SBSD can foreclose on that collateral. The ultimate effect of this collateralized hedge transaction is to collateralize the underlying credit exposure of the nonbank SBSD to the original derivatives counterparty.[72]

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[71] Also, if the Commission adopts the proposed 10% aggregate threshold, it should only apply when the credit risk charges exceed 10% of tentative net capital, not when the unweighted amount of uncollected VM (before application of credit risk charge methodology) exceeds that level.

[72] To the extent it does not collect margin from the hedge counterparty, the nonbank SBSD will take capital charges for any uncollateralized exposure to that hedge counterparty, consistent with the fact

Under similar circumstances, the U.S. banking regulators permit institutions to replace the capital charge that would apply to the hedged exposure with the charge that applies to the credit risk hedge itself, where that credit risk hedge satisfies certain criteria regarding its effectiveness as a hedge.[73] The Commission should adopt a similar approach and allow a nonbank SBSD that enters into a qualifying hedging transaction for an OTC derivative to substitute the credit risk charge or deduction it takes on the credit risk hedge for the credit risk charge or net capital deduction it would take on the OTC derivative.

Recommendation: The Commission should permit a nonbank SBSD to substitute the credit risk capital charge or deduction it takes on a qualifying hedge transaction for the charge or deduction it would otherwise take for exposure to a counterparty on the OTC derivative counterparty hedged by that transaction.

D. IM Posted by SBSDs

The 2012 Proposal would require a nonbank SBSD to take a 100% capital deduction for any IM that the nonbank SBSD delivers to a counterparty.[74] The October 2018 Release requests comment on whether there should be an exception from the requirement to take a deduction if: (1) the IM requirement is funded by a fully executed written loan agreement with an affiliate of the nonbank SBSD;[75] (2) the loan agreement provides that the lender waives re-payment of the loan until the IM is returned to the nonbank SBSD; and (3) the nonbank SBSD's liability to the lender can be fully satisfied by delivering the collateral serving as IM to the lender. These conditions are the same as those set forth in a no-action letter (the "**Staff Letter**") issued by the staff of the Division of Trading and Markets that allows a BD to post margin collateral to SDs and other counterparties in respect of non-cleared swaps without taking capital charges.[76]

Although the Staff Letter has not posed material issues for the few BDs currently relying on it, we have concerns whether it would be scalable to the additional standalone SBSDs and OTCDDs that might in the future need to rely on it, not only for their non-cleared SBS transactions but also non-cleared swaps already subject to CFTC or Prudential Regulator margin rules. Exacerbating this concern is the significant expansion of IM requirements under the WGMR framework scheduled to occur in 2020.

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that the nonbank SBSD has substituted the credit risk it faces to the original derivatives counterparty with credit risk to the hedge counterparty.

[73] *See, e.g.*, 12 C.F.R. § 217.36.

[74] 2012 Proposal, 77 Fed. Reg. at 70242.

[75] Although the October 2018 Release references BDs, rather than nonbank SBSDs, we assume the intent was for any nonbank SBSD to be able to rely on this exception.

[76] *See* Letter from Michael A. Macchiaroli., Division of Trading and Markets, Commission, to Ms. Kris Dailey, FINRA, dated August 19, 2016 at 2.

To the extent that nonbank SBSDs are not in a position to satisfy the conditions in the Staff Letter, then requiring them to treat IM posted to third-party custody accounts as unsecured receivables subject to a 100% net capital deduction would make the cost of transacting with WGMR-compliant counterparties so significant as to make those transactions uneconomical to the SBSD. This would effectively push nonbank SBSDs out of the SBS and swaps markets, which would have a detrimental impact on market liquidity. Especially for firms already engaged in substantial swaps business in compliance with CFTC or other WGMR-compliant margin rules, this treatment would create strong incentives to separate their SBS business into a different legal entity, with ensuing negative effects on netting and risk management.

The CFTC, in considering the Commission's treatment of collateral posted to third-party custodians, decided that the treatment of such collateral as an unsecured receivable was inappropriate.[77] Like the CFTC, we believe that a nonbank SBSD should not need to satisfy the Staff Letter's conditions when it posts IM held in a segregated account at an independent, third-party custodian in a manner that complies with CFTC, Prudential Regulator, or equivalent, WGMR-compliant foreign margin rules. As discussed above, the CFTC and the Prudential Regulators established the segregation structure to protect *both* pledgors and secured parties. The pledgors are protected not only because their assets are segregated from the estate of the secured party (and therefore immune from the claims of the secured party's general unsecured creditors), but also because such arrangements generally provide pledgors with the ability to access their IM (to the extent it exceeds the secured party's current exposure to the pledgor) in the event of a counterparty default or the termination of the transaction. As a result, although the assets cannot be used while the related swap or SBS is outstanding, an SBSD can withdraw the margin if the counterparty defaults or the SBSD terminates the transaction.

The ability of a nonbank SBSD to withdraw IM subject to a segregation regime is thus analogous to the right of a BD to withdraw cash and securities posted to a carrying broker-dealer or held as a clearing deposit. Just as SEC Rule 15c3-1 does not require a BD to take a capital charge in respect of such cash and securities,[78] the Commission should not require a nonbank SBSD to take a deduction from net capital for IM it posts to a third-party custodial account, so long as the custodial arrangement satisfies the requirements of CFTC, Prudential Regulator or equivalent, WGMR-compliant foreign margin rules.

If the Commission nonetheless imposes such a charge, it should not apply it to IM posted by SDs in connection with non-cleared swaps. As noted above, in proposing capital requirements for SDs, the CFTC found it inappropriate to require SDs to take a capital charge for IM posted to a third-party custodian. The CFTC instead provided that SDs that elect to compute capital requirements using a net liquid assets test should treat such IM as a current asset, provided the custodial agreement limits re-hypothecation and is valid,

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[77] Capital Requirements of [SDs] and Major Swap Participants, 81 Fed. Reg. at 91262 (Dec. 16, 2016).

[78] *See* 17 C.F.R. § 240.15c3-1(c)(2)(iv)(E)(2) and (3).

binding, and enforceable.[79] Were the Commission to require SD-SBSDs to take a 100% capital charge on such IM, it would effectively override the CFTC's policy decision and further incentivize firms to move their SBS business into a standalone entity, reducing opportunities for netting, increasing credit risk, and making hedging and funding activities less efficient.

Recommendation: The Commission should not require a nonbank SBSD to take a capital charge for margin it posts to a counterparty if either (1) such margin satisfies the conditions set out in the Staff Letter or (2) the margin is maintained at a third-party custodian in accordance with the WGMR framework. If the Commission nonetheless imposes such a charge, it should not apply the charge to IM posted by SD-SBSDs in connection with non-cleared swaps, due to the separate CFTC regulations in this area.

We also wish to draw the Commission's attention to the fact that, as part of their resolution and recovery planning plans, many bank holding companies have entered into funding and liquidity arrangements with material operating entities, including some SBSDs.[80] These arrangements generally provide that the holding company is required to provide sufficient liquidity and funding to the material operating entity to ensure it could survive a failure of the parent company, including by meeting IM posting requirements. Considering such arrangements generally present the same limited liquidity risk as the arrangements that are subject to the Staff Letter, the Commission should extend them the same capital treatment. Due to the compressed comment period, however, we have not been able to work with our members to identify the particular contours of all such arrangements and recommend what conditions they should meet in order to receive this treatment. We intend, however, to work with our members to provide greater detail and analysis to the Commission or its staff in the coming months.

E. Market Risk Charges

The Proposed Rules would require nonbank SBSDs to take market risk charges from net capital in respect of their proprietary positions, including their SBS and swaps positions. Consistent with current SEC Rule 15c3-1, these charges would be calculated using a standardized haircut unless the Commission has approved the nonbank SBSD's use of an internal value-at-risk ("**VaR**") model to determine them. The Proposed Rules generally provide for the standardized haircuts for swaps and SBS to be calculated by applying a specified multiplier to the notional amount of the transaction, subject to

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[79] Capital Requirements of [SDs] and Major Swap Participants, 81 Fed. Reg. at 91262 (Dec. 16, 2016).

[80] Proposed resolution planning guidance would, if adopted, require U.S. systemically important bank holding companies to design and implement inter-company liquidity and funding arrangements to support material entity subsidiaries, including SBSD subsidiaries that are deemed material entities, in the event of the parent company's material financial distress or failure. 83 Fed. Reg. 32,856 (Jul. 16, 2018).

reductions in specified cases in which the swap or SBS position is offset by a related position.

The October 2018 Release does not request specific comment on either the Proposed Rules' standardized haircuts or the application process for VaR models. In addition to our prior comments regarding the Proposed Rules' market risk charges,[81] we incorporate by reference the comments on the Commission's market risk charges included in the SIFMA letter on the CFTC's proposed capital requirements.[82]

As we indicated in both the letter to the CFTC as well as our 2013 comment letter on the Proposed Rules, our quantitative analysis regarding the impact that the Proposed Rules' standardized haircuts would have on the business of nonbank SDs and SBSDs indicated that the standardized haircuts would require nonbank SDs and SBSDs to maintain net capital equal to many multiples of both (1) the clearing agency margin requirements for the same kinds of transactions and (2) the market risk charges that would apply using the Basel 2.5 framework.

Data supporting these conclusions follows.

[81] *See* Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, to the SEC, dated February 22, 2013 at 13-21.

[82] *See* Letter from Mary Kay Scucci, Managing Director, SIFMA, to the CFTC, dated May 15, 2017 at 9-13.

Table 1: Cleared Interest Rate Swap Portfolio (in millions)

					Capital Approach as Proposed			**Alternative Capital Approaches**				
					Standardized Haircuts Including the 1% Minimum (a)			**Charges Based on Clearing House Maintenance Margin Requirement (MMR)** (b)**		**Standardized Haircuts Excluding the 1% Minimum (c)**		
Maturity Category	**Government Haircut***	**Notional Value Long**	**Notional Value Short**	**Notional Value Net**	**1% Minimum of Matched Notional Long/Short Value**	**Charge on Unhedged Notional of Long/Short Position**	**Total**	**Total MMR**	**150% of MMR**	**Hedged**	**Unhedged**	**Total**
Category 1	0% - 1%	$377,500	$(372,500)	$5,000	$3,725	$50	$3,775			$-	$28	$28
Category 2	1.5% - 2%	95,000	(97,500)	(2,500)	950	83	1,033			-	83	83
Category 3	3% - 4%	150,000	(152,500)	(2,500)	1,500	73	1,573			-	73	73
Category 4	4.5% - 6%	10,000	(10,000)	-	100	-	100			-	-	-
Total		**$632,500**	**$632,500**	**$-**	**$6,275**	**$206**	**$6,481**	**$45**	**$68**	**$-**	**$184**	**$184**

*Each maturity category within the U.S. government haircut schedule has two or more subcategories. A blended haircut percentage was applied to categories 2 through 4.
**MMR is provided by the clearing corporation.

Table 1 compares (a) the proposed standardized haircuts to (b) clearing house maintenance margin requirements with and without an additional 50% requirement for non-clearing member firms and (c) the proposed standardized haircuts excluding the 1% minimum notional charge. As the table illustrates, the standardized haircuts would be more than 144 times higher than the clearing house margin requirements ($6,481 v. $45) and more than 95 times higher than the clearing house margin requirements for a non-clearing member firm ($6,481 v. $68). Given that the clearing house margin requirements serve essentially the same purpose as the capital requirements (one is intended to assure the safety of the clearing house, the other the soundness of the dealer), this disproportion should give the Commission considerable pause. Similarly, the standardized haircuts that include the 1% minimum capital requirement would result in market risk charges that are nearly 35 times higher than the charges without the 1% minimum ($6,481 v. $184).

Table 2: Diversified Product Portfolio (in millions)	**Standardized Haircuts (Including the 1% Minimum for the entire IRP)**	**Standardized Haircuts (Including the 1% Minimum for Uncleared IRP Only)**	**Standardized Haircuts (Using Government Grid for the entire IRP)**	**Standardized Haircuts (Using Government Grid for Uncleared IRP Only)**	**Market Risk Total Portfolio VaR (Basel 2.5)**
Interest Rate Products (“**IRP**”)	$35,691	$19,132	$2,055	$462	
Equity Products	5,968	5,968	5,968	5,968	
FX Products	462	462	462	462	
Total Capital Charge	**$42,121**	**$25,562**	**$8,485**	**$6,892**	**$391**
Times Greater v. Basel 2.5 (last column)	108	65	22	18	

Table 2 illustrates the non-competitive gap between the market risk capital requirements imposed by the standardized haircuts on a diversified portfolio of interest rate, equity, and FX products, and the Basel 2.5 market risk charge. The standardized haircuts would result in market risk charges that can be more than 100 times higher than those calculated using, for example, a risk-based methodology. Even the standardized haircuts applicable to government securities (the “**Government Grid**”) under SEC Rule 15c3-1 would impose capital requirements 22 times higher than a risk-based methodology.

As illustrated by the charts above, a firm that is charged for capital based on the notional value of its transactions—as the standardized haircuts would require—likely would not be able to stay in business. The standardized haircuts would thus serve to create a barrier to entry into the SBS markets, with firms that do not have the resources to develop complex models unable to participate in the SBS markets.

It goes without saying that excessive standardized haircuts will disproportionately affect small and mid-size firms and allow larger firms to increase their market share. Indeed, in anticipation of the Commission’s capital requirements, many of our mid-size members have substantially limited their SBS and swap dealing activities so as to stay below the $8 billion aggregate gross notional threshold required to qualify for the *de minimis* exception from the SBSD and SD definitions. Many of our other members have been racing to develop models that can be used for market risk.

In order to avoid unnecessarily forcing nonbank SBSDs that do not have the capacity to develop internal models out of the SBS and swaps markets, the Commission should not impose its proposed standardized haircuts until it conducts further economic analysis to confirm that those haircuts are appropriately sized to the risk the relevant positions present. This analysis should be based on quantitative data regarding the swaps and SBS markets since the enactment of Dodd-Frank.

