Morgan Stanley

October 29, 2014

Ms. Elizabeth M. Murphy
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. 34-68071; File No. S7-08-12.

Ladies and Gentlemen:

We support the Securities and Exchange Commission's (the "**Commission**") efforts to establish capital, margin, and segregation requirements in security-based swap markets, and the Commission's broader agenda to ensure robust customer protection and mitigate systemic risk.

In 2012, the Commission released its notice of proposed rulemaking (the "**Proposal**") to establish capital, margin, and segregation requirements for security-based swap dealers ("**SBSDs**") and major security-based swap participants and capital requirements for broker-dealers.[1] We submitted a comment letter to the Commission on the Proposal on February 22, 2013.[2] Subsequently, in September 2013, the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions published final margin standards for uncleared derivatives ("**BCBS-IOSCO Margin Framework**").[3] The Commodity Futures Trading Commission ("**CFTC**") and the U.S. banking agencies ("**Banking Agencies**") then each re-proposed margin requirements in response to the BCBS-IOSCO Margin Framework.[4] We understand that the Commission is currently considering how to modify both the margin- and capital-related elements of the Proposal in response to the BCBS-IOSCO Margin Framework.

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[1] 77 Fed. Reg. 70,214 (Nov. 23, 2012).

[2] Our 2013 comment letter is available on the Commission's website at: http://www.sec.gov/comments/s7-08-12/s70812-32.pdf.

[3] BCBS-IOSCO, *Margin requirements for non-centrally cleared derivatives* (September 2013), available at: http://www.bis.org/publ/bcbs261.pdf

[4] *See* CFTC, "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," 79 Fed. Reg. 59,898 (Oct. 3, 2014) ("**CFTC 2014 Margin Re-Proposal**"); Banking Agencies, "Margin and Capital Requirements for Covered Swap Entities," 79 Fed. Reg. 57,348 (Sept. 24, 2014) ("**Banking Agencies 2014 Margin Re-Proposal**").

Our comments in this letter supplement our February 2013 letter and provide Morgan Stanley's recommendations for how the Commission should implement capital requirements for SBSDs in light of ongoing regulatory efforts to develop and finalize margin requirements. Since the Proposal's capital rules rely on the Proposal's margin rules, with interdependence between the two, we believe that SBSD capital requirements must be tailored to complement and support potentially different margin standards. In particular, regardless of which margin framework the Commission adopts, the Commission's capital rules must work consistently with the BCBS-IOSCO Margin Framework, as reflected in the proposed rulemakings of the CFTC and the Banking Agencies, since SBSDs dual-registered as swap dealers will be subject to both the Commission's margin rules as well as to potentially divergent margin standards adopted by other U.S. regulators.

Given the interdependence between capital and margin rules, and the alternative margin formulations, there is significant uncertainty around how the Commission's proposed capital rules would be applied under various margin scenarios. Accordingly, we also recommend that the Commission re-propose for comment both its capital and margin rules to ensure that the two rulemakings complement and support one another.

I. Summary of recommendations

We reiterate and supplement our recommendation that the Commission consider these key principles when developing SBSD capital standards:

- **Legacy account deduction**. The legacy account deduction should be eliminated and replaced with a credit risk charge, which would ensure that SBSDs hold appropriate capital against all transactions without undermining the Commission's proposed margin exemption for legacy positions.

- **Third-party custodian deduction**. The third-party custodian deduction should be eliminated where third-party custodian arrangements meet rigorous legal and operational criteria, thereby promoting counterparties' choice of custodians, as directed by the Dodd-Frank Act, and harmonization with the CFTC's and Banking Agencies' re-proposed margin rules, which in each case require third-party custodians to hold initial margin.

In addition, regardless of whether the Commission adopts margin rules based on the BCBS-IOSCO Margin Framework, we recommend that the Commission consider, and modify SBSD capital standards to reflect, three features of the BCBS-IOSCO approach that were not contemplated in the Proposal. In particular, SBSD capital standards would need to accommodate the four-year initial margin transition period, initial margin collection thresholds, and a wider class of parties exempted from posting initial margin. Because dual-registered firms will be subject to multiple margin regimes, our recommendations are designed to result, to the maximum extent practicable, in SBSD capital requirements that are comparable across entities regulated by the Commission and other U.S. regulators, consistent with the Dodd-Frank statutory mandate.[5]

In particular, we recommend that SBSD capital standards reflect these principles:

- **Timing of implementation and staggered application**. SBSD capital requirements should apply at the later of (i) two years from the implementation of initial margin requirements and (ii) the effective date of the swaps push-out rule. After two years, when capital requirements apply, these requirements should be scaled to the transaction activity of counterparties subject to initial margin requirements in the current year of the BCBS-IOSCO staggered transition period. Full capital and margin rules would apply after completion of the BCBS-IOSCO four-year transition period. This approach would align transition arrangements for capital and margin, thereby ensuring an orderly transition and avoiding market disruptions.

