Morgan Stanley

November 19, 2018

Mr. Brent Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers; Release No. 34-84409; File No. S7-08-12.

Ladies and Gentlemen:

Morgan Stanley, a global financial services firm, provides access to security-based swap markets to a large and diversified group of clients and counterparties, including commercial end users ("**CEUs**") and institutional investors. We anticipate that one or more of our subsidiaries may register as nonbank security-based swap dealers ("**SBSDs**") with the Securities and Exchange Commission (the "**Commission**").

We appreciate the opportunity to submit comments to the Commission in connection with the reopened comment periods on three related rulemakings that would establish the regulatory framework for security-based swap markets and SBSDs.[1] The reopened comment periods, coupled with potential rule language published by the Commission that would modify rule text in the three proposals (the "**Modified Rule Text**"), represent important, concrete steps toward implementation of a comprehensive regulatory regime for security-based swaps. In particular, publication of the Modified Rule Text provides important transparency in the development of these significant rulemakings.

Our comments are primarily focused on the Commission's rulemaking to establish capital, margin and segregation requirements for nonbank SBSDs ("**Nonbank SBSDs**") and certain broker-dealers (the "**2012 Proposals**") and related Modified Rule Text provisions.[2] We support comments submitted by the Securities Industry and Financial Markets Association ("**SIFMA**") and the Futures Industry Association in connection with the reopened comment periods. We are submitting this comment letter to highlight issues of particular concern to Morgan Stanley and our clients that are active in security-based swap markets.

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[1] 83 Fed. Reg. 53,007 (Oct. 19, 2018). <u>See</u> 77 Fed. Reg. 70,213 (Nov. 23, 2012); 78 Fed. Reg. 30,967 (May 23, 2013); 79 Fed. Reg. 25,193 (May 2, 2014).
[2] 77 Fed. Reg. 70,213 (Nov. 23, 2012).

I. Executive Summary

Our recommendations include:

- Section II: Capital. In general, the Modified Rule Text better achieves the Commission's statutory obligation to impose capital requirements on Nonbank SBSDs that are:

  - Comparable to capital requirements imposed on bank SBSDs ("**Bank SBSDs**");

  - Designed to ensure the safety and soundness of Nonbank SBSDs; and

  - Appropriate for risks associated with non-cleared security-based swaps.

  While we have certain technical comments on the capital-related provisions of the Modified Rule Text, we believe that the Modified Rule Text, in general, would result in capital requirements for Nonbank SBSDs that are conservative, robust, risk-sensitive and facilitate Nonbank SBSDs' ability to perform their roles as market intermediaries.

- Section III: Customer protection and segregation requirements. The customer protection and segregation standards of Proposed Rule 18a-4 should be tailored to the particular activities engaged in by SBSDs and, in the case of full-service broker-dealers ("**Full Service B-Ds**") dual-registered as SBSDs ("**Full Service B-D/SBSDs**"), integrated with the Commission's existing Rule 15c3-3 customer reserve calculations.

  - *SBSDs not providing client clearing services*. Where an SBSD is not providing client clearing services, a security-based swap client should be permitted with the option of placing non-cleared security-based swap initial margin with any of:

    (i) the SBSD, where Proposed Rule 18a-4 would not apply (unless the SBSD is separately providing client clearing services in security-based swaps to the client);

    (ii) a Full Service B-D affiliate of the SBSD, where the client's initial margin would be subject to Rule 15c3-3 protections applicable to any customer property held by the Full Service B-D; or

    (iii) an independent third-party custodian.

  - *SBSDs providing client clearing services*. An SBSD clearing security-based swaps on behalf of clients should treat any initial margin received as customer property subject to Proposed Rule 18a-4.

  - *Full-Service B-Ds*. Rule 15c3-3 should be revised to include references to security-based swap initial margin so that the requirements of Proposed Rule

18a-4 are merged into a single customer reserve calculation applicable to Full Service B-Ds.

- Section IV: Liquidity requirements. The Commission should re-propose, rather than finalize, any liquidity requirements for SBSDs or Alternative Net Capital B-Ds ("**ANC B-Ds**"), taking into account material changes, since the Commission originally proposed liquidity requirements in 2012, in other liquidity regulatory standards directly or indirectly applicable to SBSD and ANC B-D subsidiaries of large bank holding companies ("**BHCs**").

- Section V: Given the complexity of the issues involved, we support the Commission's suggestion that the SBSD regulatory regime should become effective 18 months after publication of relevant final rules in the Federal Register.

Our comments in the body of this letter focus on the Commission's proposed framework for SBSDs. The Commission has also proposed to make a variety of changes to Rule 15c3-1 net capital requirements for Full Service B-Ds, which would apply even in circumstances where the Full Service B-D is not registered with the Commission as an SBSD.[3] We encourage the Commission to limit the application these Rule 15c3-1 revisions to circumstances in which a Full Service B-D also registers as an SBSD. Annex A to this letter contains detailed explanations of potential issues arising from the proposed changes to Rule 15c3-1.

II. Capital

The Commission has a statutory obligation to impose regulatory capital requirements on Nonbank SBSDs.[4] As required by the statute, regulatory capital requirements for Nonbank SBSDs must (i) be, "to the maximum extent practicable," comparable to those established by the Prudential Regulators for Bank SBSDs;[5] (ii) help ensure the safety and soundness of Nonbank SBSDs; and (iii) be appropriate for the risk associated with non-cleared security-based swaps held by Nonbank SBSDs.[6]

The Modified Rule Text more clearly advances each of these statutory objectives than the 2012 Proposals.

A. Initial margin-related credit risk charges (legacy accounts)

We support the Commission's approach in the Modified Rule Text to applying credit risk charges for non-collected initial margin in legacy accounts.

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[3] 77 Fed. Reg. at 70,329-33.
[4] Securities Exchange Act ("**SEA**") § 15F(e)(2)(B)(i).
[5] We use the term "**Prudential Regulators**" to refer to the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), the Office of the Comptroller of the Currency (the "**OCC**") and the Federal Deposit Insurance Corporation (the "**FDIC**").
[6] SEA § 15F(e)(3)(A), (e)(3)(D)(ii)(I).

Similar to the 2012 Proposals, the Modified Rule Text would recognize initial margin exemptions for certain SBSD clients, including for legacy clients that executed security-based swaps before the effective date of regulatory initial margin requirements.[7] Notwithstanding the legacy account exemption, the 2012 Proposals would have required a Nonbank SBSD to recognize a full capital deduction in the amount of any exempt, non-collected initial margin for such legacy accounts.[8] In effect, such a deduction would have nullified the legacy account initial margin collection exemption, forcing a Nonbank SBSD to attempt to collect such initial margin, which may have been impractical, since clients would be under no legal or regulatory obligation to provide it.

The Modified Rule Text, by contrast, would permit a Nonbank SBSD to apply credit risk charges that reflect the absence of initial margin received.[9] This approach is comparable to the Prudential Regulators' regulatory capital rules for Bank SBSDs, which apply credit risk charges for derivatives transactions with non-collected initial margin rather than a deduction.[10] This approach also promotes the safety and soundness of Nonbank SBSDs, as the net capital of Nonbank SBSDs otherwise would fluctuate from deductions, potentially in large amounts, whenever a counterparty made use of a permitted initial margin exemption.

Most importantly, however, a credit risk charge-based approach appropriately reflects the risks associated with non-cleared security-based swaps when initial margin is not collected. In these cases, a Nonbank SBSD has no unsecured receivable that would, under general principles, be subject to deduction in the net capital rule; instead, the Nonbank SBSD has greater exposure to potential future changes in its counterparty's risk profile. The Commission's well-established approach for addressing such risks in the broker-dealer net capital framework is to impose maximum potential exposure ("**MPE**") credit risk charges.[11] While MPE credit risk charges may be reduced by initial margin received, in the absence of initial margin the MPE charge is greater, reflecting the relatively greater risk of potential future counterparty exposures. As such, a credit risk charge is most appropriate for the risks associated with non-cleared security-based swaps held by Nonbank SBSDs.