Additionally, considering that, absent substantial changes to the haircuts, effectively all nonbank entities that wish to stay in the SBS and swaps dealing business will need to rely on internal VaR models to calculate market risk charges, the Commission should streamline its model approval process so that smaller and mid-size SBSDs are not kept out of the market or placed at a steep competitive disadvantage while awaiting approval. Even with such streamlining, the model-approval process will be a very time-consuming undertaking, as the National Futures Association ("**NFA**") detailed in its letter to the CFTC regarding the CFTC's proposed capital rules.[83] In that letter, NFA advised that reviewing credit and market risk models would require substantially more time and resources than NFA's previous review of margin models. This is because there is no industry-wide model to provide a point of reference, each SD would likely submit multiple models, and the models will be more complex than the industry-standard margin model.

In view of these complexities and the fact that nearly all SDs will likely seek model-approval at the same time, NFA advised the CFTC to adopt an alternative model review process that leverages the model reviews conducted by peer regulators. Specifically, NFA proposed allowing SDs that are subsidiaries of prudentially regulated bank holding companies ("**BHC**s") to use credit and market risk models previously approved by a prudential regulator without obtaining the separate approval of the CFTC or NFA. NFA would monitor the model's performance as part of its ongoing examination and capital compliance processes, but would not require the re-submission of the model. This approach, NFA noted, would not only allow the CFTC and NFA to focus their resources on previously un-reviewed models, but also avoid unnecessarily duplicating regulatory efforts.

In order to ensure that smaller nonbank SBSDs are able to compete on a level playing field with bank SBSDs and larger nonbank SBSDs, the Commission should follow the approach set out by NFA and allow nonbank SBSDs to use models approved by prudential regulators, a foreign regulator that is either based in a G20 jurisdiction or is a member of the Basel Committee or the Board of IOSCO, or a U.S. self-regulatory organization ("**SRO**"), at least until the Commission is able to independently review the models.[84]

Recommendation: The Commission should conduct further economic analysis to confirm that its proposed standardized haircuts are appropriately sized before imposing them. Considering the substantial number of nonbank SBSDs that will need rely on internal VaR models rather than standardized haircuts to calculate market risk charges, the Commission should allow nonbank SBSDs to use models approved by other supervisory authorities.

83 *See* Letter from Carol A. Wooding, Vice President and General Counsel, NFA, to the CFTC, dated May 15, 2017.

84 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.

F. Liquidity Stress Test Requirements

The Proposed Rules would subject ANC BDs and models-approved standalone SBSDs to liquidity risk management requirements that require the BD or SBSD to: (i) perform a liquidity stress test at least monthly that takes into account certain assumed conditions lasting for 30 consecutive days; (ii) maintain at all times liquidity reserves, composed of unencumbered cash or U.S. government securities, based on the results of the liquidity stress test; and (ii) establish a written contingency funding plan.[85]

These requirements were, in their objective, similar to the liquidity stress testing requirements issued by the U.S. banking regulators. However, as we identified in our 2013 comment letter on the Proposed Rules,[86] there were a number of discrepancies between the Proposed Rules' requirements and those of the banking regulators. If left unaddressed, those departures could create sizable implementation difficulties and frustrate the banking regulators' efforts by trapping liquidity resources. We raised similar concerns in our letter on the CFTC's liquidity requirements,[87] which comments we incorporate herein by reference.

Since the release of the Proposed Rules, there have been substantial developments with respect to liquidity requirements. The Basel Committee issued a revised liquidity coverage ratio in January 2013,[88] and the federal banking regulators promulgated liquidity coverage ratio requirements for certain banking organizations in September 2014.[89] The Financial Industry Regulatory Authority ("**FINRA**"), meanwhile, has requested comment on new liquidity reporting and notification requirements.[90] Additionally, the Federal Reserve Board's liquidity framework is continuing to evolve, both through further rulemakings (such as a proposed net stable funding ratio requirement) and through guidance, together with the FDIC, effectively requiring pre-positioning of funding and liquidity at material operating entities as part of recovery and resolution planning.

The Commission's liquidity stress test requirements are most similar to the Federal Reserve Board's Regulation YY, which took effect in 2015 and requires a BHC to model liquidity stress, including at material operating entities, and manage liquidity

85 2012 Proposed Rules, 77 Fed. Reg. at 70525.

86 *See* Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, to the SEC, dated February 22, 2013 at 30.

87 *See* Letter from Mary Kay Scucci, Managing Director, SIFMA, to the CFTC, dated May 15, 2017 at 22-27.

88 Basel Committee on Banking Supervision, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013.

89 79 Fed. Reg. 61440 (Oct. 10, 2014) (Liquidity Coverage Ratio: Liquidity Risk Measurement Standards; Final Rule).

90 FINRA Regulatory Notice 18-02 (Jan. 8, 2018).

accordingly.[91] As discussed in our comment letters to FINRA and the CFTC regarding liquidity requirements,[92] firms that are subsidiaries of BHCs subject to Regulation YY have established liquidity risk management processes in response to those rules. In many ways, these processes can be leveraged in order to establish liquidity requirements for BDs and SBSDs that are robust and consistent with firms' global liquidity management strategies.

The October 2018 Release does not request specific comment on the Proposed Rules' liquidity stress test requirements, and it is our understanding that the Commission is not planning to finalize those requirements at this time. In light of the recent developments with respect to liquidity requirements and to ensure consistency across regulated entities, the Commission should defer adoption of liquidity stress test requirements for nonbank SBSDs until after it finalizes parallel requirements for BDs and other regulators, including the CFTC and the Federal Reserve Board, have finalized their liquidity requirements. Such a deferral will allow the Commission to implement requirements that are aligned to the extent appropriate with those of other regulators and to benefit from the data that the existing bank regulators' requirements will provide.

Recommendation: The Commission should not impose liquidity stress testing requirements at this time and defer such implementation until it finalizes parallel requirements for BDs and other regulators have finalized their liquidity requirements.

G. Application of SEC Rule 15c3-1 Amendments to Non-SBSDs

As currently drafted, the Proposed Rules would impose the same capital requirements on BDs engaging in limited SBS activity that are not required to register SBSDs as it imposes on BDs that register as SBSDs. This identical treatment of differently situated institutions would undermine the SBSD *de minimis* exception set out in Dodd-Frank[93] and limit the ability of BDs to use SBS for hedging purposes.

The existing BD capital requirements have mechanisms in place to address risks associated with SBS activity. Existing SEC Rule 15c3-1, for instance, already requires BDs to take capital charges for unsecured receivables. Where the BD is an ANC BD, Appendix E to SEC Rule 15c3-1 allows the ANC BD to take credit risk charges in lieu of dollar-for-dollar capital deductions.

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91 12 C.F.R. §§ 252.34-35.

92 *See* Letter from Mary Kay Scucci, Managing Director, SIFMA, to the CFTC, dated May 15, 2017 at 26-27; Letter from Mary Kay Scucci, Managing Director, SIFMA, to FINRA, dated March 8, 2018, at 6-7.

93 *See* 15 U.S.C. § 78c(a)(71)(D). A similar exception applies in connection with the SD definition.

The Commission's proposed capital requirements for nonbank SBSDs would override these provisions in respects that only make sense for a registered SBSD or SD.[94] For instance, the Commission's capital charges related to uncollateralized non-cleared SBS and swaps are tied to the requirements set out in the Commission's and CFTC's margin rules. As a result, if a BD enters into an SBS, swap, or other OTC derivative that does not fall within one of the exceptions to the Commission's or CFTC's margin rules, the BD would be required to take dollar-for-dollar deductions from net capital, both for uncollected VM and IM, even though the BD is not subject to margin requirements.

These 100% capital deductions would force the BD to collect IM and VM from the counterparty or increase the costs of the SBS or swap, in either case putting the counterparty and BD in practically identical positions to those they would have been in had the BD been an SBSD or SD. This would plainly frustrate Congress's intent in enacting the *de minimis* exceptions and limit hedging activity. On the other hand, by operation of the *de minimis* exceptions, the extent of this activity is necessarily quite limited and thus poses *de minimis* risk to the BD.

Recommendation: To avoid undermining the SBSD *de minimis* exception or inhibiting hedging activity by BDs not registered as SBSDs, the Commission should limit the application of the Proposed Rules' amendments to SEC Rule 15c3-1 to BDs that register as SBSDs. BDs that are not required to so register should remain subject to existing capital requirements.

H. Harmonization of SEC and CFTC Capital Requirements

Market participants dealing in swaps and SBS typically do so through the same legal entity. To address this fact, the CFTC's proposed capital rules for SDs would allow an SD to elect to calculate its capital requirements under an approach based on the Commission's capital rules for nonbank SBSDs. In so doing, however, the CFTC proposed that the SD incorporate several modifications to the Commission's SBSD capital rules. Several of those modifications relate to issues the Commission discusses in the October 2018 Release, such as use of credit risk charges, recognition of IM posted to a third-party custodian, and elimination of capital charges for the Cleared SBS Deduction Amount and the Cleared Swap Deduction Amount. But the October 2018 Release would not fully harmonize the Commission's capital rules with the CFTC's proposal.

We believe that the capital rules of the Commission and the CFTC should be harmonized for dual registrants. Harmonization is especially important because an SD might be required to register dually as an SBSD even though its SBS activities constitute

94 Specifically, the 2012 Proposal would amend SEC Rule 15c3-1e in two places to delete references to "transactions in derivative instruments" and replace them with "security-based swap transactions with commercial end users as defined in § 240.18a-3(b)(2)." In addition, the October 2018 Release's charges for uncollected IM noted above would apply to all BDs, not just BDs registered as SBSDs or SDs.

a *de minimis* proportion of its overall activities. In these situations, and as discussed in more detail above, the Proposed Rules would impose capital charges on swap positions that would interfere with the CFTC's oversight of the swap market, especially in connection with margin requirements for swaps.

In addition, in these situations involving an SD-SBSD predominantly engaged in swap, not SBS, activity, imposing different SEC and CFTC capital requirements would be highly inefficient for the agencies. The Commission in particular could not rely on the CFTC or NFA to examine and supervise for compliance with the Commission's capital requirements because they would diverge from the CFTC's. But it would be duplicative for the Commission to take on concurrent and comprehensive examination and supervision responsibilities for an entity engaged in such little SBS activity. Especially since standalone SBSDs will not be members of FINRA, taking on these responsibilities would be a poor use of the more limited resources of the Commission itself.

To address these issues, if full harmonization is not achievable, oversight of SD-SBSDs by the Commission and CFTC should be coordinated so that (1) the Commission defers to the capital rules of the CFTC for an SBSD that is not a BD and whose SBS constitute a very small proportion of its business (*e.g.*, less than a specified percentage of the notional amount of its outstanding combined swap and SBS positions) and (2) the CFTC defers to the capital rules of the Commission for an SD that is not an FCM and whose swaps constitute a very small proportion of its business.

Recommendation: If the Commission and CFTC do not harmonize their capital rules, they should defer to the capital rules of one another in the case of SD-SBSDs whose swaps or SBS represent a *de minimis* portion of the SD-SBSD's combined swap and SBS businesses.

II. Margin and Segregation Requirements

As described previously in this letter, since 2012 the CFTC, the Prudential Regulators, and several foreign regulators have adopted and implemented margin rules consistent with the WGMR framework. Several components of that framework differ from the Proposed Rules and the existing BD financial responsibility rules. Those differences would generally make U.S. nonbank SBSDs uncompetitive with bank SBSDs and foreign SBSDs. They also would result in significant implementation costs, including changes to systems and documentation affecting thousands of counterparties.

In our view, the Commission can best address these differences by generally permitting OTCDDs and standalone SBSDs to collect and maintain margin in a manner consistent with the WGMR framework, subject to certain modifications designed to take account of how OTCDDs and standalone SBSDs access funding and liquidity. BD-SBSDs, in turn, would generally integrate their margining for equity SBS and segregation of collateral for all SBS into the existing BD financial responsibility framework. A

BD-SBSD's margining for non-equity SBS would largely be consistent with the WGMR framework.

Below we describe how this approach would apply in connection with the key topics raised by the October 2018 Release: use of IM models; IM thresholds; transactions between dealers; portfolio margining; and segregation. We also discuss other operational and definitional differences between the Proposed Rules' margin requirements and the WGMR framework, including the deadlines for collecting margin, the types of assets eligible to serve as margin, the haircuts applicable to those assets, minimum transfer amounts, and the definition of "commercial end user."

A. Use of IM Models

The 2012 Proposal would generally require nonbank SBSDs to calculate IM requirements for non-cleared SBS in the same manner as they determine capital deductions, either by using standardized haircuts or, if the nonbank SBSD is an ANC BD or an SBSD approved to use internal VaR models, with such models. The 2012 Proposal would not, however, allow ANC BDs or SBSDs approved to use internal models to calculate IM requirements for equity SBS using internal VaR models. Rather, all SBSDs would be required to use a standardized method to calculate IM amounts for such positions.

The October 2018 Release requests comment on whether nonbank SBSDs should be able to apply to the Commission to use the ISDA Standard IM Model ("**SIMM**") or another standard industry model to calculate IM for SBS other than equity SBS.[95] In order to be approved, the model would need to calculate potential future exposure using a 99%, one-tailed confidence level with price changes equivalent to a ten business-day movement in rates and prices as well as risk factors sufficient to cover all material price risks inherent in the position. These requirements are consistent with the conditions that the WGMR framework requires IM models to satisfy.

1. The Commission Should Permit All Nonbank SBSDs to Use IM Models for Non-Equity SBS

Allowing nonbank SBSDs to calculate IM requirements using standard industry models would substantially reduce opportunities for regulatory arbitrage and eliminate competitive disparities. If allowed to use the SIMM, U.S. nonbank SBSDs could call for amounts of IM that are consistent with the amounts called for by bank SBSDs and foreign SBSDs. This consistency, along with the general transparency of the SIMM model calculation methodology and process, would also serve to reduce instances of margin disputes. Further, the SIMM governance framework would allow nonbank SBSDs to learn from the experience of others, as the framework requires SIMM users to report on a quarterly basis any shortfalls they identify with the SIMM, whether from benchmarking or back-testing or from persistent reconciliation difficulties. The SIMM governance

95 October 2018 Release, 83 Fed. Reg. at 53012-13.

committee can address these shortfalls, either through an *ad hoc* recalibration of the SIMM or during the annual review of the SIMM's methodology.