- **Initial margin thresholds**. Credit risk charges, not capital deductions, should apply to initial margin amounts below the collection threshold in the BCBS-IOSCO Margin Framework. Where a counterparty is exempted from posting initial margin, a credit risk charge rather than a capital deduction should apply to the uncollected initial margin amount, since applying a deduction would frustrate the purpose of the exemption and credit risk can be appropriately managed through credit risk charges.

- **Initial margin-exempt counterparties**. Credit risk charges, not capital deductions, should apply to non-collection of initial margin from counterparties exempt from initial margin requirements, including commercial end users, sovereigns and central banks. A credit risk charge-based approach would ensure SBSDs hold appropriate capital against these positions, would be consistent with the Proposal's treatment of SBSDs' under-collateralized exposures to commercial end users, and would promote consistency among the margin and capital rulemakings of all U.S. agencies, including the Commission.

- **Re-proposal of capital and margin standards**. In light of the interdependence of the capital framework and the margin framework, and the remaining open issues to be resolved in the margin framework, the Commission should re-propose both capital and margin rules for comment.

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[5] *See* Securities Exchange Act of 1934 § 15F(e)(3)(D)(ii), as modified by Dodd-Frank Act § 764(a) (The Commission and the U.S. banking agencies "shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements . . . for—(I) security-based swap dealers.").

II. Recommendations for SBSD capital standards generally

a. Legacy account deduction

Our 2013 comment letter raised concerns with the legacy account deduction, noting that the deduction would not apply under the proposed rules of the CFTC or the Banking Agencies and that the Commission could ensure that SBSDs appropriately capitalize legacy exposures without imposing a 100 percent deduction. In addition, since the BCBS-IOSCO Margin Framework likewise does not include a requirement to post initial margin on legacy positions, or otherwise require capital deductions for under-margined legacy positions, we believe that the Commission should eliminate the legacy account deduction to ensure harmonization within both U.S. and global markets.

In particular, we recommend that the Commission eliminate the legacy account deduction and apply a credit risk charge for an SBSD's under-collateralized legacy account positions. We believe that this approach is appropriate in light of the reasons why firms have historically not collected full margin from all counterparties, which is based on counterparty-specific assessments of credit risk. For example, dealers have often not collected initial margin from unleveraged counterparties with conservative investment strategies that pose low default risks. Applying a deduction for under-collateralized legacy account positions in these cases would ignore alternative, effective credit risk arrangements or approaches to settling changes in portfolio values and instead impose a 100 percent deduction where historical margining practices do not conform with future-state margin standards, even where such future standards apply to products beyond the Commission's jurisdiction, such as CFTC-regulated interest rate swaps. By contrast, our recommended approach would both ensure appropriate capital supports the SBSD's exposures and more closely align the Commission's capital standards with the approaches of the CFTC and the Banking Agencies.

b. Third-party custodian deduction

Our 2013 comment letter also raised concerns with the third-party custodian deduction, noting that the deduction is inconsistent with the capital proposals of the CFTC and the Banking Agencies and that the deduction substantially and unrealistically overstates an SBSD's collateral risk in third-party custodian arrangements. We reiterate our recommendation that the third-party custodian deduction be eliminated entirely or, at a minimum, waived where custodian arrangements meet robust legal and operational criteria to ensure SBSD access to collateral in the event of counterparty default.

In addition, we note that the Dodd-Frank Act specifically grants counterparties the right to segregate collateral with third-party custodians, and Congress's statutory intent would be frustrated if the Commission's capital rules forced SBSDs to absorb capital deductions where counterparties exercised their rights to independent custodians.[6] Accordingly, in light of permissive U.S. and international standards supporting such custodian arrangements, the Commission should eliminate the third-party custodian deduction.[7]

Finally, the proposed capital deduction directly conflicts with the 2014 margin re-proposals of the CFTC and the Banking Agencies, each of which would require that third-party custodians hold initial margin.[8] For example, entities registered as both SBSDs with the Commission and as swap dealers with the CFTC would be placed in the untenable position of segregating collateral with third-party custodians (under CFTC rules) while absorbing capital deductions for the full value of such custodian-held collateral (under SEC rules).