B. Initial margin-related credit risk charges (phase-ins and thresholds)

We support the Commission's approach in the Modified Rule Text of applying a 1 percent tentative net capital ("**TNC**")-based initial margin collection threshold, with credit risk charges applying to a Nonbank SBSD's credit risk exposure for any non-collected amount below that threshold. We recommend, however, that the threshold be based exclusively on a 1 percent TNC standard and not incorporate a separate counterparty net worth requirement, as suggested by the Modified Rule Text.

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[7] Proposed Rule 18a-3(c)(1)(iii)(D) (2012).
[8] Proposed Rule 18a-1(c)(1)(viii)(B)(3) (2012).
[9] Modified Rule Text 18a-1(a)(2), 18a-1(c)(ix)(B)(1)-(2) (2018). In what may be a drafting oversight, we believe that the modifications to Rule 18a-1(c) should be incorporated into paragraph (viii), not paragraph (ix), in accordance with the paragraph enumerations in the 2012 version of Proposed Rule 18a-1.
[10] See, e.g., 12 C.F.R. §§ 3.34(a)(2)(ii), 3.34(b), 3.37 (imposing PFE-based charges on national banks' counterparty credit risk in derivatives transactions, but permitting reduction of such charges when collateral is received).
[11] MPE charges are also referred to as Potential Future Exposure ("**PFE**") charges in some contexts.

The 2012 Proposals would have resulted in practical challenges for Nonbank SBSDs that are dual-registered as Swap Dealers ("**SDs**") with the Commodity Futures Trading Commission (the "**CFTC**"). Similar to the Commission's proposed initial margin exemption for legacy accounts, the CFTC's initial margin rules include both phase-in provisions, pursuant to which different groups of counterparties become subject to initial margin requirements at different points in time, as well as permanent initial margin thresholds, below which counterparties are not required to post initial margin to a SD.[12] The 2012 Proposals, however, would have imposed a deduction in the Commission's net capital calculation for any non-collected initial margin. As a result, a dual-registered SBSD/SD would have faced a conflict between the CFTC's margin rules, which recognize initial margin phase-in arrangements and thresholds, and the Commission's capital rules, which would have imposed deductions for any uncollected initial margin subject to a CFTC phase-in exemption or threshold.

The Modified Rule Text seeks to resolve this issue consistently with the three statutory principles by imposing credit risk charges when a Nonbank SBSD does not collect initial margin below a TNC-based threshold. Specifically, the Modified Rule Text would (i) recognize, where a counterparty meets a net worth standard, an initial margin collection threshold equal to 1 percent of a Nonbank SBSD's TNC and (ii) impose MPE-based credit risk charges for any non-collected initial margin below such threshold.[13] While the exact dollar value of the threshold will vary depending on a specific Nonbank SBSD's TNC level, the Modified Rule Text provides a risk-sensitive approach for reconciling initial margin collection thresholds with capital resiliency. This approach, which results in comparable outcomes to Bank SBSD requirements, is consistent with safety and soundness and is appropriately tailored for the risks in security-based swaps, since any initial margin collection threshold is scaled to a modest amount of the Nonbank SBSD's TNC. Separately, the potential conflict with CFTC phase-in arrangements would be addressed by the Commission's suggestion that SBSD registration requirements take effect 18 months after final publication of the necessary rules, which would likely result in Nonbank SBSD capital requirements taking effect concurrently with the completion of CFTC phase-in arrangements.[14]

We recommend, however, that the initial margin collection threshold be based exclusively on a 1 percent TNC-based standard, without any separate incorporation of a counterparty net worth test, if the SBSD demonstrates that it has an effective process to obtain and update in a timely manner relevant and material information about its counterparties, for five reasons.

First, replacing a counterparty net worth standard with a requirement to adopt an effective counterparty credit risk process, as summarized above, would align with credit risk modelling standards that already indirectly apply to many Nonbank SBSDs in their capacities as subsidiaries of bank holding companies.[15] Aligning counterparty credit risk standards in this manner would not only promote regulatory harmonization but would also impose a more holistic set of counterparty credit risk expectations than simply managing against a counterparty net worth calculation.

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[12] 17 C.F.R. §§ 23.151 (definition of "initial margin threshold amount"), 23.161(a) (transition provisions).
[13] Modified Rule Text 18a-1(a)(2), 18a-1(c)(ix)(B)(1)-(2), 18a-3(c)(1)(iii)(E) (2018).
[14] See 83 Fed. Reg. at 53,019; see also 17 C.F.R. § 23.161(a).
[15] See 12 C.F.R. § 217.122(b)(2)(iii).

Second, imposing a net worth standard would be impractical to manage, given the likely range and number of *de minimis* or small client relationships potentially in-scope and the difficulty of confirming ongoing net worth calculations above and beyond normal course counterparty risk management. Third, the net worth standard is unnecessary for safety and soundness, given the minor risks posed to a Nonbank SBSD's capital position with a 1 percent TNC-based threshold. Fourth, conditioning a Nonbank SBSD's credit risk charges on a counterparty net worth standard would result in incomparable differences between Bank SBSDs and Nonbank SBSDs, in contravention of a key statutory principle, since only the latter's ability to apply credit risk charges to would be conditioned on counterparty net worth. Finally, one of the key objectives of adopting a threshold—aligning CFTC margin rules with the Commission's capital rules for dual registrants—would be potentially weakened, since CFTC initial margin thresholds are not conditioned on counterparty net worth.[16] In sum, imposing a counterparty net worth standard would provide little risk management benefit and would be operationally impractical.

C. Third-party custodian arrangements

We support the Commission's approach in the Modified Rule Text to include reasonable accommodations that support a security-based swap client's statutory right to post initial margin to an independent third-party custodian. We recommend, however, that the Commission clarify that any swaps-related initial margin held by independent custodians in conformance with CFTC technical standards would also be deemed to be collateral held in the account of the counterparty at the SBSD, particularly in cases where the SBSD is dual-registered as an SD.

The statutory framework governing both security-based swaps and swaps provides that clients have a right to segregate collateral at an independent third-party custodian.[17] The 2012 Proposals recognized this right, in part, by permitting clients to post margin to third-party custodians, but then separately imposed a capital deduction on Nonbank SBSDs in an amount equal to the value of any margin actually posted to a custodian, which effectively undermined the utility of permitting such collateral arrangements.[18] In addition to frustrating the statutory intention of permitting clients with optional collateral segregation rights, the 2012 Proposals also imposed an unnecessarily punitive penalty on Nonbank SBSDs. An SBSD's current exposure to a client does not increase if the client posts initial margin to a custodian. While the SBSD does not directly hold such initial margin, the collateral is still available to mitigate the SBSD's exposures if the client defaults in the future.

The Modified Rule Text resolves this issue in two ways. First, the Modified Rule Text includes three criteria that would need to be met for a Nonbank SBSD to demonstrate that a third-party custodian arrangement is consistent with the SBSD's safety and soundness.[19] These criteria, in effect, require the SBSD to demonstrate that it has effective control over the initial margin held at the custodian. Second, the Modified Rule Text approaches custodial arrangements through the prism of collateral recognition rather

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[16] 17 C.F.R. § 23.151 (definition of "initial margin threshold amount").
[17] SEA §§ 3E(f)(1)(A), 3E(f)(3)(A); Commodity Exchange Act ("**CEA**") §§ 4s(l)(1)(A), 4s(l)(3)(A).
[18] Proposed Rules 18a-1(c)(1)(viii)(B)(2), 18a-3(c)(1)(iii)(C) (2012).
[19] Modified Rule Text 18a-1(c)(1)(ix)(3) (2018). Following the paragraph enumerations in the 2012 version of Proposed Rule 18a-1, we believe that this citation may be intended to be 18a-1(c)(1)(viii)(B)(3).

than deductions. Where initial margin held by a custodian meets the three criteria, the SBSD can recognize such collateral as an offset to any deductions or credit risk charges, as applicable, otherwise arising from such counterparty relationship. Where the conditions are not met, the SBSD may not recognize the value of the collateral as an offset to applicable deductions or credit risk charges, but no separate deduction for the value of the custodian-held collateral applies.