Recommendation: Consistent with the October 2018 Release, and in light of the significant benefits of using standard industry models, the Commission should permit BD-SBSDs, OTCDDs that are dually registered as SBSDs, and standalone SBSDs to calculate IM Requirements for non-equity SBS using a standard industry model such as the SIMM.

2. The Commission Should Permit OTCDDs and Standalone SBSDs to Use IM Models for Equity SBS

With respect to equity SBS, the 2012 Proposal explained that the Commission proposed to require nonbank SBSDs to use a standardized method to calculate IM amounts for equity SBS because doing so would ensure that the margin requirements for equity SBS are consistent with SRO portfolio margin rules for equity securities, which would in turn facilitate the ability of BDs to portfolio margin equity SBS with equity securities.[96] Further, the Commission noted, a standardized method would reduce the opportunity for regulatory arbitrage between nonbank SBSDs and BDs that are not SBSDs.[97] In view of these considerations, we agree that the Commission should require BD-SBSDs to calculate IM amounts for equity SBS in the same manner as BDs calculate margin amounts for equivalent cash market securities positions.[98]

However, when the SBSD is either a standalone SBSD or an OTCDD, the portfolio margin considerations are non-existent and the regulatory arbitrage concerns are substantially smaller. Standalone SBSDs and OTCDDs are not permitted to carry cash market securities positions for customers. As a result, they are not able to portfolio margin customers' equity SBS with cash market equity securities positions. Moreover, allowing them to use a standard industry IM model would not create the opportunity for counterparties to select different margin requirements from the same SBSD depending on whether the product is an SBS or equivalent cash market securities position because the SBSD would only able to offer the equity SBS, not equivalent cash market securities positions. On the other hand, if such an SBSD could not use a standard industry IM model, then customers could still engage in regulatory arbitrage by transacting instead with a bank SBSD or foreign SBSD. Thus, preventing OTCDDs and standalone SBSDs from using standard industry IM models for equity SBS would not eliminate regulatory arbitrage between different IM calculation methodologies; it only would put OTCDDs and

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[96] 2012 Proposal, 77 Fed. Reg. at 70261-62.

[97] *Id.* at 70262.

[98] A BD-SBSD, like other nonbank SBSDs, should be permitted to use approved models to compute IM for non-equity SBS.

standalone SBSDs at a competitive disadvantage as against bank SBSDs and foreign SBSDs.

Recommendation: The Commission should permit SBSDs that are dually registered as OTCDDs as well as standalone SBSDs to calculate the IM Requirement for equity SBS using an standard industry model such as the SIMM.

B. IM Thresholds

The 2012 Proposal did not include a permitted IM threshold. As a result, a nonbank SBSD would be required to collect IM from an in-scope counterparty regardless of the size of the nonbank SBSD's exposure to the counterparty. By contrast, the WGMR framework allows parties to agree to an IM threshold of up to €50 million, applicable on a group-to-group basis.[99] In implementing the WGMR framework, the CFTC and the Prudential Regulators set the threshold at $50 million, rather than €50 million.[100]

The October 2018 Release states that a fixed-dollar IM threshold, depending on the size and activities of the nonbank SBSD, may either be too large or too small.[101] It requests comment, therefore, on whether it would be appropriate for the Commission to establish an IM threshold equal to the lesser of 1% of the nonbank SBSD's tentative net capital or 10% of the counterparty's net worth.[102]

1. The Commission Should Adopt a $50 Million IM Threshold Consistent with the WGMR Framework, but Subject to Credit Concentration Capital Charges

There would be significant benefits to adopting the same $50 million IM threshold as the CFTC and the Prudential Regulators:

- The $50 million IM threshold was selected by the WGMR based on a quantitative impact study designed to assess ways to balance the systemic risk mitigation benefits of IM against the aggregate costs of locking up liquid assets as IM. Adopting a different IM threshold methodology would upset that balance;

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99 Basel Committee and IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives, (Sept. 2013, rev'd Mar. 2015).

100 *See* 12 C.F.R. § __.2 (Definitions applicable to margin requirements); 17 C.F.R. § 23.151 (Definitions applicable to margin requirements).

101 October 2018 Release, 83 Fed. Reg. at 53013.

102 *Id*.

- Relative to IM thresholds based on net worth or net capital, the $50 million IM threshold fosters predictable IM requirements because it does not vary over time;

- Relative to IM thresholds based on net worth or net capital, the $50 million IM threshold fosters transparency and helps minimize disputes because it does not require either party to assess the accuracy of IM requirements based on information (the SBSD's tentative net capital or the counterparty's net worth) that is not known to it; and

- Providing for a consistent and harmonized IM threshold methodology would prevent opportunities for counterparties to engage in regulatory arbitrage (a) between bank and nonbank SBSDs or (b) among nonbank SBSDs with different amounts of tentative net capital.

We acknowledge that there are drawbacks to the $50 million IM threshold, as a fixed dollar amount might be too large or too small relative to the net capital of an SBSD or net worth of a counterparty. We respectfully submit, however, that these drawbacks can and should be addressed through the SBSD's net capital requirements, not the IM threshold methodology. If a nonbank SBSD has material uncollateralized potential future exposure to a counterparty, it can take additional capital charges. If that counterparty is less creditworthy, those capital charges can be set higher.

Recommendation: A nonbank SBSD should be permitted to apply an IM threshold equal to an aggregate credit exposure of $50 million resulting from all non-cleared SBS between the SBSD and its affiliates on the one hand, and a covered counterparty and its affiliates on the other, subject to a credit concentration charge equal to: (1) 5% of the amount of uncollected IM in excess of 1% of the tentative net capital of the SBSD, for a counterparty with a credit risk weight of 20% or less; (2) 20% of the amount of uncollected IM in excess of 1% of the tentative net capital of the SBSD, for a counterparty with a credit risk weight of greater than 20% but less than 50%; or (3) 50% of the amount of uncollected IM in excess of 1% of the tentative net capital of the SBSD, for a counterparty with a credit risk weight greater than 50%.

2. If the Commission Does Not Adopt a $50 Million IM Threshold Consistent with the WGMR Framework, Then It Should Not Base Its Threshold on Counterparty Net Worth

As discussed in greater detail in part I.B.3, nonbank SBSDs are not able to implement an IM threshold tied to counterparty net worth because they do not have the capability to monitor such net worth in real time. Moreover, counterparties would not be in a position to provide this information. Even if they could, providing this information could create issues under securities laws relating to the disclosure of material non-public information.

As a result, were the Commission to adopt an IM threshold tied to counterparty net worth, it would, with limited exceptions, be as though the Commission had adopted no threshold at all. Nonbank SBSDs would effectively be required to collect IM from all in-scope counterparties because they would be unable to confirm that the calculated IM amounts had not crossed the relevant threshold. Such a requirement would put nonbank SBSDs at a significant competitive disadvantage relative to bank SBSDs and foreign SBSDs. Instead, we suggest that the counterparty net worth test should be eliminated if and to the extent that the SBSD demonstrates that it has an effective process to obtain and update in a timely manner relevant and material information about its counterparties.[103]

3. If the Commission Does Not Adopt a $50 Million IM Threshold, Then It Should Still Allow Smaller and Mid-Size Nonbank SBSDs to Use a Higher Tentative Net Capital IM Threshold than 1%, Subject to Credit Concentration Charges to the Extent Uncollected IM Exceeds 1% of Tentative Net Capital

For some nonbank SBSDs, a 1% tentative net capital threshold might be effective because it would ensure that the SBSD does not face uncollateralized potential future credit exposure to any single counterparty that could pose a material risk to the SBSD, while also potentially allowing the SBSD to set an IM threshold level for its counterparties that is consistent with what bank SBSDs and foreign SBSDs can apply under the WGMR framework.

For smaller and mid-size nonbank SBSDs, however, the 1% tentative net capital threshold would present several problems. These firms would need to apply smaller IM thresholds than both larger nonbank SBSDs and similarly sized bank SBSDs. Due to the costs associated with locking up liquid assets, smaller IM thresholds would effectively increase the prices offered by smaller nonbank SBSDs to counterparties relative to their competitors. Additionally, the costs of overhauling systems and re-documenting IM documentation to incorporate the new percentage thresholds would have a disproportionate impact on smaller firms, since such costs do not generally scale to a firm's size. These substantial disadvantages would likely reduce the ability of smaller nonbank SBSDs to attract counterparties, which would cause greater market concentration and less efficient pricing.

In light of these considerations, if the Commission does not adopt a $50 million IM threshold consistent with the WGMR framework, it should permit smaller and mid-size nonbank SBSDs (*i.e.*, those whose tentative net capital is below a specified dollar amount) to apply an IM threshold equal to a higher percentage of the nonbank SBSD's tentative net capital than 1%, but subject to credit concentration charges for exposures in excess of 1% of tentative net capital, as described above. The combination of a higher threshold with credit concentration charges would serve to allow smaller and mid-size nonbank SBSDs to

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103 *Cf.* 12 C.F.R. § 217.122(b)(2)(iii) (Federal Reserve Board requirements relating to assessment of credit risk for capital purposes).

compete on a more level playing field with bank SBSDs and larger nonbank SBSDs, while concurrently ensuring any material amounts of uncollected IM are offset by appropriate amounts of the SBSD's capital.

Recommendation: If the Commission does not adopt a $50 million threshold based on the WGMR framework, it should permit nonbank SBSDs with tentative capital below a specified dollar amount to apply an IM threshold equal to a percentage of the SBSD's tentative net capital that is higher than 1%, subject to a credit concentration charge equal to: (1) 5% of the amount of uncollected IM in excess of 1% of the tentative net capital of the SBSD, for a counterparty with a credit risk weight of 20% or less; (2) 20% of the amount of uncollected IM in excess of 1% of the tentative net capital of the SBSD, for a counterparty with a credit risk weight of greater than 20% but less than 50%; or (3) 50% of the amount of uncollected IM in excess of 1% of the tentative net capital of the SBSD, for a counterparty with a credit risk weight greater than 50%.

C. IM Exceptions

Under the 2012 Proposal, a nonbank SBSD must collect IM from a counterparty unless (1) the counterparty is a commercial end user, (2) the counterparty has elected segregation of its IM at an independent third-party custodian pursuant to Section 3E(f) of the Exchange Act, (3) the IM would relate to a legacy account of the counterparty, or (4) under Alternative A as described below, the counterparty is another SBSD.[104] Below we address this last exception, as well as two other areas where IM exceptions would be warranted.

1. The Commission Should Adopt an IM Exception for Regulated Financial Institutions

The 2012 Proposal contained two alternative formulations regarding the obligation of nonbank SBSDs to collect IM from other SBSDs. Under the first formulation ("**Alternative A**"), nonbank SBSDs would not be required to collect IM from other SBSDs. In the 2012 Proposal, the Commission noted that this approach aligned with existing BD margin rules, which generally do not require BDs to collect margin from one another.[105] Under the second formulation ("**Alternative B**"), nonbank SBSDs would have been required to collect IM from SBSDs and to segregate such IM at a third-party custodian in accordance with Section 3E(f) of the Exchange Act.[106] Alternative B is generally more consistent with the WGMR framework. The October 2018 Release requests comment regarding Alternatives A and B, including whether Alternative A should be expanded to

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[104] 2012 Proposal, 77 Fed. Reg. at 70265.

[105] 2012 Proposal, 77 Fed. Reg. at 70267.

[106] *Id*.

allow nonbank SBSDs to elect not to collect IM from SDs, BDs, U.S. banks, foreign banks, and foreign dealers.[107]

In principle, we favor harmonization with the WGMR framework. Such harmonization would limit opportunities for regulatory arbitrage and sources of competitive disparity. Such harmonization would also simplify implementation efforts and reduce complexities that can present ongoing costs and operational risk.

Such harmonization is not appropriate, however, where it would introduce material inconsistencies with unique aspects of the Commission's regulatory framework. In particular, unlike bank SBSDs and foreign SBSDs, U.S. nonbank SBSDs (including OTCDDs and BD-SBSDs) will be subject to capital rules establishing a net liquid assets test, not a risk-weighted assets test. These rules reflect the fact that such nonbank SBSDs do not have access to alternative, non-market based funding sources, such as deposits, or the Federal Reserve discount window. They also reflect the unique U.S. insolvency regimes applicable to such nonbank SBSDs.

Most aspects of the WGMR framework can be reconciled with a net liquid assets, as we explain throughout this letter. However, requiring dealers to exchange and segregate IM with each other, as would be required under Alternative B, presents especially challenging issues. In particular, the 2012 Proposal would impose a 100% capital deduction for IM (1) posted by a nonbank SBSD, even if held at a third-party custodian or (2) collected by a nonbank SBSD, but held at a third-party custodian. Although the October 2018 Release requests comments on changes that would ameliorate the incompatibility of these deductions with the WGMR framework, those changes would still impose burdensome conditions, as we discuss above.

In addition, we are concerned that Alternative B would put stress on the funding models of U.S. nonbank SBSDs. U.S. nonbank SBSDs may not always have access to excess cash or standby liquidity sufficient to address procyclical increases in other dealers' IM requirements during a time of market stress.

For these reasons, we strongly support Alternative A, including as expanded in the October 2018 Release. We also note that the types of counterparties covered by this IM exception are generally more creditworthy because they are subject to financial safety and soundness regulation. Nonbank SBSDs would also still collect VM from these institutions and apply credit risk charges to cover uncollected IM. These measures mitigate the risks faced by nonbank SBSDs when trading with the regulated financial institutions that would be covered by Alternative A.

Recommendation: The Commission should not require nonbank SBSDs to collect IM from other SBSDs or from SDs, BDs, U.S. banks, foreign banks, or foreign dealers.

[107] October 2018 Release, 83 Fed. Reg. at 53014.

2. IM Exception for Inter-Affiliate Transactions

While many affiliates of nonbank SBSD are regulated financial institutions that would be covered by Alternative A, some are corporate entities. These corporate affiliates facilitate the business of the broader financial institution, for instance by housing the consolidated group's employees or serving as the entity for issuing certain securities. Although not individually regulated, these affiliates are typically subject to consolidated capital, liquidity and safety and soundness supervision by the Federal Reserve Board or equivalent foreign regulators.