We would welcome an opportunity to discuss specific third-party custodian legal and operational criteria with the Commission or the Commission's staff to help resolve the policy concerns related to third-party custodian arrangements.

III. Recommendations to align SBSD capital standards with the BCBS-IOSCO Margin Framework

The Proposal did not anticipate three features of the BCBS-IOSCO Margin Framework: (a) the staggered implementation of initial margin requirements during a transition period, (b) initial margin posting thresholds of €50 million, and (c) a broader class of counterparties exempt from initial margin posting requirements than under the Proposal, including sovereigns and central banks. The CFTC's and Banking Agencies' 2012 margin re-proposals each specifically addressed these three features of the BCBS-IOSCO Margin Framework.[9] Accordingly, in light of the interplay of capital and margin requirements, we believe the Commission should modify the SBSD capital framework to reflect these aspects of the BCBS-IOSCO Margin Framework to

[6] *See* Securities Exchange Act of 1934 § 3E(f)(1), as modified by Dodd-Frank Act § 763(d); Commodity Exchange Act § 4s(l), as modified by Dodd-Frank Act § 724(c).

[7] The BCBS-IOSCO Margin Framework specifically rejects mandatory application of third-party custodian arrangements or a prohibition against such arrangements. *See* BCBS-IOSCO Margin Framework § 5(i) ("There are many different ways to protect provided margin, but each carries its own risk. For example, the use of third-party custodians is generally considered to offer the most robust protection, but there have been cases where access to assets held by third-party custodians has been limited or practically difficult. The level of protection would also be affected by the local bankruptcy regime, and would vary across jurisdictions.")

[8] *See* CFTC 2014 Margin Re-Proposal, 17 CFR §§ 23.157(a)-(b) (proposed) (initial margin posted or collected by covered swap entities must be held by a third-party custodian); Banking Agencies Margin Re-Proposal, §§ _.7(a)-(b) (proposed) (initial margin posted or collected by covered swap entities must be held by a third-party custodian).

[9] *See* CFTC 2014 Margin Re-Proposal, 17 CFR §§ 23.159(2)-(6) (proposed) (initial margin requirements apply over a four-year staggered phase-in between December 1, 2015 and December 1, 2019); 23.154(a)(5) (proposed) (exchange of initial margin is subject to "minimum transfer amounts"); 23.152(a)(1) (proposed) (initial margin requirements apply only to transactions with "covered counterparties," a category which excludes sovereigns, central banks and commercial end users); Banking Agencies Margin Re-Proposal, §§ _.1(d)(2)-(6) (proposed) (initial margin requirements apply over a four-year staggered phase-in between December 1, 2015 and December 1, 2019); _.3(a)-(b) (proposed) (exchange of initial margin is subject to an "initial margin threshold amount"); _.3(a)-(b) (proposed) (initial margin requirements apply only to transactions with "financial end users," a category which excludes sovereigns, central banks and commercial end users).

take into account dual-registered entities, regardless of whether the Commission adopts the BCBS-IOSCO Margin Framework as the basis of its own margin rules.

a. Timing of implementation and staggered application of capital requirements, consistent with BCBS-IOSCO margin transition arrangements

We recommend that SBSD capital standards take effect at the later of (i) two years after the start of the margin implementation period and (ii) the effective date of the swaps push-out rule,[10] and that, once in effect, SBSD capital standards be determined with reference to the transaction activity of counterparties subject to then-applicable initial margin requirements, taking into account the BCBS-IOSCO transition period.[11]

Numerous market participants have commented on the need to sequence SBSD capital requirements after margin requirements, given the significant anticipated resources necessary to meet new margin standards and the interplay of the Commission's proposed capital standards with the margin framework.[12] A two-year transition period would permit firms sufficient time to gauge changes in market practices in response to initial margin standards and, if necessary, internally reallocate capital to SBSD subsidiaries with higher-than-expected security-based swap volumes. In addition, since the swaps push-out rule, when fully implemented, will effectively force many firms to move their security-based swap activities from insured depository institution subsidiaries into nonbank SBSDs regulated by the Commission, SBSD capital rules should apply only after swaps push-out is completed, to avoid a fragmented marketplace between bank SBSDs and nonbank SBSDs dealing in the same products but subject to divergent capital standards.