The treatment of third-party custodian arrangements in the Modified Rule Text aligns with the three statutory principles. Counterparties posting initial margin to a third-party custodian would not result in a deduction for a Bank SBSD, and applying deductions to Nonbank SBSDs for such arrangements would result in incomparable outcomes. This approach also promotes Nonbank SBSD safety and soundness, as the credit risk exposure mitigation benefits for arrangements that meet the three criteria provide appropriate incentives for Nonbank SBSDs to establish prudent, legally enforceable custodian arrangements. Finally, this approach is appropriate for risks in non-cleared security-based swap markets since it protects clients' rights to make use of third-party custodian arrangements, whereas a deduction-based regime would undermine their practical ability to do so.

We recommend, however, that the Commission's net capital rules incorporate appropriate cross-references to CFTC third-party custodian technical standards and provide that, where a swap counterparty places swaps-related initial margin with an third-party custodian in conformance with CFTC standards, the Commission's net capital rules recognize such collateral as collateral held in the account of the counterparty at the SBSD. As noted elsewhere in this letter, Nonbank SBSDs will, in practice, likely be dual-registered as SDs, and any technical differences between the Commission's and the CFTC's third-party custodian standards will result in potential ambiguities and uncertainties in the recognition of collateral for credit risk calculations in the two agencies' capital regimes. Similar to the Commission's proposed approach, the CFTC's existing rules for third-party custodians are designed to ensure an SD's prompt access to initial margin in the event of counterparty default.[20] Failure to recognize CFTC-governed third-party custodian arrangements for swaps initial margin as functionally equivalent to the Commission's standards would create marketplace confusion over the applicable standards governing swaps-related initial margin and would interfere with CFTC regulation of swaps markets.

D. Commercial end user exposures

We support the Commission's approach in the Modified Rule Text to include reasonable accommodations for a Nonbank SBSD's current exposure to CEUs. We recommend, however, that a Nonbank SBSD's ability to apply credit risk charges in lieu of deductions for uncollateralized current exposures be subject to a 1 percent TNC-based individual CEU counterparty limit, rather than the 10 percent TNC-based aggregate CEU counterparty limit suggested by the Modified Rule Text. If, however, the Commission deems it necessary to impose an aggregate CEU counterparty limit, then we recommend that this limit be set at 20 percent of TNC, which would align with the Commission's calibration of early warning thresholds.

[20] See 17 C.F.R. 23.157(c).

The 2012 Proposals exempted CEUs from certain variation margin requirements and provided that a Nonbank SBSD would be permitted to apply credit risk charges in lieu of deductions for any uncollateralized current exposure to CEUs.[21] As noted by the Commission in 2012, "This charge would be designed to balance the concern of *commercial end users* that delivering collateral to nonbank SBSDs could disrupt their ability to enter into hedging transactions with the need for nonbank SBSDs to account for their credit risk to *commercial end users*."[22]

The Modified Rule Text appears to introduce a new restriction on Nonbank SBSDs' ability to use credit risk charges for CEU exposures. Specifically, under the Modified Rule Text, a Nonbank SBSD's ability to apply credit risk charges to CEU current exposures would be subject to a 10 percent TNC-based cap.[23] The Commission suggested, when releasing the Modified Rule Text, that imposing a TNC-based threshold "would be designed to limit the nonbank SBSD's aggregate exposure arising from not collecting variation margin from commercial end users and would be scalable to the nonbank SBSD's financial condition."[24]

We do not disagree with the Commission's stated concern that providing a Nonbank SBSD with an unlimited ability to apply credit risk charges for current exposures to CEUs may pose risks. Similarly, we recognize the potential value of a TNC-based limitation when calibrating exposure thresholds to CEUs. We believe, however, that the Commission's policy objectives could be achieved more directly through adoption of a 1 percent TNC-based counterparty-by-counterparty threshold, for four reasons.

First, imposing an aggregate counterparty-based limitation on credit risk charges would aggravate differences in the capital regimes of Bank SBSDs and Nonbank SBSDs.[25] There is no limit, either on an aggregate or counterparty-by-counterparty level, to a Bank SBSD's ability to apply credit risk charges to CEU current exposures.[26] Second, an individual counterparty TNC-based limit would be simpler to manage and monitor than an aggregate exposure threshold, as the latter approach would necessarily involve attempting to aggregate numerous CEU exposures in real time to manage to a cumulative TNC-based limit. Third, a 1 percent TNC-based threshold is most consistent with the risks associated with non-cleared security-based swaps, as it balances an individual CEU's margin exemptions with a net capital limit that protects a Nonbank SBSD's safety and soundness. Fourth, weakening a Nonbank SBSD's

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[21] Proposed Rule 18a-1(a)(2) (2012).
[22] 77 Fed. Reg. at 70,241 (italics in original).
[23] The treatment of excess current exposure above 10 percent TNC is potentially unclear in the Modified Rule Text. Modified Rule Text 18a-1(a)(2) (2018) discusses the credit risk charge as an alternative to Proposed Rule 18a-1(c)(1)(iii), which imposes deductions for assets not readily convertible into cash, including unsecured receivables, suggesting that a deduction may apply to any current exposure in excess of 10 percent TNC. On the other hand, however, it may be illogical to split the CEU current exposure amount between deductions and credit risk charges, and applying a 100 percent credit risk charge for any residual CEU current exposure in excess of 10 percent TNC would coherently group all CEU-related exposures into a single line item in the net capital formula.
[24] 83 Fed. Reg. at 53,010.
[25] Bank SBSDs would risk-weight their uncollateralized current exposures in derivatives based on counterparty type. <u>See</u>, <u>e.g.</u>, 12 C.F.R. §§ 3.34(a)(2)(i) (describing the net current credit exposure for national banks' derivatives exposures in a netting set). Even where a relatively higher risk-weight applies, however, to the current exposure, a bank SBSD's resulting capital requirement associated with the current exposure risk-weighted asset would only be a fraction of the outcome that would result from a deduction or a 100 percent credit risk charge in the net capital rule.
[26] <u>See</u>, <u>e.g.</u>, 12 C.F.R. § 3.34(a)(2)(i).

ability to provide CEUs with market access would be in tension with Congress's 2015 amendments to the SEA and CEA that exempt CEUs from non-cleared margin requirements.[27]

Alternatively, if the Commission is concerned that a 1 percent TNC-based CEU threshold would, by itself, potentially result in SBSD business models that are over-exposed to CEUs, an appropriately calibrated aggregate standard could be added as a separate requirement. We note, in this regard, that a 20 percent TNC-based aggregate CEU credit risk charge limit would align with the Commission's 20 percent early warning TNC threshold and would effectively limit an SBSD's economic exposure without impairing the SBSD's ability to provide normal course market access to CEUs.[28]

E. Forgivable loans in lieu of deductions

The Modified Rule Text contemplates that, when providing initial margin to counterparties, a Nonbank SBSD could avoid recognizing a capital deduction in the amount of the initial margin provided to the extent that the SBSD receives a forgivable loan from an affiliate.[29] We support the policy behind this approach, which appropriately recognizes the role of an SBSD as a subsidiary of a larger banking organization.