Some of these affiliates enter into SBS with their nonbank SBSD affiliates, either for their individual hedging purposes or as part of the consolidated group's broader risk management strategy. Requiring nonbank SBSDs to collect IM from these affiliates would provide little risk management benefit since the entities are all part of the same consolidated group, which has developed both liquidity and resolution procedures in order to ensure that assets are deployed where and when necessary so as to allow the group as a whole to continue operating. IM requirements would interfere with these liquidity plans by requiring that assets be locked up at a specified subsidiary. They would also increase the cost of hedging transactions. Also, like with transactions covered by Alternative A, a nonbank SBSD's transactions with its affiliates would remain subject to credit risk capital charges.

Similar considerations have led the CFTC, European Commission, and the Japanese Financial Services Agency to adopt an exception from IM requirements for inter-affiliate swaps.[108]

Recommendation: The Commission should not require nonbank SBSDs to collect IM from affiliates that are subject to the same centralized risk management program as the nonbank SBSD.

3. IM Exception for Counterparties That Do Not Have Material Swaps Exposure

Under the WGMR framework, a person is not subject to IM requirements unless the person's group has €8 billion in outstanding gross notional amount of non-cleared

[108] 17 C.F.R. § 23.159(a)(1); *See* Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for [SDs] and [MSPs], 81 Fed. Reg. at 63381 (Sept. 15, 2016) and Comparability Determination for the European Union: Margin Requirements for Uncleared Swaps for [SDs] and [MSPs], 82 Fed. Reg. at 48399 (Oct. 18, 2017).

derivatives.[109] In implementing the WGMR framework, the CFTC and the Prudential Regulators set this amount at $8 billion and called it "material swaps exposure."[110]

This IM exception for persons that do not have materials swaps exposure is intended to (1) exclude market participants whose non-cleared derivatives activity is not a source of systemic risk and (2) relieve such a market participant from the operational burden of compliance with IM requirements, given that its non-cleared derivatives activity is unlikely to expose its counterparties to potential future exposure in excess of the $50 million IM threshold. For the same reasons, the Commission should likewise adopt an IM exception permitting a nonbank SBSD not to collect IM in connection with non-cleared SBS with a counterparty that does not have a material swaps exposure. As with the other IM exceptions described above, the risks faced by a nonbank SBSD on transactions covered by this exception would still be addressed by credit risk capital charges. In addition, if nonbank SBSDs did not benefit from this exception, then they would face a competitive disadvantage relative to bank SBSDs and foreign SBSDs subject to the WGMR framework when transacting with smaller, less risky counterparties.

As discussed above, recent analyses by SIFMA, ISDA, and the CFTC all support the view that the material swaps exposure threshold should be raised and exclude physically settled FX swaps and forwards.[111] To the extent the CFTC raises the threshold above $8 billion, the Commission should, for the same reasons set out above, make conforming changes.

Recommendation: The Commission should not require nonbank SBSDs to collect IM from counterparties that do not have a "material swaps exposure" and should define the "material swaps exposure" threshold so that it is consistent with the equivalent thresholds set out in the CFTC's and Prudential Regulators' margin rules.

D. Deadline for Collecting Margin

The 2012 Proposal would require a nonbank SBSD to calculate margin requirements as of the end of each business day and collect any required margin by noon of the next business day.[112] In contrast, the CFTC and Prudential Regulators require an SD or SBSD, as applicable, to collect margin by the end of the business day following the day of execution of a transaction and at the end of each business day thereafter, with special provisions to address operational difficulties associated with parties located in different

109 Basel Committee and IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives (Sept. 2013, rev'd. Mar. 2015).

110 *See* 12 C.F.R. § __.2 (Definitions applicable to margin requirements); 17 C.F.R. § 23.151 (Definitions applicable to margin requirements).

111 *See* note 10, *supra.*

112 2012 Proposal, 77 Fed. Reg. at 70291.

time zones.[113] To avoid undue operational difficulties associated with transacting across time zones, and to enable use of similar margin systems and documentation to those in use for purposes of other regulators' rules, the Commission should conform its margin collection deadline to those of the CFTC and Prudential Regulators.

Recommendation: Consistent with the CFTC's and Prudential Regulators' margin rules, the Commission should require an SBSD to collect margin by the end of the business day following the day of execution and at the end of each business day thereafter, with appropriate adjustments to address operational difficulties associated with parties located in different time zones.

E. Eligible Collateral and Haircuts

The 2012 Proposal would require a nonbank SBSD to collect margin in the form of cash, securities, or money market instruments, provided the assets: (i) are subject to the SBSD's physical possession or control; (ii) are liquid and transferable; (iii) may be liquidated promptly; (iv) are subject to an enforceable security agreement; (v) do not consist of securities issued by the counterparty, its affiliate or an affiliate of the SBSD; and (vi) are of a type for which the Commission has approved the use of a VaR model (if the SBSD has been approved to use VaR models).[114] The 2012 Proposal would require a nonbank SBSD to haircut the fair market value of collected margin by the amount of deductions the SBSD would apply to the assets under SEC Rule 15c3-1 or 18a-1, as applicable.[115]

The CFTC and Prudential Regulators, by contrast, have specified particular types of currencies and highly liquid securities and gold as eligible collateral and adopted specified, fixed haircuts applicable to each type of collateral (for securities, ranging from 0.5% for government debt with residual maturity less than one year to 25% for equities included in the S&P 1500 index but not the S&P 500 index) and prohibitions designed to address wrong-way risk (*e.g.*, a prohibition on securities issued by either of the parties or any of their affiliates).[116]

Recommendation: We recommend the Commission (i) clarify that the types of collateral eligible under the CFTC's and Prudential Regulators' margin rules also satisfy SEC Rule 18a-4(c)(4); (ii) adopt a conforming amendment to SEC Rule 18a-4(c)(4)(i) to reflect permissible use of an independent, third-party custodian that satisfies the

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113 *See* 12 C.F.R. §§ __.2 "day of execution", __.3(a), __.4(b); 17 C.F.R. §§ 23.151 "day of execution", 23.152(a), 23.153(a).

114 2012 Proposal, 77 Fed. Reg. at 70263-70264.

115 *Id*.

116 12 C.F.R. § __.6(a), *See* 12 C.F.R. § __(Appendix B); 17 C.F.R. § 23.156(a)(1), (3)(i)(B).

Custodial Conditions, as modified in accordance with part I.C.2. above; and (iii) permit the use of the collateral haircuts specified in the CFTC's and Prudential Regulators' margin rules.

F. Minimum Transfer Amount

The 2012 Proposal would allow a nonbank SBSD to agree to a minimum transfer amount of up to $100,000.[117] By contrast, the CFTC and Prudential Regulators allow a minimum transfer amount of up to $500,000.[118] In the 2012 Proposal, the Commission explained that the $100,000 amount was based on the amount the CFTC had set in its then-proposed non-cleared swaps margin rules.

Recommendation: In order to retain consistency with the CFTC and reduce unnecessary costs of overhauling systems and re-documenting credit support annexes, the Commission should, like the CFTC did, increase the permissible minimum transfer amount to $500,000.

G. Definition of "Commercial End User"

The 2012 Proposal would define commercial end user to mean any person (other than a natural person) that: (1) engages primarily in commercial activities that are not financial in nature and that is not a financial entity as the term is defined in Section 3C(g)(3) of the Exchange Act; and (2) is using non-cleared SBS to hedge or mitigate risk relating to the commercial activities.[119]

By contrast, the CFTC and Prudential Regulators each adopted a "financial end user" definition covering a wide range of entities subject to financial industry registration or licensing requirements, as well as private funds, commodity pools, and proprietary trading entities, among others. These definitions also excluded Sovereigns and certain entities excepted or exempted from mandatory clearing requirements. A person not defined as a financial end user is not required to exchange margin. The agencies also separately adopted exceptions for swaps or SBS excluded or exempted from mandatory clearing requirements, as required by TRIPRA.[120]

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[117] 2012 Proposal, 77 Fed. Reg. at 70272.

[118] *See* 12 C.F.R. § __.5(b); 17 C.F.R. § 23.151 "minimum transfer amount."

[119] 2012 Proposal, 77 Fed. Reg. at 70266.

[120] *See* 12 C.F.R. § __.2 "financial end user"; 17 C.F.R. § 23.151 "financial end user."

Recommendation: In order to avoid creating unnecessary competitive disparities and in light of the appropriately risk-sensitive approach taken by the CFTC and Prudential Regulators, the Commission should adopt the same "financial end user" definition, including related exceptions, as the CFTC and the Prudential Regulators. The Commission also should fulfill its own obligations to exclude SBS covered by the TRIPRA exclusion.

H. Portfolio Margin

The Proposed Rules do not contain provisions authorizing the portfolio margining of SBS with other kinds of positions, though, as noted above, the Commission explained that its margin requirements for equity SBS were designed to facilitate portfolio margining of such SBS with cash market securities positions. The October 2018 Release requests comment on whether the Commission should permit nonbank SBSDs to portfolio margin SBS with other kinds of positions. Specifically, the October 2018 Release asks:[121]

(1) Whether a BD-SBSD-SD should be permitted to hold swaps in an SBS account in order to portfolio margin such swaps with SBS and cash market securities and listed options positions;

(2) Whether an FCM-SBSD-SD should be permitted to hold SBS in a swaps account in order to portfolio margin swaps, SBS and futures positions; and

(3) Whether an SD-SBSD should be permitted to hold SBS in a swaps account or swaps in an SBS account and, if so, what model should the SBSD be permitted to use to determine margin requirements.

The October 2018 Release also requests comment on how these various positions would be treated in the event of a liquidation of the relevant SBSD.[122]

As the October 2018 Release notes, portfolio margining enhances market efficiency and liquidity and reduce volatility by aligning a customer's margin requirements with the full scope of its positions. Customers often hedge or offset the risk associated with a particular position using a different type of product. The price of such product may be better than the product the customer used to establish the original position or, when combined with the original position, may allow the customer to establish the particular exposure it is seeking. Either way, the risk of the intermediary to the customer is substantially smaller by virtue of the offsetting positions.

However, when the positions are subject to different regulatory regimes and arrangements, the intermediary is often required to assess separate margin calls. This can

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[121] October 2018 Release, 83 Fed. Reg. at 53014-16.

[122] *Id.* at 53015.

serve as a liquidity drain and create significant inefficiencies, both for the customer and the intermediary. It can also create greater risk to the intermediary if the intermediary has not obtained or is unable to obtain liens or setoff rights in respect of all of the customer's accounts. Portfolio margining alleviates many of these issues by allowing the intermediary to maintain all of the customer's positions in a single account and calculate a single margin call for the whole account. These margin calls can reflect the full suite of the customer's positions, rather than one segment.

In addition to improving efficiency and liquidity, allowing U.S. intermediaries to portfolio margin customer positions improves the ability of such intermediaries to compete with their foreign counterparts. Many foreign intermediaries are subject to a single regime that governs all or most of its customer positions. In particular, unlike in the United States, other jurisdictions do not have an arbitrary (*i.e.*, non-risk-based) distinction between swaps and SBS. As a result, a foreign intermediary is able to incorporate all of the customer's positions into its margin calculations and make a single margin call that reflects the customer's aggregate net economic position.

Portfolio margining would also help to limit unbalanced IM requirements in transactions between nonbank SBSDs and bank SBSDs. Because the Prudential Regulators dictate the margin requirements for both non-cleared SBS and non-cleared swaps entered into by bank SBSDs, the amount of IM a bank SBSD must collect from a nonbank SBSD will reflect the risks of all of the parties' non-cleared SBS and swaps, calculated on a portfolio-wide basis. In contrast, absent portfolio margining, the nonbank SBSD will be required to calculate and collect IM for non-cleared swaps and SBS separately. That would result in two SBSDs collecting different amounts of IM from one another, which will likely lead to disputes and pricing discrepancies.

Considering the significant benefits to both customers and intermediaries of portfolio margining, the Commission should permit nonbank SBSDs to portfolio margin SBS with swaps and other positions to the greatest extent that is possible without harming customers or creating uncertainty regarding the treatment of claims in liquidation proceedings.

In particular, we support permitting the portfolio margin scenarios described in the table below, under the conditions specified therein. We provide a detailed analysis of how the counterparty's positions and related collateral would be treated in each of these scenarios in a liquidation or insolvency of the SBSD in **Appendix A**. Additionally, we provide more details regarding our recommendations concerning the segregation requirements applicable to these arrangements in part II.J below.