The BCBS-IOSCO Margin Framework also recognizes a transition period during which, year-by-year, initial margin requirements apply to an increasing pool of market participants, with

[10] The swaps-push out rule is contained in Section 716 of the Dodd-Frank Act. After swaps push-out is completed, insured depository institutions will generally be prohibited from acting as dealers in equity swaps and uncleared credit default swaps, including security-based swaps in those asset classes. Dodd-Frank Act § 716(d). The Banking Agencies have determined that the swaps-push out rule took effect on July 16, 2013. *See* "Guidance on the Effective Date of Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act," 77 Fed. Reg. 27,456 (May 10, 2012). Dodd-Frank recognizes a transition period for compliance with the swaps push-out rule of up to three years, meaning that, under current guidance, the final compliance date for swaps push-out will be no later than July 16, 2016.

[11] The transition period under the BCBS-IOSCO Margin Framework is scheduled to begin in December 2015. Since swaps push-out is scheduled to be completed no later than July 16, 2016, we currently expect that two years into the margin transition period will be December 2017, which is later than swaps push-out. We have suggested application of SBSD capital rules at the later of the two years after the start of the margin rules and the completion of swaps push-out to account for the possibility of an extension of swaps push-out completion beyond July 16, 2016.

[12] *See, e.g.,* Letter from the Securities Industry and Financial Markets Association to the Commission dated March 12, 2014, page 26, available at: http://www.sec.gov/comments/s7-08-12/s70812-58.pdf.

full implementation of initial margin requirements at the end of the fourth year.[13] The Proposal's capital rules, which are based on an assumed single implementation date for capital and margin standards, need to be reconciled with the BCBS-IOSCO staggered implementation of margin requirements. We believe that a staggered approach for SBSD capital is consistent with the design and spirit of the BCBS-IOSCO Margin Framework, would promote an orderly implementation of capital and margin requirements, and would avoid potentially significant market disruptions that might arise from sudden implementation capital requirements as markets adjust to new regulatory margin standards.

1. Alignment of capital and margin implementation transition periods

After the initial two-year period, we recommend that the Commission align SBSDs' capital requirements with the BCBS-IOSCO transition period, with capital standards scaled to the transaction activity of counterparties subject to initial margin requirements in the current year of the transition period. The BCBS-IOSCO Margin Framework recognizes a four-year transition period during which, year-by-year, initial margin requirements apply to an increasing number of market participants, with full implementation of initial margin requirements at the end of the fourth year. These margin requirements are staggered based on the notional volume of market participants' derivatives positions, with initial margin requirements applying earlier to firms with larger positions. In adopting this approach, BCBS-IOSCO noted that phase-in arrangements are necessary in light of the "liquidity, operational and transition costs associated with implementing [new] requirements."[14]

For example, under this approach, in Year 3 of the margin implementation period, an SBSD's capital requirements would be scaled to the total transaction activity of counterparties with €1.5 trillion of notional derivatives activities, which is the BCBS-IOSCO threshold in Year 3 for application of initial margin standards and also includes all counterparties covered in Year 1 and Year 2. In Year 4, the threshold for both margin and capital would drop to €0.75 trillion of notional derivatives activities, as provided in the BCBS-IOSCO Margin Framework. Finally, in Year 5, initial margin standards would generally apply to all covered counterparties, and SBSD capital requirements would likewise be set with reference to all counterparties.

2. Factors favoring alignment of capital and margin standards

An alignment of capital and margin standards is appropriate for several reasons. First, since capital requirements are based on margin requirements, an aligned approach would ensure orderly, concurrent implementation of new standards. In light of the complexity and uncertainty associated with new initial margin requirements, aligning SBSD capital requirements with initial

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[13] BCBS-IOSCO specifically rejected an immediate application of initial margin requirements to all market participants, noting that "changes must be managed effectively so as to allow for an appropriate transition and not create unduly large transition costs."[13] BCBS-IOSCO Margin Framework ¶ 8(a).
[14] BCBS-IOSCO Margin Framework § 8.

margin standards during the transition period would provide a solid foundation for SBSD capital requirements as market participants adjust their trading and risk management activities in response to the new margin regime.

Second, since the BCBS-IOSCO Margin Framework imposes initial margin requirements first on the largest market participants, aligning SBSD capital and margin standards in the same phase-in period would result in significant capital requirements in Year 3 of the transition period, establishing a strong interim capital position before the final margin and capital regime is in place.