We note, however, that the Modified Rule Text does not refer to resolution planning guidance proposed jointly by the Federal Reserve and the FDIC earlier this year (the "**Proposed Resolution Planning Guidance**").[30] The Proposed Resolution Planning Guidance, if adopted, would require U.S. GSIBs, including Morgan Stanley, 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. When the Proposed Resolution Planning Guidance is adopted in final form by the Federal Reserve and FDIC, we recommend that the Commission evaluate whether such inter-company liquidity and funding arrangements and loss absorbing capacity mandated by the guidance would achieve, in substance, the same policy objectives as a forgivable loan requirement and, as such, should be recognized in the Commission's net capital rules as a second alternative to deductions for initial margin posted.

We also encourage the Commission to reconcile its forgivable loan draft guidance with the CFTC's proposed capital rules for nonbank SDs ("**Nonbank SDs**"), which would permit SDs to recognize initial margin posted to a custodian as a current asset without any forgivable loan requirement.[31] In the case of dual-registered Nonbank SBSD/SDs, we encourage the Commission to consider deferring to the CFTC's treatment of initial margin posted by such SBSD/SD in connection with swap transactions and limit application of any forgivable loan requirement to initial margin posted in connection with security-based swap transactions subject to the Commission's jurisdiction.

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[27] Pub. L. 114-1 § 302 (Jan. 12, 2015), which added SEA § 15F(e)(4) and CEA § 4s(e)(4).
[28] The Commission proposed a 120 percent TNC early warning threshold in its 2014 SBSD recordkeeping and reporting requirements proposal. <u>See</u> 79 Fed. Reg. at 25,318 (Proposed Rule 18a-8(b)(1)).
[29] 83 Fed. Reg. at 53,012.
[30] 83 Fed. Reg. 32,856 (Jul. 16, 2018).
[31] CFTC Proposed Rule 23.101(a)(1)(ii)(A)(4) (2016).

III. Customer protection and segregation requirements

The Modified Rule Text makes several changes to the proposed customer protection and segregation framework that would govern all SBSDs. Beyond the technical changes contemplated by the Modified Rule Text, there are more fundamental issues related to the legal status of, and need for, an SBSD customer protection and segregation regime modelled on Rule 15c3-3 based on whether the entity is:

- a Full Service B-D/SBSD;
- a Bank SBSD;
- domiciled in the United States, but neither a Full Service B-D nor a Bank SBSD (a "**Standalone SBSD**"), including entities that are dual-registered as OTC Derivatives Dealers ("**OTC DDs**"); or
- domiciled outside the United States (a "**Foreign SBSD**").

In addition, in each case, the legal status of potential security-based swap customer claims depends on whether or not the claims arise in connection with security-based swap transactions in which the SBSD is providing client clearing services. Finally, for client cleared security-based swaps, any customer protection and segregation regime should work coherently with the CFTC's futures commission merchant ("**FCM**") standards since, in practice, FCMs facilitate the vast majority of client clearing in security-based swaps.

A. Summary of recommendations

We recommend that the Commission adopt an SBSD customer protection and segregation regime grounded in two principles: legal certainty and client choice. As explained more fully below, application of these two principles would result in a security-based swap customer protection and segregation regime designed in the following manner:

- <u>SBSDs which provide client clearing services in security-based swaps</u>. In general, no customer protection and segregation regime would apply to an SBSD unless it elects to provide security-based swap client clearing services.

  - *Full Service B-D/SBSDs*. Where a Full Service B-D/SBSD elects to provide security-based swap client clearing services, the Full Service B-D/SBSD would be subject to Rule 15c3-3 (as revised to incorporate client clearing security-based swap references in an integrated customer protection formula).

  - *Standalone SBSDs*. Where a Standalone SBSD elects to provide security-based swap client clearing services, the SBSD would become subject to Proposed Rule 18a-4 to the extent the SBSD receives customer property in connection security-based swap client clearing.

- *Bank SBSDs or Foreign SBSDs*. A Bank SBSD or a Foreign SBSD would become subject to Proposed Rule 18a-4 if (i) the SBSD elects to provide client clearing services in security-based swaps and (ii) the Commission enters into a memorandum of understanding ("**MOU**") with the FDIC or foreign regulator, as applicable, confirming that, in the event of the insolvency of the Bank SBSD or Foreign SBSD, customer claims arising under Proposed Rule 18a-4 would be enforced in the insolvency proceeding. The Commission should not permit a Bank SBSD or a Foreign SBSD to provide client clearing services in security-based swaps in the absence of such an MOU.

- <u>SBSDs which do not provide client clearing services in security-based swaps</u>. SBSDs that do not elect to provide security-based swap client clearing services would not be subject to Proposed Rule 18a-4. However, the SBSD would:

    - Be required to provide a notice to all non-cleared security-based swap clients modelled on the Commission's existing notice requirement for OTC DDs clearly disclosing that the client has no customer claim in the event of the SBSD's insolvency;

    - Be permitted to provide non-cleared security-based swap clients with the option of placing initial margin at an affiliate Full Service B-D of the SBSD, where the client's initial margin would be treated as customer property in the event of an insolvency proceeding of the Full Service B-D under the Securities Investor Protection Act ("**SIPA**"); and

    - Be required to provide a notice to all non-cleared security-based swap clients that they may elect to place initial margin at an independent third-party custodian.

B. Explanation

1. <u>SBSDs which provide client clearing services in security-based swaps</u>

The Commission should impose Proposed Rule 18a-4 on SBSDs that elect to provide client clearing services in security-based swaps, but only permit Bank SBSDs and Foreign SBSDs to provide such client clearing services if the Commission confirms with applicable regulators that customer net equity claims based on Proposed Rule 18a-4 would be recognized in the event of insolvency proceedings involving such SBSDs.

Section 3E of the SEA provides the statutory framework governing any security-based swap customer protection and segregation framework and related customer claims. In particular, Section 3E of the SEA states that any collateral received by a Standalone SBSD in connection with security-based swap client clearing is customer property giving rise to a net equity claim in the event of the Standalone

SBSD's insolvency under the U.S. Bankruptcy Code (the "**Code**").[32] As a result, it is clear that, if an SBSD provides client clearing services in security-based swaps, the Commission should apply a customer protection and segregation regime to the SBSD to protect client-clearing customers' net equity claims in the event of the SBSD's insolvency.[33]

The Commission's obligation to impose a customer protection and segregation regime, however, must be reconciled with the limits of its statutory authority. The Commission, as the primary regulator of Full Service B-D/SBSDs and Standalone SBSDs, can unilaterally impose financial responsibility rules that will result in the protection, in a SIPA proceeding (in the case of Full Service B-D/SBSDs) or a Code proceeding (in the case of Standalone SBSDs), of customers' net equity claims related to security-based swap client clearing. For these entities, Rule 18a-4 or Proposed Rule 15c3-3 are each, in principle, mechanisms that would protect security-based swap customer claims in client clearing transactions.

The Commission does not, however, control the insolvency or receivership proceedings of a failing Bank SBSD or Foreign SBSD. A failing Bank SBSD would be placed into receivership by the FDIC pursuant to the Federal Deposit Insurance Act ("**FDIA**"); a Foreign SBSD insolvency or receivership would be subject to foreign law. In the case of Bank SBSDs, neither the FDIA nor the FDIC's receivership regulations include any provisions that specifically address security-based swap client clearing transaction customer claims.[34] In addition, since the Commission did not issue Proposed Rule 18a-4 jointly with the FDIC, it is unclear how the FDIC would assess any customer claim asserted under Proposed Rule 18a-4 against a failing Bank SBSD in an FDIC receivership. This legal uncertainty is even more striking in the case of Foreign SBSDs, where it is unclear if Proposed Rule 18a-4 customer claims would be upheld in an insolvency or receivership proceeding conducted under foreign law.