<table>
<tr><th colspan="6">Recommended Portfolio Margining (“PM”) Arrangements</th></tr>
<tr><th>Type of SBSD</th><th>Account Type</th><th>PM Products</th><th>Margin Methodology</th><th>Segregation Requirements</th><th>Insolvency Considerations</th></tr>
<tr><td rowspan="2">Full-purpose BD that is registered as an SBSD and SD</td><td>Securities account</td><td>• Non-cleared SBS
• Non-cleared swaps
• Cash market securities
• Listed securities options
• OTC securities options</td><td>Methodology applicable under SEC and SRO rules for PM accounts</td><td>SEC Rule 15c3-3, with single possession and control calculation and reserve account calculation for all positions</td><td>BD-SD-SBSD would be eligible for liquidation under the Securities Investor Protection Act (“SIPA”)

All claims for return of SBS and swaps collateral should be “customer” claims under SIPA because such collateral would be held in a securities account</td></tr>
<tr><td>Swaps account</td><td>• Non-cleared SBS
• Non-cleared swaps
• OTC securities options</td><td>Methodology applicable under CFTC rules for non-cleared swaps</td><td>IM segregated at independent third-party custodian

VM not subject to segregation</td><td>Counterparties to non-cleared SBS and OTC securities options would subordinate their claims for those positions to the claims of securities customers and thereby waive “customer” status under SIPA for those positions and related collateral

Those counterparties would instead be protected by the CFTC’s third-party segregation requirements</td></tr>
</table>

Recommended Portfolio Margining ("PM") Arrangements					
Type of SBSD	Account Type	PM Products	Margin Methodology	Segregation Requirements	Insolvency Considerations
OTCDD that is registered as an SBSD and SD; or Standalone SBSD that is registered as an SD	SBS account	• Non-cleared SBS • Non-cleared swaps • For OTCDD, OTC securities options	Approved models, including for equity SBS, swaps, and securities options	Counterparty may elect segregation at third-party custodian or to maintain collateral at a BD affiliate of the SBSD (see part II.J.2 below). Otherwise, no segregation requirements would apply	SBSD would potentially be subject to stockbroker liquidation provisions under the U.S. Bankruptcy Code (the "**Code**"), not SIPA Claims by counterparties to non-cleared SBS and OTC securities options for return of collateral would not be given "customer" status, but if the counterparty elects third-party segregation, existing insolvency law would exclude such assets from SBSD's estate (and thus from claims of SBSD's general unsecured creditors) Counterparty claims for margin held at a third-party which is a BD affiliate would be entitled to protection under SEC Rule 15c3-3 and SIPA

Recommended Portfolio Margining ("PM") Arrangements					
Type of SBSD	Account Type	PM Products	Margin Methodology	Segregation Requirements	Insolvency Considerations
	Swaps account	• Non-cleared SBS • Non-cleared swaps • For OTCDD, OTC securities options	Methodology applicable under CFTC rules for non-cleared swaps	IM segregated at independent third-party custodian VM not subject to segregation	SBSD would provide a notice similar to that provided by OTCDDs today under SEC Rule 15c3-3(a)(1), but no subordination agreement would be necessary because, as per the row above, counterparties to non-cleared SBS and OTC securities options would not otherwise have "customer" status

In addition, although not addressed in the table above, we support the continued ability of a BD-FCM to portfolio margin cleared swaps and cleared SBS together pursuant to the CDS Portfolio Margin Exemption, which has worked effectively for over four years. We also would support the ability for an FCM-SBSD-SD to hold SBS in a swaps account in order to portfolio margin swaps, SBS and futures positions.

I. Cross-Margining

Market participants have developed arrangements for cross-margining positions held in accounts subject to different segregation regimes. Under these arrangements, the total IM would be calculated based on the risks of all the positions. Although this will result in a lower total IM requirement, it will more accurately reflect the risk of default on a portfolio basis. For cleared positions, the clearing organization would receive the full amount of IM to which it is entitled and the dealer would receive the remainder. In an event of default, the clearing organization and clearing broker would be paid in full with the IM they hold and any excess margin would be available (subject to the prior claims of the clearing organization, clearing brokers, and customers) to satisfy the claim of the dealer.

These arrangements have been in place for years to establish cross-margining between futures contracts and OTC derivatives, and have proven to be an effective mechanism for calibrating margin requirements to reflect accurately the overall risk presented by a counterparty's portfolio. Similar arrangements are also commonly used in other areas, such as to cross-margin derivatives and correlated cash positions (margin loans and short positions in prime brokerage arrangements), listed options, repo, and/or securities lending positions.

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

Recommendation: The Commission should permit non-cleared SBS to be cross-margined with other types of positions.

J. Segregation Requirements

The 2012 Proposal would generally require an SBSD, whether a nonbank SBSD or a bank SBSD, to maintain collateral for cleared and non-cleared SBS in accordance with omnibus segregation requirements modeled on the BD customer protection rule.[123] An exception to these requirements would apply if a customer elected individual segregation of its IM for non-cleared SBS at an independent third-party custodian pursuant to Section 3E(f) of the Exchange Act or waived segregation of its collateral for non-cleared SBS.[124] In each of these cases, the customer would be required to enter into an agreement with the SBSD subordinating the customer's claims to the claims of SBS customers.[125]

The October 2018 Release requests comment on whether there are aspects of the 2012 Proposal's omnibus segregation requirements or the cross-border application of those requirements under the 2013 Proposal on which greater clarity is required.[126] The October 2018 Release also asks specific technical questions regarding the omnibus segregation requirements.[127]

In order to address these requests, we believe it is necessary to address a topic on which the October 2018 Release does not generally request comment, namely the proper scope of the proposed omnibus segregation requirements. The 2012 Proposal would apply omnibus segregation requirements to all SBSDs and SBS, irrespective of the type of SBS, the SBSDs, or the organizational structure or applicable insolvency regime. For the reasons discussed below, such an expansive application is not only unnecessary, but inconsistent with the Exchange Act and potentially harmful to counterparties.

1. The Commission Should Not Impose Omnibus Segregation Requirements on Bank SBSDs and Foreign SBSDs That Do Not Clear SBS for Customers

a. Imposing Omnibus Segregation Requirements on Bank SBSDs Could Conflict with Bank Liquidation or Resolution by the FDIC

In order to promote confidence in the U.S. SBS markets, it is paramount that the Commission's segregation requirements provide a high degree of certainty regarding (1) the rights and obligations of SBSDs with respect to collateral received by customers in connection with cleared and non-cleared SBS and (2) the manner in which such collateral

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123 2012 Proposal, 77 Fed. Reg. at 70276.

124 *Id.* at 70291.

125 *Id.*

126 October 2018 Release, 83 Fed. Reg. at 53016.

127 *Id.*

will be distributed in the event the SBSD is subject to liquidation. In the absence of such certainty, market participants will be reticent to enter into SBS transactions with SBSDs. Worse yet, they might panic in market stress situations.

In light of these considerations, and as the Commission has noted, SEC Rule 15c3-3's omnibus segregation requirements are specifically designed to work in tandem with SIPA and the related stockbroker liquidation provisions of the Code.[128] SIPA and the Code protect customers by providing them with net equity claims that have priority over other claims to the part of the broker-dealer's estate that consists of "customer property."[129] SEC Rule 18a-4 accordingly requires that an SBSD retain in its estate sufficient customer property to satisfy all customer claims.

Bank SBSDs, however, cannot become subject to SIPA or the Code.[130] A U.S. bank whose deposits are insured by the FDIC would be subject to resolution under the Federal Deposit Insurance Act (the "**FDI Act**"). Unlike SIPA and the stockbroker liquidation provisions of the Code, the FDI Act does not provide securities or SBS customers of a bank with priority claims to securities or SBS customer property held within the bank's estate. Instead, the FDI Act generally gives priority to the claims of the bank's depositors.[131] The Commission has not, to our knowledge, consulted with the FDIC regarding how it would treat SBS customers of a bank SBSD, whether the proposed omnibus segregation requirements would be consistent with such treatment, or otherwise whether those requirements would help or hinder the liquidation or other resolution of a bank SBSD. Nor does the 2012 Proposal address these matters.

b. Applying Omnibus Segregation Requirements to Foreign SBSDs Would Cause Cross-Jurisdictional Disputes

If a foreign SBSD became insolvent, it is very likely that the SBSD or its foreign authorities would commence resolution or insolvency proceedings in the SBSD's home jurisdiction. As noted above, the customer protection regime embodied in SIPA and the stockbroker liquidation provisions of the Code are unique. It is therefore quite unlikely that the applicable foreign insolvency or resolution regime will afford any priority status to U.S. customers on the basis of the omnibus segregation arrangement. Indeed, foreign laws might impose their own, conflicting segregation requirements designed to work with foreign insolvency laws.

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128 2012 Proposal, 77 Fed. Reg. at 70275.

129 *See* 15 U.S.C. § 78fff-2(b); 11 U.S.C. § 752(a).

130 *See* 11 U.S.C. § 109(b)(2), (3) (prohibiting domestic banks and foreign banks that have a branch or agency in the United States from being debtors under chapter 7 of the Code); 15 U.S.C. § 78eee (limiting the application of SIPA to members of the Securities Investor Protection Corporation).

131 12 U.S.C. § 1821(d)(11).

Imposing the Commission's omnibus segregation requirements on foreign SBSDs, moreover, has the potential to impede the orderly resolution of a foreign SBSD by foreclosing the possibility of ancillary U.S. bankruptcy proceedings. In 2005, Congress added chapter 15 to the Code to facilitate the reorganization and liquidation of entities organized outside the U.S.[132] Chapter 15 permits foreign representatives of a non-U.S. entity to bring ancillary bankruptcy proceedings in the U.S. In connection with these proceedings, a bankruptcy court can order that the debtor's U.S. assets be distributed consistently with the foreign proceedings.[133] Ancillary proceedings accordingly allow for an orderly liquidation of an insolvent entity and limit the likelihood of ring-fencing and cross-jurisdictional disputes.

Were the Commission to impose omnibus segregation requirements on foreign SBSDs' non-cleared SBS, it would foreclose the possibility of chapter 15 proceedings. Such omnibus segregation requirements would cause counterparties of non-cleared SBS with such foreign SBSDs to be considered "customers" for purposes of the Code, which would in turn cause such foreign SBSDs to be considered "stockbrokers."[134] Section 1501(c) of the Code provides that ancillary proceedings under Chapter 15 cannot be commenced in respect of a "stockbroker."

In the absence of ancillary proceedings, the only U.S. federal insolvency proceedings available to a foreign SBSD would be proceedings under the stockbroker liquidation provisions of the Code. Although the stockbroker liquidation provisions would provide customers with priority "net equity" claims in the manner described above, it is unclear the extent to which such priority claims would actually serve to benefit the customers because the priority status would likely be at odds with the home country's distribution regime. As a result, customers may receive competing orders from U.S. and non-U.S. courts, with the ultimate result being confusion, litigation, and uncertainty.

c. Imposing Omnibus Segregation Requirements on Bank and Foreign SBSDs' Non-Cleared SBS Collateral Is Not Consistent with the Exchange Act

Congress did not authorize the Commission to adopt omnibus segregation requirements for non-cleared SBS collateral absent commingling with collateral for cleared

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132 *See* Pub. L. 109-8 (Apr. 20, 2005).

133 11 U.S.C. § 1519.

134 Section 3E(g) provides that "[t]he term 'customer', as defined in [the stockbroker liquidation provisions of the Code], excludes any person, to the extent that such person has a claim based on any . . . non-cleared security-based swap except to the extent of any margin delivered to or by the customer with respect to which there is a customer protection requirement under section 78o(c)(3) of this title or a segregation requirement." Section 101 of the Code defines a "stockbroker" as any person with respect to which there is a customer and that is engaged in the business of effecting transactions in securities, including SBS, either for the account of others or with members of the general public, from or for such person's own account. 11 U.S.C. § 101(53A).

SBS. The only provision potentially authorizing omnibus segregation for an SBSD (other than a BD subject to Section 15(c)(3) of the Exchange Act) is Section 3E(c)(2) of the Exchange Act, but that provision only addresses commingling of collateral in connection with cleared SBS. In contrast, the provision of Dodd-Frank specifically designed to address non-cleared SBS, Section 3E(f) of the Exchange Act, solely authorizes the Commission to adopt rules addressing the right of a counterparty to elect individual segregation of IM for non-cleared SBS at an independent, third-party custodian.

In adding Section 3E(f) to the Exchange Act, Congress prescribed a specific, well-established mechanism for non-cleared SBS counterparties to protect their margin. As discussed above, pledgors in the U.S. and abroad use third-party segregation in connection with a variety of transactions to ensure that they will be able to recover their assets in the event of the secured party's insolvency. Congress not only required SBSDs to allow such segregation when requested by a counterparty, but also mandated that SBSDs alert their counterparties to the option of segregation.

Congress thus gave counterparties to non-cleared SBS the option of electing to have their IM segregated away from the SBSD. To the extent counterparties exercise this election, they can ensure that they can recover the IM in the event of the SBSD's liquidation. If they do not, the SBSD can obtain a funding benefit that is passed onto its counterparties through better transaction pricing. By adding a third option not contemplated by the Exchange Act and making that option the default, the Commission would upend the specific choice Congress intended to provide non-cleared SBS counterparties and, in the case of bank and foreign SBSDs, create a false sense of protection and disputes with the FDIC and foreign resolution authorities.

d. The Commission Should Work with the FDIC and Foreign Regulators to Provide Appropriate Protections if a Bank SBSD or Foreign SBSD Clears SBS for Customers

Unlike with respect to non-cleared SBS, Congress specifically provided for omnibus segregation in the context of cleared SBS collateral and any commingled collateral.[135] Such omnibus segregation makes sense considering that most U.S. customers clears derivatives transactions through a BD or FCM (or BD-FCM), which have long been subject to an omnibus segregation regime and special insolvency treatment of customer property.

Nonetheless, for the reasons set out above, it is unlikely that omnibus segregation requirements will actually provide protection to customers of bank SBSDs and foreign SBSDs. In an analogous context, namely the treatment of a BD under the FDIC-administered orderly liquidation authority provisions of the Dodd-Frank Act, the Commission has been coordinating with the FDIC to issue a joint rule to make clear how

[135] *See* Exchange Act § 3E(c).

customer claims would be treated.[136] If bank SBSDs or foreign SBSDs ever elect to clear SBS, the Commission should take a similar approach and coordinate with the FDIC or the relevant foreign authorities to make clear the rights of cleared SBS customers in the event the SBSD is subject to liquidation proceedings.

Recommendation: A bank SBSD or foreign SBSD should only be subject to omnibus segregation requirements if it elects to clear SBS for customers (or, in the case of a foreign SBSD, U.S. customers). Before a bank SBSD or foreign SBSD makes such an election, the Commission should consult with the FDIC or the relevant foreign authorities to either (1) confirm that omnibus segregation requirements will have their desired effect under the applicable insolvency regime or (2) exempt the SBSD from omnibus segregation requirements so as to enable application of other mechanisms designed to provide equivalent customer protection under applicable insolvency laws.

If a bank SBSD or foreign SBSD does not clear SBS for customers (or, in the case of a foreign SBSD, U.S. customers), then (1) it should not be subject to omnibus segregation requirements and (2) collateral it collects for non-cleared SBS should not be subject to segregation at all unless the customer elects individual segregation at a third-party custodian pursuant to Section 3E(f) of the Exchange Act.[137] The bank SBSD or foreign SBSD should be required to offer individual segregation to a non-cleared SBS counterparty that posts IM not already subject to third-party segregation under Prudential Regulator, CFTC, or equivalent foreign margin rules. In addition, with respect to foreign SBSDs, we recommend that these individual segregation requirements solely apply to non-cleared SBS with U.S. persons.