Accordingly, to promote legal certainty and protect potential customer claims, we recommend that the Commission only permit a Bank SBSD or a Foreign SBSD to elect to provide client clearing services in security-based swaps, and thereby become subject to Proposed Rule 18a-4, if the Commission executes an MOU with the FDIC or applicable foreign regulator confirming that Proposed Rule 18a-4 customer claims would be upheld in an insolvency or receivership proceeding. Failure to execute such an MOU would potentially place market participants receiving client-clearing services from these SBSDs in a position of substantial legal uncertainty.[35]

In addition to providing legal certainty, we also note that this recommendation would be relatively simply to implement since, in practice, client clearing services in both swaps and security-based

[32] SEA § 3E(b)-(e), (g). A similar net equity claim would arise in the case of a SIPA insolvency proceeding of a Full-Service B-D holding customer property in connection with cleared security-based swaps, but such proceeding would be governed by SIPA, not the Code.
[33] For a complete analysis of the SEA and related insolvency law issues in Proposed Rule 18a-4, please see Appendix A to the SIFMA comment letter to the Commission dated November 19, 2018 on the re-opened proposals.
[34] See FDIA § 11(c) (describing the FDIC's authorities as receiver in a failed bank proceeding); 12 C.F.R. § 360.3 (describing the priority of claims in an FDIC receivership without including any references to security-based swap customer claims or, more generally, customer claims recognized under the Commission's rules).
[35] Alternatively, the Commission could exempt Bank SBSDs or Foreign SBSDs from Proposed Rule 18a-4 if an applicable regulator confirmed, in an MOU, that a separate customer protection framework enforceable against the SBSD in an insolvency proceeding would protect cleared transaction security-based swap customer claims.

swaps are largely, if not entirely, currently facilitated in U.S. markets by Full Service B-D/FCMs rather than by Bank SBSDs or Foreign SBSDs.[36] As a result, imposing an MOU condition before permitting Bank SBSDs or Foreign SBSDs to provide client clearing services in security-based swaps would result in little practical burden on the Commission or limitations on the marketplace. Nonetheless, we believe it is critical that Proposed Rule 18a-4 rest on a foundation of legal certainty.

2. SBSDs which do not provide client clearing services in security-based swaps

Absent an election by an SBSD to provide client clearing services, the Commission should not apply Proposed Rule 18a-4 on any SBSD that engages in non-cleared security-based swaps (or clears only its own "house" security-based swaps):

- In contrast to security-based swap client clearing transactions, the SEA does not require imposition of a customer protection framework with respect to non-cleared security-based swaps beyond providing clients with an opportunity to place collateral at an independent third-party custodian;
- The Commission lacks clear legal authority to impose Proposed Rule 18a-4 on Bank SBSDs and Foreign SBSDs, and applying it only to Nonbank SBSDs would result in marketplace fragmentation and inconsistent client protections across SBSDs;
- There is no need for Proposed Rule 18a-4 when an SBSD is not providing client clearing services in security-based swaps, since clients can achieve collateral segregation, if desired, through other available means; and
- Applying Proposed Rule 18a-4 to dual-registered SBSD/SDs would result in inconsistent levels of protection for clients' non-cleared security-based swap and swap positions.

For the avoidance of doubt, we note that in some cases an SBSD may bilaterally negotiate a security-based swap with a client that is ultimately cleared by each of the parties. In these cases, we recommend that Proposed Rule 18a-4 not apply unless the SBSD itself provides client clearing services to the client in connection with the cleared transaction.

Statutory framework

Section 3E of the SEA does not impose customer protection and segregation requirements on non-cleared security-based swaps other than providing clients with a right to place collateral at an independent third-party custodian.[37] The relevant provisions of Section 3E that recognize mandatory customer net equity claims are limited to cleared security-based swaps and do not apply to non-cleared

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[36] The Commission has permitted, since 2012, FCMs to provide client clearing services in certain credit product security-based swaps. See 77 Fed. Reg. 20,536 (Apr. 5, 2012). We are unaware of any material client clearing activity in U.S. markets in security-based swaps that is not included within the scope of the Commission's 2012 final rule.

[37] See SEA §§ 3E(f)(1)(A) (requiring SBSDs to provide clients with collateral segregation rights in non-cleared security-based swaps); 3E(f)(3) (clarifying that "the segregated account described in paragraph (1) shall be . . . carried by an independent third-party custodian").

security-based swaps.[38] In the case of non-cleared security-based swaps, the SEA expressly excludes any customer claim except where the Commission imposes a customer protection and segregation standard.[39] In other words, while the SEA provides mandatory statutory recognition for client clearing transaction security-based swap customer claims in the event of an SBSD insolvency, any customer claims related to non-cleared security-based swaps are contingent on the Commission adopting and implementing an applicable customer protection and segregation regime.

Marketplace fragmentation and inconsistent client protections

Extending Proposed Rule 18a-4 to include non-cleared security-based swap claims would result in significant marketplace legal uncertainty since Bank SBSDs and Foreign SBSDs are among the largest dealers in security-based swap markets and, as discussed in the proceeding section, the legal status of Proposed Rule 18a-4 customer claims against these entities is uncertain in the absence of Commission MOUs with the FDIC and applicable foreign regulators.[40] By contrast, the legal status of customer claims in cleared security-based swaps is explicit in the SEA and limitations on the Commission's jurisdiction over Bank SBSDs and Foreign SBSDs in cleared security-based swaps is less relevant, since these entities are not major providers of security-based swap client clearing services. If the Commission extends Proposed Rule 18a-4 to all SBSDs, including for non-cleared security-based swap claims, it will result in significant legal uncertainty with respect to potential customer claims against Bank SBSDs and Foreign SBSDs.

An even worse scenario would arise, however, if the Commission only applied Proposed Rule 18a-4 to SBSDs within its exclusive jurisdiction (i.e., Standalone SBSDs). In this case, end users active in non-cleared security-based swap markets would face a range of SBSD relationships subject to dramatically different customer or non-customer statuses. This outcome would also be unprecedented in Commission practice, as the Commission does not recognize any exemption from Rule 15c3-3 for a subcategory of Full-Service B-Ds.

The Commission has historically recognized the need for legal certainty when determining the scope of customer protection and segregation regimes. In particular, the Commission expressly elected to not apply the provisions of SIPA to OTC DDs because doing so "would create legal uncertainty about the rights of derivatives counterparties in transactions with OTC derivatives dealers in the event of dealer insolvency."[41] Based on this judgment, the Commission determined that property received by an OTC DD would not be treated as customer property subject to Rule 15c3-3 (or an equivalent thereof) to the extent

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[38] SEA § 3E(b)-(e), (g).
[39] SEA § 3E(g).
[40] The CFTC estimated in 2016 that roughly half of provisionally registered SDs would be Nonbank SDs subject to CFTC capital regulation. See 81 Fed. Reg. at 91,284. Based on marketplace dealing activity, we believe that there may be a similar split between Bank SBSDs and other SBSD registrants.
[41] 63 Fed. Reg. 59,362, 59,367 (Nov. 3, 1998). See also 63 Fed. Reg. at 59,382 n. 202 ("Under the typical relationship where a counterparty delivers collateral to an OTC derivatives dealer in order to cover its contractual obligations to the dealer, the counterparty and the OTC derivatives dealer have a relationship more analogous to a debtor-creditor relationship than a fiduciary one. Accordingly, these counterparties are not the type of investor intended to be protected under SIPA.").

that the OTC DD complied with certain notification requirements.[42] It is also worth noting that the Commission's OTC DD analysis rested, in part, on the fact that OTC DDs do not face retail clients, a similarity they share with Nonbank SBSDs but not Full Service B-Ds.[43] The Commission's reasoning in the case of OTC DDs is a compelling precedent but also highlights the potential oddity of applying Rule 18a-4 to SBSDs in connection with non-cleared security-based swaps while not applying a similar customer protection or segregation regime to OTC DDs.

Alternative client options for achieving collateral segregation

There is no compelling need to impose a customer protection and segregation regime with respect to non-cleared security-based swaps since clients in these products have two legally certain and operationally viable options for placing initial margin at alternative custodians. On the one hand, clients can elect, as permitted by the SEA and Proposed Rule 18a-3, to place initial margin with third-party custodians.[44] As noted earlier, the SEA does not require any mandatory customer protection and regime framework for non-cleared security-based swaps beyond clients' right to place collateral at an independent third-party custodian.[45]

On the other hand, the Commission could also permit clients to elect to place initial margin at a Full Service B-D affiliate of the SBSD. In this latter example, the client's initial margin would be treated as customer property subject to the protections of Rule 15c3-3 and the SBSD would receive a lien against the initial margin held by its affiliate Full-Service B-D to cover potential exposures in the event of client default.

The Commission might further augment these arrangements by requiring the SBSD to provide its non-cleared security-based swap clients with a prominent notice explaining that they have no customer claims against the SBSD in an insolvency proceeding of the SBSD under the Code, similar to the same notice the Commission requires OTC DDs to provide to its clients.[46] Following the precedent of OTC DDs, delivering such a notice would render unnecessary the requirement for an SBSD to receive an executed subordination agreement from a client for the provisions of Proposed Rule 18a-4 to not apply.[47]

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[42] 63 Fed. Reg. at 59,387.
[43] 62 Fed. Reg. 67,940, 67,949-50 n. 65 (Dec. 30, 1997) ("The Commission believes that the counterparty collateral that would be held by OTC derivatives dealers should not be considered customer assets for purposes of SIPA. Congress enacted SIPA in 1970 primarily to protect the retail customers of a broker-dealer in the event of its financial difficulty. Congress was concerned that prior to the enactment of SIPA, public customers sometimes had encountered difficulty in obtaining their cash balances or securities from insolvent broker-dealers. Congress analogized the need for SIPA to the need which prompted establishment of the Federal Deposit Insurance Corporation. H.R. Rep. No. 91–1613, 91st Cong., 2d Sess. 2 (1970). The Commission believes that the type of privately negotiated transactions and counterparty assets (collateral) involved in the OTC derivatives business are quite different from the ordinary brokerage business and customer assets contemplated by SIPA.").
[44] SEA § 3E(f)(3); Proposed Rule 18a-3(c)(1)(iii)(C).
[45] SEA §§ 3E(f)(1)(A), 3E(f)(3).
[46] See 17 C.F.R. § 240.15c2-1(b)(1).
[47] Proposed Rule 18a-4(d)(2)(ii) (2012).

Harmonized treatment of non-cleared security-based swap and swap positions

Our recommended approach would foster greater harmonization with the CFTC's regulatory framework for swaps, which does not impose any customer protection regime for non-cleared swaps. In practice, we believe that many, perhaps nearly all, SBSDs will be dual-registered as SDs because the security-based swaps market is comparatively small relative to the swaps market, market participants active in Commission-regulated single-name credit or single-name equity positions will generally have investments or hedging positions in CFTC-regulated index credit or index equity positions, and non-dealer clients are generally not attuned to the definitional distinctions between security-based swaps and swaps but instead are seeking to hedge or invest in underlying credit or equity positions.

The interplay of the Commission's and the CFTC's respective standards raises another point of potential legal uncertainty of applying Proposed Rule 18a-4 to non-cleared security-based swaps, since a non-cleared swap client would not have a customer claim against a SD in the event of an SD insolvency proceeding. While, in some circumstances, the Commission could elect to recognize customer status for certain non-cleared security based swaps, there is no equivalent statutory authority in the CEA to recognize customer claims arising from non-cleared swaps. Where a dual-registered SBSD/SD faces clients in non-cleared security-based swap and swap positions, imposition of Proposed Rule 18a-4 might result in the SBSD/SD recognizing credits in its customer reserve formula in connection with client margin received for non-cleared swaps, introducing a misalignment between the scope of Code customer claims and putative customer protections under Proposed Rule 18a-4.

C. Alternative recommendation

We believe that our recommendations in the preceding section would result in an appropriately tailored customer protection and segregation regime that avoids legal uncertainty, promotes client choice and applies a coherent framework across any cleared or non-cleared markets where an SBSD is active.

If, however, the Commission elects to impose Proposed Rule 18a-4 directly on all SBSDs with respect to both cleared and non-cleared security-based swaps, we believe that recognized debit items, and parallel exclusions from the definition of "excess securities collateral," should be expanded to better reflect SBSDs' funding and risk management practices.

The foundational logic of Rule 15c3-3 is the integrated relationship between customer credits and debits in the customer reserve calculation. In general, to the extent that a Full Service B-D receives cash from a customer or makes use of a customer's fully paid securities, the Full Service B-D recognizes a credit in the customer reserve calculation. Similarly, to the extent that the Full Service B-D provides funding to a customer, or takes certain other actions to facilitate a customer transaction, the Full Service B-D recognizes a debit in the formula. While, in general, credits typically exceed debits, and thus some amount of customer property is subject to "lock up," the integrated relationship between credit and debit items facilitates the Full Service B-D's ability to serve as a market intermediary.

We believe that Proposed Rule 18a-4, in its current form, would not permit an integrated relationship between an SBSD's credit and debit items. In practice, it is unlikely that any debit items in

Proposed Rule 18a-4 could be meaningfully used by an SBSD in support of its risk management activities, which are distinct from the debit items relied on by Full Service B-Ds in Rule 15c3-3. If the Commission ultimately imposes Proposed Rule 18a-4 on SBSDs in a manner that includes non-cleared security-based swap activity, we recommend consideration of the additional debit items and, as applicable, related exceptions to the definition of "excess securities collateral":

- Equity securities held by an SBSD as market risk hedges to client-facing non-cleared security-based swaps, which are a necessary component of an SBSD's risk management program, with debit items limited to circumstances where the equity securities are recognized as valid hedges, for purposes of the SBSD's market risk capital requirements, to client-facing non-cleared security-based swaps;

- All initial margin provided by the SBSD in connection with inter-dealer or cleared transaction hedging of client-facing non-cleared security-based swaps, including in circumstances where the SBSD executes hedge transactions with SDs or CFTC-regulated derivatives clearing organizations and including any security-based swap, swap or future, to the extent such positions are recognized as valid hedges for purposes of the SBSD's market risk capital requirements; and

- A prime brokerage margin loan-equivalent debit item, measured as the effective economic exposure received by a client to underlying equity positions through the non-cleared security-based swaps, calculated as if the client had achieved the same economic exposure in margin loan form.[48]

Expanding Proposed Rule 18a-4 in this manner would better support SBSDs' risk management programs and market intermediary roles.

IV. Liquidity requirements

The 2012 Proposals included proposed liquidity requirements for SBSDs and ANC B-Ds.[49] The Modified Rule Text did not include any adjustments to these requirements or otherwise provide any commentary related to proposed liquidity standards.