2. The Commission Should Not Impose Omnibus Segregation Requirements on Standalone SBSDs and OTCDDs That Do Not Clear SBS for Customers

a. The Exchange Act and Insolvency Laws Applicable to a Standalone SBSD or OTCDD Do Not Support Imposition of Omnibus Segregation Requirements on Non-Cleared SBS

As noted above, Section 3E of the Exchange Act does not authorize the Commission to impose omnibus segregation requirements for non-cleared SBS collateral. It only authorizes such requirements for cleared SBS collateral. Thus, the Commission

[136] Covered [BD] Provisions Under Title II of [Dodd-Frank], 81 Fed. Reg. 10798 (Mar. 2, 2016).

[137] Consistent with our recommendations for OTCDDs and standalone SBSDs below, such a customer could alternatively elect to hold its collateral at a full-purpose BD affiliate of the bank SBSD or foreign SBSD, subject to a lien in favor of the SBSD. The customer would thus receive the protections of SEC Rule 15c3-3 and SIPA.

cannot impose omnibus segregation requirements on an SBSD that does not clear SBS for customers unless the SBSD is also a BD subject to Section 15(c)(3) of the Exchange Act.[138]

This differential treatment for cleared and non-cleared SBS collateral accords with the different ways in which customer/counterparty claims would be treated in the event of the standalone SBSD's or OTCDD's insolvency. As discussed in greater detail in **Appendix A**, if a standalone SBSD or OTCDD that is an SBSD clears SBS for customers, the SBSD would be subject to the stockbroker liquidation provisions of the Code and the customers of such SBSD would be entitled to priority "net equity" claims in respect of their cleared SBS collateral. Omnibus segregation requirements would facilitate the ability of customers of such SBSDs to recover on their claims to cleared SBS collateral in the event of such a liquidation because such requirements ensure that there is sufficient customer property to satisfy the net equity claims.

By contrast, if a standalone SBSD or OTCDD that is an SBSD does not clear SBS for customers, its non-cleared SBS counterparties should not be "customers" for purposes of the stockbroker liquidation provisions of the Code because (1) such counterparties are not "customers" except to the extent of margin posted subject to customer protection or segregation requirements[139] and (2) the Commission is not authorized to adopt any such requirements for an SBSD that does not clear SBS for customers. Instead of stockbroker liquidation provisions, regular Code proceedings would apply to such a registrant. In that instance, the counterparty's claim for performance on the transactions would be treated in the same way as a claim of an OTCDD's counterparty is currently treated in the event of the OTCDD's insolvency: To the extent the counterparty has collected margin, it can apply that margin to the SBSD's obligations under the Code's "swap agreement" safe harbors.[140] To the extent it does not have such collateral, it will be an unsecured creditor.

When counterparties post IM for non-cleared SBS, in lieu of protecting that IM through omnibus segregation, Congress gave counterparties the option to elect whether to make the IM bankruptcy remote through segregation at a third-party custodian.

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[138] Although OTCDDs are BDs, the Commission has exempted them from SIPA and the application of SEC Rule 15c3-3 in order to ensure that OTC derivatives counterparties of OTCDDs are able to terminate the derivatives and exercise remedies against collateral in the event of the OTCDD's insolvency. *See* OTC Derivatives Dealers, 63 Fed. Reg. 59362, 59367 (Nov. 3, 1998); 17 C.F.R. § 240.15c3-3(a)(1).

[139] We view Exchange Act Section 3E(g)'s reference to a customer protection or segregation requirement as intended to allow portfolio margining by providing that, if a customer of an SBSD portfolio margins non-cleared SBS with cleared SBS, the customer will be able to recover the collateral it posts in respect of the non-cleared SBS in the same way it would recover its cleared SBS collateral. Without such a provision, it would effectively be impossible for standalone SBSDs to portfolio margin cleared and non-cleared SBS since the claims for the return of commingled collateral would be subject to different and conflicting regimes.

[140] *See* 11 U.S.C. § 362(b)(17).

Dodd-Frank requires SBSDs not only to segregate counterparty IM upon a request, but also to alert counterparties that segregation is an option.

As discussed above, segregation is a well-established mechanism that market participants use in different jurisdictions for a variety of transaction types. If the counterparty elects segregation, it will ensure that its IM is locked up and insulated from the claims of the SBSD's other creditors. To the extent the counterparty allows the standalone SBSD or OTCDD that is an SBSD to on-transfer the collateral, it may receive a price reduction because it would facilitate the ability of the SBSD to hedge its exposure. Recognizing this, Congress gave counterparties a choice and did not require segregation.

Were the Commission to impose omnibus segregation requirements on non-cleared SBS collateral when that collateral is not commingled with cleared SBS collateral, it would fundamentally upend the interconnected arrangement that Congress set out in Dodd-Frank. It would also confuse the clear choice that Congress gave to counterparties with a default option that Congress neither intended nor authorized.

If the Commission nonetheless wants to ensure that non-cleared SBS counterparties can have their collateral protected through segregation by a Commission registrant, a more appropriate way to do so, consistent with the statute, would be to require a standalone SBSD or OTCDD to offer custody of IM at a full-purpose BD affiliate. In this case, the IM would be protected by SEC Rule 15c3-3 and SIPA, subject to a lien in favor of the SBSD or OTCDD.

b. The Nature of a Standalone SBSD's or OTCDD's Relationship with its Non-Cleared SBS Counterparties Does Not Justify Imposition of Omnibus Segregation Requirements

As Congress recognized in creating the arrangements discussed above, omnibus segregation requirements are not necessary or appropriate when an SBSD's SBS and swaps business is limited to entering into non-cleared SBS and swaps with counterparties. This is because the relationship between a standalone SBSD or OTCDD to its counterparty is substantially less complex than that of a full-purpose BD to a customer. Full-purpose BDs' relationships with their customers are multifaceted. The full-purpose BD serves as custodian of customer's assets, clearing member for the customer's positions, a source of financing and a counterparty. The formulas of SEC Rule 15c3-3 are designed to address these various activities through a system of debits and credits that allow for the aggregation and netting of the customer's positions.

The role of a standalone SBSD or OTCDD is, by contrast, much more limited. The dealer, in its proprietary capacity, enters into SBS and, in the case of a OTCDD, OTC securities options transactions with the counterparty. All of its counterparties to these transactions are institutional; unlike with a full-purpose BD, retail customers are not permitted.[141] In connection with those transactions, the SBSD or OTCDD collects margin to the extent required and determined by the SBSD or OTCDD to be commercially appropriate. The SBSD or OTCDD may likewise need to post margin to the counterparty, either because such margin is required by rule or regulation or because the counterparty requires such margin for commercial purposes. In either case, the only exposures of the counterparty to the dealer are (1) for the return of margin and (2) for the performance on the transactions.

The relationship between a standalone SBSD or OTCDD and a counterparty is much more akin to the relationship of a bank SBSD or foreign SBSD with a counterparty. If the Commission follows our recommendation above not to apply omnibus segregation to bank SBSDs or foreign SBSDs unless they elect to clear SBS, it should take the same approach to standalone SBSDs and OTCDDs so as to avoid the market confusion that would result from applying differential customer protection rules to market participants that provide practically identical services.

c. Omnibus Segregation Requirements Would Impair Hedging and Funding Activities of Standalone SBSDs and OTCDDs

We are concerned that the proposed omnibus segregation requirements would have an adverse impact on the ability for a standalone SBSD or OTCDD to hedge and fund its business. In particular, the exception to the definition of "excess securities collateral" for hedging activity by an SBSD and the parallel debit item in the proposed reserve formula are unduly narrow in that they solely envision hedging of non-cleared SBS transactions on a back-to-back basis with other non-cleared SBS transactions. In reality, however, dealers hedge their SBS activity through a variety of means, including cash market securities positions, cleared and non-cleared SBS and swaps, options, and futures.

Failure to recognize these other hedging strategies would create undue regulatory incentives to transact using one type of instrument versus another. We illustrated this issue in the examples below, by comparing economically equivalent transactions entered into by a standalone SBSD under proposed SEC Rule 18a-4:

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141 Under the Exchange Act, all non-cleared SBS counterparties are required to be eligible contract participants.

Transaction 1: Synthetic Non-Cleared Short Position, Hedged with Short Sale

- Customer synthetically shorts stock XYZ by entering into a short non-cleared SBS, with a notional amount of $100, with SBSD.
- Customer posts $15 in cash IM.
- SBSD shorts the underlying stock to hedge the SBS, borrowing $100 of the stock to deliver on the short sale and posting $102 of cash collateral to the stock lender.

Reserve account calculation:

Debits	Credits
	$15 cash IM (item 1)

Because the $102 cash collateral for the stock loan is not a debit in the reserve account calculation, the SBSD is required to use its own $2 (plus $100 of the short proceeds) to post collateral to borrow the stock necessary to execute its hedge.

Transaction 2: Synthetic Non-Cleared Short Position, Hedged with Non-Cleared SBS

- Customer synthetically shorts stock XYZ by entering into a short non-cleared SBS with a notional amount of $100, with SBSD.
- Customer posts $15 IM.
- SBSD enters into an offsetting non-cleared SBS with a bank SBSD to hedge the SBS and posts the IM to a qualified third-party custodial account.

Reserve account calculation:

Debits	Credits
$15 IM posted by SBSD (item 16 (BD-SBSD) or item 14 (standalone SBSD))	$15 cash IM (item 1)

Because the $15 of customer IM is re-hypothecated by the SBSD to post as IM to a qualified account, the SBSD is not required to use its own cash to execute the hedge.

Note: As comparing these examples illustrates, the Proposed Rules would discourage hedging in the cash markets in favor of hedging in the non-cleared SBS markets.

Transaction 3: Short Non-Cleared CDS Position, Hedged with Cleared CDS

- Customer sells CDS protection via a non-cleared SBS with a notional amount of $100.
- Customer posts $15 IM.
- SBSD enters into offsetting cleared CDS to hedge the SBS and posts $15 IM to the clearing agency. Because SBSD enters into the position in a proprietary capacity, the IM is maintained in the SBSD's proprietary account at the clearing agency rather than a qualified clearing agency account.

Reserve account calculation:

Debits	Credits
	$15 cash IM (item 1)

Because the $15 IM for the cleared CDS hedge is not a debit in the reserve account calculation, the SBSD is required to use its own $15 to meet the clearing agency IM requirements necessary to execute the hedge.

Transaction 4: Short Non-Cleared CDS Position, Hedged with Non-Cleared CDS

- Customer sells CDS protection via a non-cleared SBS with a notional amount of $100.
- Customer posts $15 IM.
- SBSD enters into an offsetting non-cleared CDS with a bank SBSD to hedge the SBS and posts the IM to a qualified third-party custodial account.

Reserve account calculation:

Debits	Credits
$15 IM posted by SBSD (item 16 (BD-SBSD) or item 14 (standalone SBSD))	$15 cash IM (item 1)

Because the $15 of customer IM is re-hypothecated by the SBSD to post as IM to a qualified account, the SBSD is not required to use its own cash to execute the hedge.

Note: As comparing these examples illustrates, the Proposed Rules would discourage hedging in the cleared SBS markets in favor of hedging in the non-cleared SBS markets.

In addition, even if one modified proposed SEC Rule 18a-4's definition of "excess securities collateral" and parallel debits in its reserve formula to address these discrepancies, it would be impossible to address all of the relevant hedging strategies as exceptions to omnibus segregation requirements.

And, even if one could fulfill both of these tasks, requiring that the IM re-hypothecated by an SBSD be held in a separate account from IM it has posted to support its other principal positions would often not be feasible since the relevant custodial arrangements and associated margin requirements do not distinguish positions held to hedge customer-related transactions from other principal positions.

The likely practical consequence of all of these challenges is that omnibus segregation requirements would effectively prevent an SBSD from reusing its non-cleared SBS customers' IM to fund its hedging activities, thus putting a strain on the liquidity of the SBSD.

Recommendation: Based on these considerations, we recommend that segregation requirements apply to a nonbank SBSD that is a standalone SBSD or OTCDD as follows:

Cleared SBS Collateral	Non-Cleared SBS Collateral
Omnibus segregation should apply if the SBSD elects to clear SBS for customers	Omnibus segregation should only apply if (1) the SBSD elects to clear SBS for customers and (2) the SBSD commingles the collateral for non-cleared SBS with cleared SBS collateral Other collateral posted in connection with non-cleared SBS should not be subject to mandatory segregation at all Counterparty may elect individual segregation of IM under Section 3E(f) of the Exchange Act or segregation at a full-purpose BD affiliate of the SBSD

In order to ensure that the counterparty understands its rights, a standalone SBSD or OTCDD should be required to provide the counterparty with a prominent written notice similar to that currently required to be delivered by OTCDDs.[142] That notice should state that, unless the counterparty elects segregation pursuant to Section 3E(f) of the Exchange Act or custody at a full-purpose BD affiliate of the SBSD or OTCDD and except as may otherwise agree between the SBSD or OTCDD and the counterparty: (1) the SBSD or OTCDD may repledge or otherwise use the counterparty's collateral in its business; (2) in the event of the SBSD's or OTCDD's failure, the counterparty will likely be considered an unsecured creditor of the SBSD or OTCDD as to that collateral; (3) SIPA and the stockbroker liquidation provisions of the Code do not protect the counterparty; and (4) the collateral will not be subject to the requirements of § 240.18a-4 or, for an OTCDD, § 240.8c-1, § 240.15c2-1, or § 240.15c3-3. Additionally, because many standalone SBSDs and OTCDDs are unlikely to clear SBS, the Commission should make clear that omnibus segregation requirements will only apply in the manner described above if a standalone SBSD or OTCDD affirmatively elects to clear SBS for customers.

[142] *See* 17 C.F.R. § 240.15c3-3(a)(1).

3. The Commission Should Impose Omnibus Segregation Requirements on Full-Purpose BDs, but Integrate Those Requirements into SEC Rule 15c3-3

The Proposed Rules' omnibus segregation requirements for SBS are based heavily on existing SEC Rule 15c3-3. However, rather than amend SEC Rule 15c3-3 to incorporate provisions related to SBS, the Proposed Rules set out an entirely independent provision, SEC Rule 18a-4.[143] This rule would apply to both BD-SBSDs and standalone SBSDs and contain its own possession and control and reserve account calculations, which calculations would not interact with the analogous equations in SEC Rule 15c3-3.