Our understanding is that the Commission may defer adoption of any liquidity requirements until a future point after imposition of capital standards on Nonbank SBSDs. We support deferring adoption of final liquidity standards, as liquidity regulation has evolved extensively since the 2012 Proposals. In practice, we expect that SBSDs will, in many cases, be material operating entities ("**MOEs**") of large BHCs and, as such, subject, either directly or indirectly, to the Federal Reserve's liquidity risk

[48] This recommendation may only be suitable for inclusion in Proposed Rule 18a-4 without any corresponding adjustment to Rule 15c3-3 for Full-Service B-Ds or Full-Service B-D/SBSDs. In substance, the purpose of including this debit item in Proposed Rule 18a-4 would be to recognize equivalent debit items in Rule 15c3-3 and Proposed Rule 18a-4 where clients receive equivalent economic exposure in either margin loan or security-based swap form.
[49] Proposed Rule 18a-1(f) (2012); Proposed Rule 15c3-1(f) (2012).

management requirements in Regulation YY (effective since 2015), the Liquidity Coverage Ratio (effective since 2015) and liquidity- and funding-related requirements imposed through recovery and resolution planning adopted jointly by the Federal Reserve and the FDIC (which these agencies jointly proposed to revise in 2018).[50] We believe that any imposition of SBSD- or ANC B-D-specific liquidity requirements by the Commission should be integrated with and complement liquidity and funding requirements imposed on the consolidated organizations of MOE SBSDs and ANC B-Ds. In addition, while the Commission has a statutory obligation to impose capital standards on Nonbank SBSDs, there is no corresponding statutory obligation to impose liquidity standards.[51]

V. Timeline

The Commission's October 2018 Release requests comment on whether the Commission should establish an effective date for SBSD registration 18 months after the publication, in the Federal Register, of an inter-locking set of final rules governing SBSDs.[52]

We support an 18-month effective date, for three reasons. First, as discussed in this letter, there are variety of complex technical questions, particularly in Proposed Rule 18a-4, that would require adequate time to resolve before building and testing operational capabilities that will fully meet the Commission's expectations. Second, for dual-registered SBSD/SDs, final capital requirements will only become clear after publication of final CFTC capital rules for Nonbank SDs and adjustments in client execution practices may be required in response to the final content of Commission or CFTC rules. Third, firms may not have finalized registration decisions for future SBSDs, and preparing adequate governance processes and internal controls will likely require extensive planning and effort, particularly for dual-registered SBSD/SDs that must comply with two distinct sets of standards.

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[50] See, e.g., 83 Fed. Reg. 32,856 (Jul. 16, 2018); see also 81 Fed. Reg. 35,124 (Jun. 1, 2016) (proposing to apply the Net Stable Funding Ratio to certain large BHCs and bank entities, including bank entities that may register with the Commission as Bank SBSDs).
[51] See SEA § 15F(e)(2)(B)(i).
[52] 83 Fed. Reg. at 53,019.

Thank you for reopening the comment periods on these important proposals. We would welcome an opportunity to answer any questions you may have concerning this comment letter.

Respectfully submitted,

Sebastian Crapanzano
Managing Director

Soo-Mi Lee
Managing Director

cc: Hon. Jay Clayton, Chair

Hon. Kara M. Stein, Commissioner

Hon. Robert J. Jackson, Jr., Commissioner

Hon. Hester M. Pierce, Commissioner

Hon. Elad L. Roisman, Commissioner

Brett Redfearn, Director, Division of Trading and Markets

Michael A. Macchiaroli, Associate Director, Division of Trading and Markets

<u>Annex A</u>: Proposed changes to Rule 15c3-1

The 2012 Proposals, together with the Modified Rule Text, would make certain changes to Full Service B-D net capital rules that appear to be beyond updating references to accommodate security-based swaps. Most of these revisions would apply to a Full Service B-D even if it is not separately registered with the Commission as an SBSD. As a general matter, we recommend that the existing Full Service B-D rules continue to apply in their current form, without revisions to accommodate security-based swaps, unless the Commission includes economic analysis in a final rulemaking to justify changes to the Full Service B-D framework that are necessary for non-SBSD activities.

Various technical comments on potential revisions to the Full Service B-D framework are noted below and are summarized in <u>Table A-1</u>.

a. <u>Scope of permitted Appendix E credit risk charges</u>. The 2012 Proposals would modify 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)."[53] These revisions could be interpreted as eliminating a Full Service B-D's ability to utilize Commission-approved internal models to calculate credit charges for all transactions other than security-based swaps with CEUs. We request that the Commission clarify that Commission-approved internal models can continue to be use for all derivative counterparty exposures, including security-based swap transactions with CEUs, particularly in cases where a Full Service B-D is not dual-registered as an SBSD.

b. <u>Application of Appendix E credit risk charges where initial margin is not collected</u>. The Modified Rule Text states that, where a Full Service B-D is exempt from collecting initial margin from a counterparty on security-based swap or swap transactions, the Full Service B-D "may use the credit risk standards of Appendix E" to compute credit risk charges for non-collection of exempted initial margin instead of other provisions of the Modified Rule Text that would impose a full deduction in the amount of such non-collected initial margin.[54] We agree that, for an SBSD, credit risk charges should apply in lieu of deductions for non-collected initial margin, but note that the revisions to Appendix E referenced above could be understood as restricting the use of Appendix E credit risk charges to security-based swap transactions with CEUs. We have two technical comments to raise related to this point:

(i) We request clarification that Appendix E credit risk charges, as applied in Proposed Rule 15c3-1(a)(7) in connection with initial margin collection exempted by Proposed Rule 18a-3(c)(1)(iii), can be applied to non-collected initial margin from any counterparty, CEU or non-CEU, subject to a valid initial margin exemption for security-based swap or swap transactions. This clarification appears to be fully consistent with the Commission's intent in the Modified Rule Text, as limiting the scope of Appendix E credit risk charges to CEUs would effectively nullify the non-CEU initial margin collection exemptions that are incorporated by reference in Proposed Rule 15c3-1(a)(7).

[53] 77 Fed. Reg. at 70,332.
[54] Modified Rule Text 15c3-1(a)(7) (2018).

(ii) Separately, there appears to be no need to apply the underlying non-collected initial margin deductions at all where a Full Service B-D is not separately registered as an SBSD. The Commission proposed to incorporate these deductions into Rule 15c3-1 to parallel corresponding provisions of Proposed Rule 18a-1 applicable to Standalone SBSDs, but they appear to be irrelevant to a non-SBSD entity.[55] Even if not applicable, however, inclusion of the deductions in any revised version of Rule 15c3-1 would create a potential ambiguity related to any swap or security-based swap positions of the Full Service B-D that are executed outside of an SBSD capacity.

c. Application of Appendix E credit risk charges to CEU current exposures. The Modified Rule Text would permit a Full Service B-D to apply an Appendix E credit risk charge to current exposures arising from security-based swap and swap transactions with CEUs.[56] Consistent with our comments above, we request confirmation that Appendix E credit risk charges can be applied for a current exposure arising from both security-based swap and swap transactions. In addition, we request confirmation that Appendix E credit risk charges can be applied to any current exposure with a CEU without product restriction, particularly for a Full Service B-D not dual-registered as an SBSD.

d. Margin difference and client clearing. The 2012 proposals would impose a new charge on Full Service B-Ds that provide client clearing services, even if such Full Service B-Ds are not registered as SBSDs. In particular, as proposed, a Full Service B-D providing client clearing services would be required to deduct the "margin difference," which would be defined to include the difference between, on the one hand, any deductions or charges, as calculated by the Commission, that would apply to any client clearing security-based swap or swap transactions if such positions were house positions of the Full Service B-D and, on the other hand, the actual initial margin collected by the Full Service B-D.[57] We have three concerns with applying a margin difference calculation in this manner:

(i) Since the margin difference calculation would apply to client clearing in CFTC-regulated swaps, this amendment would effectively subject a dual-registered Full Service B-D/FCM that principally engages in CFTC-regulated swaps clearing to a duplicative set of Commission-mandated swap margin requirements. We believe that the Commission's net capital rule should work in tandem with CFTC standards, and that no margin difference calculation should apply to any swaps-related client clearing.