The October 2018 Release requests comment on whether the Commission should amend SEC Rule 15c3-3 to add a new paragraph (p) and a new Exhibit B that would contain segregation requirements that parallel those in proposed SEC Rule 18a-4. The reason for this amendment would be to permit BDs that engage in SBS but are not SBSDs to calculate segregation requirements that are tailored to SBS and to locate in SEC Rule 15c3-3 the SBS segregation requirements for BD-SBSDs.

We agree the Commission should amend existing SEC Rule 15c3-3 in order to incorporate into it the Commission's segregation requirements related to SBS. However, it will not be sufficient for the Commission simply to replicate SEC Rule 18a-4 in SEC Rule 15c3-3 as new paragraph (p) and Exhibit B. Requiring separate possession and control and reserve account calculations for SBS, on the one hand, and other securities positions, on the other hand, will raise serious issues.

First, requiring separate calculations will effectively prevent portfolio margining. If the calculations are separate, BD-SBSDs looking to portfolio margin SBS with cash market securities, OTC securities options and listed securities options positions will face the near impossibility of untangling otherwise commingled credits and debits to allocate them to two different possession and control and reserve account calculations. For example, if a customer has posted $50 million of cash IM to a BD-SBSD for a combined portfolio of SBS, margin loans, short positions, OTC securities options, and listed securities options, how will the BD-SBSD know which portion of that $50 million to credit to the existing reserve formula versus the new SBS formula? If the BD-SBSD has posted $50 million of cash IM in connection with a non-cleared SBS entered into to hedge the overall exposure of the customer portfolio, how will it know which portion of that $50 million to debit the existing reserve formula versus the new SBS formula?

Moreover, requiring separate calculations could harm customers by fostering legal uncertainty in a liquidation under SIPA. As discussed in **<u>Appendix</u> <u>A</u>**, "customer" status under SIPA arises when a counterparty's cash and securities margin are maintained in a portfolio margined "securities account." Separate calculations could suggest separate

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143 October 2018 Release, 83 Fed. Reg. at 53016.

securities and SBS accounts, thus raising questions regarding the application of SIPA to claims relating to SBS.

To address these issues, the Commission should instead fully integrate the requirements of SEC Rule 18a-4 into SEC Rule 15c3-3 in a way that creates a single possession and control calculation and a single reserve account calculation for both SBS and cash market securities and listed and OTC securities options positions, on a fully integrated basis.

Recommendation: The Commission should apply the omnibus segregation requirements of SEC Rule 15c3-3 to SBS and related collateral maintained at a full-purpose BD-SBSD, but use a single possession and control calculation and single reserve account calculation for all securities positions, including SBS, and positions portfolio margined with these positions.

4. The Commission Should Engage with Affected Parties to Resolve Technical Questions Regarding Omnibus Segregation Requirements Before Finalizing Them

In our comments on the 2012 Proposal, we raised a series of technical questions regarding the proposed omnibus segregation requirements. Several of those questions remain relevant today. For example, the treatment of VM posted by an SBSD remains unclear. So does the treatment of a situation when a customer posts a combination of cash and securities collateral. Some of these questions were also recently discussed with Commission and FINRA staff in connection with FINRA's proposed margin rules for to-be-announced transactions in agency securities. Resolving these questions is a critical prerequisite to finalizing the Proposed Rules.

To help resolve these questions, we intend in the future to provide the Commission with detailed recommendations for how it should amend SEC Rule 15c3-3 to incorporate SBS directly into the rule's possession and control requirements (including related definitions) and customer reserve formula and PAB formula.

III. Substituted Compliance

The 2013 Proposal would allow foreign nonbank SBSDs to satisfy the Commission's capital and margin requirements through substituted compliance. In order for such substituted compliance to be available, the Commission would, among other things, need to make a determination that the foreign nonbank SBSD's home country capital and margin requirements are comparable to the Commission's requirements.[144]

[144] 2013 Proposal, 78 Fed. Reg. at 31207-08.

The October 2018 Release requests comment on whether the potential modifications to the Proposed Rules set out in the October 2018 Release would affect the Commission's substituted compliance determinations. It additionally asks what factors the Commission should consider in making substituted compliance determinations with respect to the Commission's capital requirements and, in particular, if the Commission should consider whether the foreign nonbank SBSD's home country capital requirements are designed to help ensure the safety and soundness of registrants in a manner that is comparable to the Commission's proposed nonbank SBSD capital requirements. In this regard, the October 2018 Release asks whether the Commission should include as a condition of a substituted compliance determination that a foreign nonbank SBSD maintain liquid assets in excess of its unsubordinated liabilities.[145]

Many of the modifications to the Proposed Rules on which the October 2018 Release requests comment would facilitate the ability of the Commission to make substituted compliance determinations. Foreign authorities' capital and margin requirements are, like those of the Prudential Regulators' rules, generally based on the Basel Committee's capital standards and the WGMR framework, respectively. As a result, to the extent the Commission enhances the risk-sensitivity of its capital requirements and aligns its margin rules with the WGMR framework, it will make it easier for both the Commission to make substituted compliance determinations in respect of foreign nonbank SBSDs and for foreign authorities to make equivalent determinations in respect of U.S. nonbank SBSDs. For the reasons discussed above, the modifications set forth in the October 2018 Release are important strides in both these respects. However, as also discussed above, the Commission should take additional steps to align its capital and margin rules with the risk-based capital rules of other regulators as well as with the WGMR framework.

One of the areas where the Commission's capital requirements depart most dramatically from those of foreign regulators and the Prudential Regulators is the actual capital ratio itself. As discussed above, the Proposed Rules would require nonbank SBSDs to satisfy a net liquid assets test that is similar to that imposed on BDs under existing SEC Rule 15c3-1. U.S. banks, including bank SBSDs, and foreign banks and securities firms, by contrast, are generally subject to local implementations of the Basel Committee's risk-based capital standards, which focus less on liquidity and more on the equity of the firm relative to its risk-weighted assets.

In the 2013 Proposal, the Commission explained the reason it subjects BDs to a net liquid asset test, rather than a risk-based capital test, and why it proposed the same approach for nonbank SBSDs. The different rules, the Commission noted, are on account of the "operational, policy, and legal differences between" nonbank and bank firms.[146] Specifically, BDs and other nonbank entities have a different funding model and access to

[145] October 2018 Release, 83 Fed. Reg. at 53016.

[146] 2012 Proposal, 78 Fed. Reg. at 31001.

different kinds of financial support. For instance, banks are able to obtain funding through customer deposits and can generally obtain liquidity through the Federal Reserve's discount window. These sources of liquidity are not available to broker-dealers or other U.S. nonbank SBSDs. Such firms must therefore maintain sufficient liquid assets to meet customer outflows. On the expectation that the same differences between U.S. bank and nonbank entities would exist in foreign jurisdictions, the Commission proposed in the 2013 Proposal that it likewise apply a net liquid asset test to foreign nonbank SBSDs. A similar rationale appears to undergird the October 2018 Proposal's question regarding the requirements for substituted compliance.

Following the 2008 financial crisis, global authorities found that mere access to discount windows was insufficient to ensure that banks and other financial firms had sufficient liquidity to meet all outflows. The Basel Committee therefore supplemented its risk-based capital requirements with the liquidity coverage ratio (the "**LCR**"), which local authorities either have fully implemented or are in the process of adopting.[147] The LCR requires firms to maintain sufficient liquid assets to meet outflows over a 30-day stress scenario and thus serves much the same purpose of the Commission's net liquid assets test.[148]

Additionally, the liquidity differences between nonbank and bank financial services firms are not as profound in many non-U.S. jurisdictions as they are in the U.S. For example, a number of jurisdictions allow large nonbank financial services firms to access discount window and similar facilities. Many jurisdictions also treat such firms similarly to banks for resolution purposes by allowing them to enter into proceedings under special resolution regimes with liquidity backstops.

Considering that many foreign nonbank SBSDs are subject to liquidity requirements and share more similarities with banks than U.S. nonbank firms share with depository institutions, requiring foreign nonbank SBSDs to satisfy a net liquid assets requirement will principally serve to impose unfair costs and an unfamiliar administrative burden, with little concomitant policy benefits. Accordingly, the Commission should not establish such a test as a condition for substituted compliance, but instead permit foreign nonbank SBSDs to rely on substituted compliance if such firms are subject to Basel-like capital and LCR standards.

Recommendation: The Commission should not condition substituted compliance on a foreign nonbank SBSD satisfying a net liquid assets test, but should allow a foreign nonbank SBSD to substitute compliance with Basel-like capital and LCR standards.

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147 We also note that local authorities in the major financial jurisdictions have adopted a number of other market regulations applicable to SBS, including margin, business conduct, and reporting requirements.

148 Basel Committee, Basel III: The [LCR] and Liquidity Risk Monitoring Tools, January 2013.

IV. Compliance Dates

When the Commission finalized it rules concerning the registration process for SBSDs and MSBSPs, it provided that the compliance date (the "**Registration Compliance Date**") for its registration requirements would be the later of: (1) six months after the publication in the Federal Register of the Commission's final capital, margin, and segregation requirements for SBSDs and MSBSPs; (2) the compliance date of the Commission's final rules establishing recordkeeping and reporting requirements for SBSDs and MSBSPs; (3) the compliance date of the Commission's final rules establishing business conduct requirements under Sections 15F(h) and 15F(k) of the Exchange Act; or (4) the compliance date of the Commission's final rules establishing a process for a registered SBSD or MSBSP to make an application to the Commission to allow an associated person who is subject to a statutory disqualification to effect or be involved in effecting SBS on the SBSD or MSBSP's behalf.[149]

The October 2018 Release requests comment on whether this approach provides enough time for SBSDs and MSBSPs to come into compliance with the relevant requirements.[150] Additionally, it asks whether 18 months after the publication of the last of the four preceding releases (the "**Core SBS Releases**") would be more appropriate.[151] Lastly, the October 2018 Release asks whether the Commission should consider the timing of the phased implementation of the IM requirements provided for by other regulators in making any changes to the compliance period.[152]

Implementing the Commission's SBSD regulatory framework will be a time-consuming exercise for both market participants and the Commission. Nonbank SBSDs will need time to adjust their balance sheets to comply with the Commission's capital requirements, work with counterparties to document the Commission's margin requirements, and develop the systems and procedures to ensure compliance and proper reporting. Nonbank SBSDs will also need to create and submit applications for new VaR models for capital purposes as well as the SIMM for IM amounts. Even if the Commission permits nonbank SBSDs to use models approved by other regulators or SROs, it will still require substantial time to assess new models that other authorities have not previously approved.[153]

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149 *See* Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, Release No. 34-75611 (Aug. 5, 2015), 80 Fed. Reg. 48963 (Aug. 14, 2015).

150 October 2018 Release, 83 Fed. Reg. at 53019.

151 *Id.*

152 *Id.*

153 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

Additionally, foreign SBSDs and foreign authorities will need time to submit, and the Commission will need time to review, substituted compliance applications. Although SEC Rule 15Fb2-4(c) already sets out a procedure for substituted compliance applications, that procedure mandates that foreign SBSDs submit a certification and opinion regarding Commission access to books and records. Foreign SBSDs will not be able to provide such certifications and opinions without relief or clarification from the Commission.[154] The Commission should therefore extend the Registration Compliance Date as described in the October 2018 Release and further defer the compliance date of the relevant requirements until after the Commission has made the related substituted compliance determinations.

Moreover, to ensure that nonbank SBSDs are not kept out of the SBS markets during the pendency of the Commissions' review of any models, the effective date of the Commission's capital requirements should only be the Registration Compliance Date if the Commission adopts our recommendation above to allow nonbank SBSDs to use models approved by other regulators or SROs. If it does not, the Commission's capital and margin requirements should not become effective until after a sufficient time for the Commission to approve all VaR and IM model applications.

Lastly, in order to avoid placing nonbank SBSDs at a competitive disadvantage relative to bank SBSDs and foreign SBSDs, the Commission should phase in its IM requirements according to the same timeline as the Prudential Regulators, the CFTC and relevant foreign regulators have phased in their IM requirements. Under those timelines, IM requirements will come into effect on September 1, 2019 for transactions with counterparties that have an aggregate notional amount of non-cleared swaps, SBS and other derivative transactions of greater than $750/€750 million and on September 1, 2020 for all other counterparties. If the Registration Compliance Date falls before September 1, 2020 (or to the extent the WGMR timeline is extended, the latest WGMR IM compliance date), then the Commission should phase in its IM requirements in a manner consistent with the remaining phases of the WGMR timeline.

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consolidated risk management program as the affiliate for whom the model was previously approved.

154 *See* SIFMA and the Institute of International Bankers, "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.*

Recommended Compliance Schedule	
Registration Compliance Date	18 months after the later of (a) the publication of the Core SBS Releases or (b) the completion of all relevant substituted compliance determinations
SBSD Capital Requirements	The Registration Compliance Date, provided the Commission allows nonbank SBSDs to use VaR models approved by other regulators or SROs; otherwise, after the Commission has made all relevant VaR model approvals
VM Requirements	The Registration Compliance Date
IM Requirements	If the Registration Compliance Date falls after the latest IM compliance date under the WGMR timeline (currently September 1, 2020) and the Commission allows nonbank SBSDs to use IM models approved by other regulators or SROs, the Registration Compliance Date. If the Registration Compliance Date falls before that latest IM compliance date, then the Commission should phase in its IM requirements in a manner consistent with the WGMR timeline, including to the extent that timeline is subsequently modified. If the Commission requires separate IM model approval, then IM requirements should not apply until after the Commission has made all relevant IM model approvals.

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We would be pleased to provide further information or assistance at the request of the Commission or its staff. Please do not hesitate to contact Kyle Brandon [redacted] or Mary Kay Scucci [redacted]) if you should have any questions with regard to the foregoing.

Respectfully Submitted,

Kenneth E. Bentsen, Jr.
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Appendix A:
<u>Treatment of SBS and Swaps in Liquidation Proceedings for Nonbank SBSDs</u>

The analysis below informs our recommendations regarding portfolio margining and segregation, as set forth in parts II.H and II.J, respectively.

<u>Nonbank SBSD Dually Registered as a Full-Purpose BD</u>[155]

<u>Positions Held in a Securities Account</u>

Registered BDs are generally required to be members of the Securities Investor Protection Corporation ("**SIPC**"), [156] and SIPC members are generally subject to liquidation proceedings under SIPA, not the Code. SIPA provides for the priority distribution of a BD's "**customer property**" ratably to "**customers**" on the basis and to the extent of their allowed "**net equity**" claims. Accordingly, the treatment of an SBS or swap counterparty or customer of a BD-SBSD under SIPA depends on whether such counterparty or customer qualifies as a "customer," maintains "customer property" with the BD-SBSD, and has a "net equity" claim against the BD-SBSD:

> ***"Customer."*** SIPA defines a "customer" as including "any person . . . who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral, security, or for purposes of effecting transfer."[157] The definition further includes "any person who has a claim against the debtor for cash [or] securities . . . received, acquired, or held in a portfolio margining account carried as a securities account pursuant to a portfolio margining program approved by the Commission."[158]
>
> ***"Customer Property."*** SIPA defines "customer property" as including "cash and securities . . . at any time received, acquired, or held by

155 We note that the following analysis would also apply to a full-purpose BD that is not registered as an SBSD. In addition, if a full-purpose BD received securities or cash from the counterparty to an affiliated OTCDD or standalone SBSD and held such securities or cash in a securities account, then that counterparty should be considered a "customer" of the BD under the SIPA definition discussed below and such securities and cash should constitute "customer property."

156 *See* 15 U.S.C. § 78ccc(2). As noted below, an OTCDD is exempt from this requirement.

157 15 U.S.C. § 78lll(2)(A).

158 15 U.S.C. § 78lll(2)(B)(ii).

or for the account of a debtor from or for the securities accounts of a customer."[159]

"Net Equity." SIPA defines "net equity" to mean, in relevant part, the "dollar amount of the account or accounts of a customer."

SIPA does not, however, define a "security" to include an SBS.[160] Nor is a swap considered a "security" under SIPA. Therefore, if an SBS or swap counterparty or customer merely had a claim against a BD-SBSD on account of an open SBS or swap position, that person would not be entitled to treatment as a "customer" under SIPA. Nor would such a person be entitled to "customer" treatment if such person had provided cash or securities to the BD-SBSD as collateral for SBS or swaps under an arrangement permitting the BD-SBSD to make free use of such cash or securities,[161] or any arrangement pursuant to which such cash or securities are held by the counterparty's third-party custodian and not received, acquired, or held by the BD-SBSD.

In contrast, if an SBS or swap counterparty or customer provides a BD-SBSD with cash or securities collateral that the BD-SBSD receives or holds in its securities account for the person pursuant to a Commission-approved portfolio margining program, then the person would be a "customer" under SIPA. That cash or securities would also be "customer property." The person will have a "net equity" claim on account of that cash or securities, since that cash or securities will flow into the dollar value of the person's securities account with the BD-SBSD.[162]

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159 15 U.S.C. § 78lll(4).

160 In this regard, SIPA treats SBS in a different manner from the Exchange Act, of which SIPA otherwise is a part, and the Code, which SIPA otherwise incorporates by reference. However, the provisions of the Exchange Act do not apply to SIPA to the extent "otherwise provided" in SIPA. 15 U.S.C. § 78bbb. Similarly, the Code applies to liquidation proceedings under SIPA only "[t]o the extent consistent with the provisions of" SIPA. 15 U.S.C. § 78fff(b).

161 *Cf. In re Lehman Bros., Inc.*, 791 F.3d 277 (2nd Cir. 2015) (finding that a counterparty to a repurchase agreement with a BD was not a "customer" under SIPA where such counterparty did not entrust the purchased securities to the BD).

162 Unlike positions in non-SBS securities and commodity futures and options thereon—whose contribution to a customer's net equity claim is factored in as though the debtor liquidated those positions on the filing date—SIPA's "net equity" definition does not address how the liquidation of open positions in SBS or swaps are to factor into the "net equity" calculation. The Commission might consider exercising its authority pursuant to Section 3(e)(3) of SIPA to direct SIPC to adopt a rule clarifying similar treatment of SBS or swaps held in a portfolio margining account carried as a securities account.

Positions Held in a Swap Account

A person is not considered a "customer" under SIPA if the person has a claim for cash or securities which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor, or is subordinated to the claims of any or all creditors of the debtor.[163] Accordingly, if an SBS customer or counterparty agrees to subordinate its claims against a BD-SBSD regarding its SBS and related collateral to the claims of the BD-SBSD's customers, then it would not be treated as a customer.[164]

If the SBS customer or counterparty then elects to portfolio margin its SBS in a swaps account, the treatment of such SBS would depend on whether they are cleared or not. If the SBS are cleared, and thus portfolio margined with cleared swaps, then the BD-SBSD would also be a registered FCM[165] and thus be subject to liquidation under the Code's commodity broker liquidation provisions and the CFTC's Part 190 rules thereunder. Like SIPA, the Code's commodity broker liquidation provisions provide the FCM's customers with priority claims to customer property in respect of the customer's "commodity contracts" and associated margin carried by the FCM.[166] The definition of "commodity contracts" includes not only futures positions, but also any contracts that are cleared at a CFTC-registered derivatives clearing organization.[167] As a result, if an FCM carries SBS cleared at a derivatives clearing organization for a customer and portfolio margins such SBS with cleared swaps, the customer's claims in respect of such SBS would be treated the same as, and aggregated and netted with, the customer's claims for the related swaps. Indeed, it is under this framework that BD-FCMs portfolio margin cleared single-name CDS with cleared CDS subject to the CFTC's jurisdiction.

If the SBS are non-cleared, and thus portfolio margined with non-cleared swaps, then no special customer property distribution regime would apply, regardless of whether the BD-SBSD was also registered as an FCM or SD. The reason is that non-cleared swaps are not treated as "commodity contracts" under the commodity broker liquidation provisions of the Code. Nor is there any other customer property distribution regime for swaps. Thus a non-cleared swap counterparty is solely an unsecured creditor. However, non-cleared swap counterparties are able to insulate their IM from the claims of other

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163 15 U.S.C. § 78lll(2)(C)(ii).

164 *See, also* Interpretation Rule 15c3-3(a)(1) /021 Non-Conforming Subordination Agreements for Customer Account Exclusion.

165 *See* 7 U.S.C. § 6d(f)(1) (requirement to register as an FCM in order to accept margin for cleared swaps).

166 *See* 11 U.S.C. § 766(h).

167 *See* 11 U.S.C. § 761(4)(f)(ii).

unsecured creditors of an SD by electing to segregate such IM at an independent third-party custodian. Non-cleared SBS counterparties can do the same thing.

<u>Nonbank SBSD that is Dually Registered as an OTCDD or is a Standalone SBSD</u>

<u>Positions Held in a Securities Account</u>

SIPA does not require a standalone SBSD to become a member of SIPC, and thus SIPA would not govern the liquidation of a standalone SBSD. In addition, although an OTCDD is registered as a BD, it is exempt from SIPA.[168] Accordingly, the liquidation of a standalone SBSD or a nonbank SBSD that is dually registered as an OTCDD would be governed by the Code.

Dodd-Frank added Section 3E(g) to the Exchange Act, which clarifies the treatment of cleared and non-cleared SBS and non-cleared securities options under the stockbroker liquidation provisions of the Code. In particular, Section 3E(g) provides that an SBS is a "**security**" for purposes of Section 101(53A)(B) and subchapter III of chapter 7 the Code. The effect of this treatment is to make a standalone SBSD or a nonbank SBSD that is dually registered as an OTCDD eligible for liquidation under the stockbroker liquidation provisions of the Code.[169] Similar to SIPA, the stockbroker liquidation provisions of the Code provide that the trustee of an insolvent stockbroker is required to distribute "**customer property**" of the stockbroker ratably to "**customers**" on the basis and to the extent of their allowed "**net equity**" claims.[170] Accordingly, the treatment of an SBS or swap counterparty or customer of a standalone SBSD or SBSD that is dually registered as an OTCDD under the Code depends on whether such counterparty or customer qualifies as a "customer," maintains "customer property" with the SBSD, and has a "net equity" claim against the SBSD:

> ***"Customer."*** The Code defines a "customer" as including an "entity with whom a person deals as principal or agent and that has a claim against such person on account of a security received, acquired, or held by such person in the ordinary course of such person's business as a stockbroker, from or for the securities account or accounts of such entity . . . for safekeeping[,] with a view to sale[,] to cover a consummated sale[,]

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168 17 C.F.R. § 240.36a1-2.

169 Section 101 of the Code defines a "stockbroker" as any person with respect to which there is a customer and that is engaged in the business of effecting transactions in securities, including SBS, either for the account of others or with members of the general public, from or for such person's own account. 11 U.S.C. § 101(53A).

170 *See* 11 U.S.C. § 752(a).

> pursuant to a purchase[,] as collateral under a security agreement[,] or for purposes of effecting registration of transfer."[171]
>
> ***"Customer Property."*** The Code defines "customer property" as including "cash, security, or other property, and proceeds of such cash, securities, or property, received, acquired, or held by or for the account of the debtor, from or for the securities account of a customer."[172]
>
> ***"Net Equity."*** The Code defines "net equity" to mean, in relevant part, "with respect to all accounts of a customer that such customer has in the same capacity . . . the aggregate dollar balance that would remain in such accounts after the liquidation, by sale or purchase, at the time of the filing of the petition, of all securities positions in such accounts . . . minus . . . any claim of the debtor against such customer in such capacity that would have been owing immediately after such liquidation."[173]

Because Section 3E(g) of the Exchange Act defines an SBS as a "security" for purposes of these provisions, a person carrying a cleared SBS with a standalone SBSD[174] would be treated as a "customer" under the stockbroker liquidation provisions of the Code, the person's SBS positions and related collateral would be treated as "customer property," and the person would have a "net equity" claim on account of the liquidation value of those SBS positions and related collateral. We also note that collateral provided to a standalone SBSD by a customer for the customer's cleared SBS would be subject to segregation pursuant to Sections 3E(b) through (e) of the Exchange Act.

With respect to non-cleared SBS, however, the analysis is different. Section 3E(g) of the Exchange Act provides that the term "customer" for purposes of the stockbroker liquidation provisions of the Code "excludes any person, to the extent that such person has a claim based on any open . . . non-cleared [SBS] except to the extent of any margin delivered to or by the customer with respect to which there is a customer protection requirement under Section 15(c)(3) of [the Exchange Act] or a segregation requirement."[175]

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171 11 U.S.C. § 741(2). Section 3E(g) of the Exchange Act also clarifies that an account that holds an SBS, other than a portfolio margining account referred to in Section 15(c)(3)(C) of the Exchange Act (*i.e.*, a futures account), shall be considered a securities account.

172 11 U.S.C. § 741(4).

173 11 U.S.C. § 741(6).

174 Rule 15a-1 under the Exchange Act would generally prevent an OTCDD from carrying cleared SBS positions for customers.

175 Because Section 3E(g) of the Exchange Act applies the same treatment to a non-cleared securities option counterparty, the following analysis would also apply to such counterparties when trading with an OTCDD.

Accordingly, if the SBSD clears SBS, it would be subject to the stockbroker liquidation provisions of the Code because it would have "customers", and any non-cleared SBS collateral commingled with cleared SBS collateral would give rise to a priority "net equity" claim. If, however, the SBSD's activities are limited to non-cleared SBS, it would not have "customers" since (a) a counterparty's claim under the non-cleared SBS is not a customer claim, (b) a counterparty's claim for margin is only a customer claim if the margin is subject to a segregation requirement and (c) Section 3E does not permit the imposition of segregation requirements on non-cleared SBS collateral unless such collateral is commingled with cleared SBS collateral.

So, as described in part II.J.2 above, we recommend that the Commission (1) retain the existing exception from Rule 15c3-3 under the Exchange Act for OTCDDs and (2) provide that (a) an SBSD that is not a full-purpose BD is not subject to segregation requirements unless it is clearing SBS for customers and (b) such requirements do not apply to collateral delivered to the SBSD for non-cleared SBS unless commingled with collateral for cleared SBS. Under this approach, a non-cleared SBS counterparty to a standalone SBSD or SBSD dually registered as an OTCDD would not be a customer for purposes of the stockbroker liquidation provisions of the Code unless the counterparty is also clearing SBS through the SBSD and has commingled its collateral for non-cleared SBS with its collateral for cleared SBS.

In addition, if a non-cleared SBS counterparty elected individual segregation of its IM at a third-party custodian pursuant to Section 3E(g) of the Exchange Act, such counterparty would not be a "customer" with respect to that IM because the IM would not be received, acquired, or held by the SBSD.[176]

Finally, the treatment of swaps or related collateral held by an SBSD under a portfolio margining arrangement would depend on how the SBS being portfolio margined with the swaps were treated under the foregoing analysis. Only to the extent such SBS give rise to "customer" status should swaps-related collateral held in a securities account for such an SBS customer also be considered "customer property" and factor into the customer's net equity claim.

<u>Positions Held in a Swap Account</u>

Unlike SIPA, the stockbroker liquidation provisions of the Code do not contain an exception from the "customer" definition for a person who has subordinated its claims to those of any or all creditors. However, as noted above, Section 3E(g) of the Exchange Act excludes a non-cleared SBS counterparty from being considered a "customer" under such provisions except to the extent such person has delivered margin subject to a customer

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[176] However, if the counterparty held such IM with a full-purpose BD affiliate of the SBSD, then the counterparty should be treated as a customer of that BD affiliate.

protection requirement under Section 15(c)(3) of the Exchange Act or a segregation requirement.

Accordingly, if the Commission adopts our proposal regarding segregation for non-cleared SBS, as set forth in part II.J.2 then it would neither be necessary nor helpful to require a non-cleared SBS counterparty to enter into a subordination agreement in order to portfolio margin its non-cleared SBS with non-cleared swaps. Rather, so long as margin for such SBS is not subject to a customer protection or segregation requirement, as contemplated by our proposal, the counterparty would not be a "customer" but rather could protect its margin by electing third-party segregation.