(ii) The more fundamental issue with the margin difference calculation, however, is that it applies to client clearing activity at all. The Commission has separately proposed to impose a deduction for a Full Service B-D's failure to collect initial margin from a client

[55] See Modified Rule Text 15c3-1(c)(2)(xv)(B)(1)-(2) (imposing deductions for non-collection of initial margin from exempted security-based swap and swap counterparties); Modified Rule Text 18a-1(c)(1)(ix)(1)-(2) (imposing the same deductions).
[56] Modified Rule Text 15c3-1(a)(7) (2018).
[57] Modified Rule Text 15c3-1(c)(2)(xiv)(A)(1) (2018).

in a clearing transaction that is less than the initial margin obligation imposed by the clearing agency on the same client position.[58] The Commission can more efficiently and directly address any concerns with client clearing margining requirements through direct regulation of clearing agencies rather than by indirectly setting cleared transaction margin requirements through client clearing margin difference calculations applied to Full Service B-Ds.

(iii) Further to the above point, we note that client clearing markets in the United States are, in their current composition, dominated by CFTC-regulated swaps. While there is some existing client clearing with respect to security-based swaps involving non-index credit underliers, the Commission has permitted, since 2012, client clearing in such products to be included in CFTC-regulated FCMs where clients have both index and non-index credit positions to be cleared.[59] Accordingly, integration of Commission net capital rules with CFTC net capital rules is particularly important in the case of client clearing, since the existing marketplace is subject almost universally to FCM standards.

e. Minimum net capital requirement. The Modified Rule Text would also modify the long-standing 2 percent aggregate debit test by adding to it an additional amount, calculated as 8 percent of the risk margin amount, when determining a Full Service B-D's minimum net capital requirement.[60] Combining the aggregate debits test with a risk margin amount standard in this manner raises several conceptual and practical issues:

(i) It is unclear what analysis supports a minimum net capital standard that combines 2 percent of one measurement (aggregate debits) and 8 percent of a separate one (risk margin amount). At a minimum, a common 2 percent calibration should be applied consistently, unless there is an empirical basis for concluding that the activity reflected in the risk margin amount calculation presents four times the risk of B-D debits, which we do not believe to be the case.

(ii) As proposed, the Modified Rule Text would apply the combined aggregate debits and risk margin amount calculation to a Full Service B-D even if it is not separately registered as an SBSD. It is unclear why a non-SBSD should be subject to a risk margin amount-based net capital standard at all. One approach to resolving this concern would be to maintain the existing 2 percent aggregate debit standard for Full Service B-Ds not dual-registered as SBSDs, and then apply the additional risk margin-based requirement to any Full Service B-D that dual-registers as an SBSD (if not separately registered as an FCM, per our next comment).

(iii) The definition of "risk margin amount" in the Commission's proposal would result in overlap and tension with the corresponding CFTC definition. The CFTC has proposed to

[58] Modified Rule Text 15c3-1(c)(2)(xii)(B) (2018).
[59] 77 Fed. Reg. 20,536 (Apr. 5, 2012).
[60] Modified Rule Text 15c3-1(a)(7)(i) (2018).

define, for FCMs, the "risk margin amount" as the aggregate of total six components, including initial margin amounts corresponding to non-cleared, house cleared and client cleared security-based swaps and swaps.[61] The Commission, by contrast, has proposed to define "risk margin amount" as including initial margin amounts corresponding only to non-cleared and client cleared security-based swaps.[62] If a Full Service B-D is dual registered as an FCM, we believe that the entity should be subject to a single risk margin amount-based net capital standard, as calculated under the CFTC's rules, since the CFTC proposed rules would include the aggregate amount of security-based swap and swap activity without combining a portion of that activity incongruously with a differently calibrated aggregate debit calculation.

f. Notional-based measurements. In various places, the revisions to Rule 15c3-1 contemplate applying notional-based measurements to security-based swap and swap positions which, in some cases, could be replaced with approved internal model-based calculations.[63] We note that Full Service B-Ds' existing risk management systems are generally not designed to calculate notional-based haircuts for these products and there is some uncertainty around how such notional-based charges would be calculated, even for firms with approved internal models where production of notional-based charges is necessary to provide the Commission with reference information. Consistent with our recommendations above, we believe that such additional notional-based calculations should only apply to Full Service B-Ds that are dual-registered as SBSDs. The Commission may need to consider appropriate guidance addressing how Full Service B-Ds that are not dual-registered as SBSDs should incorporate any non-dealing security-based swap or swap positions into the net capital calculation required by Rule 15c3-1. For example, instead of imposing notional-based credit risk charges for certain credit default products, the Commission should instead permit firms with approved internal models to calculate credit risk charges based on the firm's net short exposure multiplied by (i) the credit risk weight applicable to the reference asset of the credit default security-based swaps, as specified in Rule 15c3-1e(c)(4)(vi) (substituting references to counterparty for reference asset) and (ii) 8 percent.

g. Collateral held at third-party custodians. The existing version of Appendix E restricts recognition of collateral to circumstances in which "the collateral is subject to the broker's or dealer's physical possession or control."[64] For the avoidance of doubt, we believe that this reference in Appendix E should include a cross-reference to the criteria in the Modified Rule Text that recognize independent custodian collateral recognition in appropriate circumstances.[65]

The table below provides a summary of these recommendations.

[61] CFTC Proposed Rules 1.17(a)(1)(i)(B), 1.17(b)(8) (2016).
[62] Modified Rule Text 15c3-1(c)(1)(i)(B) (2018).
[63] See, e.g., Modified Rule Text 15c3-1(c)(2)(vi)(O).
[64] Rule 15c3-1e(c)(4)(v)(B).
[65] See Modified Rule Text 15c3-1(c)(2)(xv)(B)(3).

Table A-1: Proposed Revisions to Rule 15c3-1

Issue	Recommendation by Entity Registration Status		
	Full Service B-D/SBSD	**Full Service B-D (non-SBSD)**	**Full Service B-D/FCM (non-SBSD)**
a. Scope of permitted Appendix E credit risk charges	Appendix E credit risk charges should continue to be permissible for all "derivative transaction" counterparty exposures	If Commission restricts SBSD use of Appendix E credit risk charges to CEU exposures, broader Appendix E permissions should continue for non-SBSDs	If Commission restricts SBSD use of Appendix E credit risk charges to CEU exposures, broader Appendix E permissions should continue for non-SBSDs
b. Application of Appendix E credit risk charges where initial margin is not collected	Clarification that Appendix E credit risk charges are permitted for all relationships with permitted non-collected initial margin, regardless of CEU status	No initial margin non-collection deduction or charge should apply at all but, if it does, Appendix E charges should be permitted	No initial margin non-collection deduction or charge should apply at all but, if it does, Appendix E charges should be permitted
c. Application of Appendix E credit risk charges to CEU exposures	Clarification that Appendix E credit risk charges are permitted for all CEU current exposures, regardless of product type	If Commission restricts SBSD use of Appendix E credit risk charges to CEU exposures, broader Appendix E permissions should continue for non-SBSDs	If Commission restricts SBSD use of Appendix E credit risk charges to CEU exposures, broader Appendix E permissions should continue for non-SBSDs
d. Margin difference and client clearing	Elimination of client clearing-related margin difference calculation	Same	If Commission applies a client clearing-related margin difference calculation to non-FCMs, this calculation should not apply to an FCM clearing CFTC-regulated swaps
e. Minimum net capital requirement	2% aggregate net debit and 2% risk margin amount, but only if Commission empirically justifies inclusion of risk margin amount	Existing 2% aggregate net debit standard without change	Existing 2% aggregate net debit standard without change; risk margin amount incorporated into FCM net capital rules
f. Notional-based measurements	Clarification of relevance and need for certain notional-based calculations	Same	Same
g. Collateral held at third-party custodians	Inclusion of cross-references in Appendix E and otherwise to independent custodian collateral recognition conditions	Same	Same