Finally, aligning capital and margin transition arrangements would avoid illogical potential outcomes in which an SBSD is required to absorb capital deductions for transactions where the counterparty is not yet required to post initial margin. For example, if SBSD capital requirements applied on a fully phased-in basis in Year 1, an SBSD would have to calculate, in Year 1, hypothetical initial margin requirements for a counterparty subject to such requirements only in Year 4, even though the counterparty's activities in Year 1 might reasonably be scaled to reflect the absence of regulatory initial margin standards in that year. Depending on how the Commission reconciled the capital elements of the Proposal with the BCBS-IOSCO Margin Framework, an SBSD would potentially be required to take a capital deduction for the initial margin amounts that the counterparty would only have to post in future years, since the Proposal generally operates from an assumption that under-margining results in a capital deduction.[15]

b. Calibrating capital standards to reflect the €50 million initial margin threshold

The Commission's proposed margin rules require all covered counterparties to post initial margin to an SBSD without regard to thresholds. The BCBS-IOSCO Margin Framework, by contrast, only requires counterparties to post initial margin where the required amount of initial margin exceeds €50 million.[16] Since the Commission's proposed SBSD capital rules assume that all counterparties post the full amount of initial margin, the SBSD capital rules must be modified to reflect the €50 million initial margin threshold, where applicable.[17]

[15] The Proposal requires SBSDs to collect initial margin from covered counterparties and does not specify whether a capital deduction would apply for non-collection of initial margin once mandatory margin rules apply. However, since other sections of the Proposal, such as the legacy account deduction, apply a capital deduction for under-collateralized positions, we think it is reasonable to infer that the Proposal, if unmodified from its present form, would potentially require an SBSD to take a capital deduction for initial margin amounts that are only required at the end of the margin transition period.

[16] BCBS-IOSCO Margin Framework ¶ 2.2.

[17] The CFTC 2014 Margin Re-Proposal and the Banking Agencies 2014 Margin Re-Proposal each apply the BCBS-IOSCO €50 million initial margin threshold in U.S. dollars as a $65 million threshold. *See* CFTC 2014 Margin Re-Proposal 17 CFR § 23.151 (proposed) (definition of "Initial margin threshold amount"); Banking Agencies 2014 Margin Re-Proposal § _.2 (proposed) (definition of "Initial margin threshold amount").

We recommend that, after the BCBS-IOSCO margin transition period, SBSD capital requirements should be established in proportion to the total volume of all customer transaction activity, irrespective of the initial margin threshold, but that no capital deduction should apply for the amount of non-collected initial margin below the threshold. Instead, the absence of initial margin would be captured in credit risk charges.

For example, consider a counterparty that would be required, in the absence of thresholds, to post \$10 million of initial margin to an SBSD. The SBSD's baseline capital requirement for the transaction would be 8 percent (under the Proposal) of \$10 million, or \$800,000, irrespective of whether or not the SBSD collects the initial margin. Since the counterparty in this example would be exempt in the BCBS-IOSCO Margin Framework from posting initial margin below the threshold, the capital rules should not impose a \$10 million deduction for the non-collected initial margin. If a capital deduction similar to the Proposal's legacy account deduction applied, the SBSD's capital requirement would be \$10.8 million: \$800,000 of baseline capital at 8 percent (again, under the Proposal) of the initial margin amount, and a \$10 million capital deduction for the "under-margined" counterparty exposure resulting from non-collection of the below-threshold amount. Instead, under our recommended approach, the SBSD's baseline capital requirement would be scaled to the initial margin amount, with an additional add-on for credit risk charges.

As demonstrated in the example above, applying a capital deduction to the initial margin amount below the threshold would result in illogical outcomes, with capital requirements in excess of initial margin requirements. Applying a deduction would eliminate the purpose of providing initial margin thresholds in the first place, which is based on a recognition that relatively small counterparty relationships do not pose the systemic risk concerns that warrant imposition of mandatory initial margin exchange. More generally, applying the deduction would be contrary to long-standing Commission precedent, which holds that a broker-dealer is only required to take a capital deduction when a counterparty is required, but fails, to post collateral to the broker-dealer.[18]

Although the Proposal does not apply a capital deduction for initial margin amounts below the BCBS-IOSCO threshold (since the Proposal included no such threshold), we believe that the Commission should clarify the interaction of the SBSD capital rules with the BCBS-IOSCO initial margin threshold. We believe that our recommendation is logical, results in meaningful capital requirements scaled to the entire scope of customer transaction activity, appropriately captures the absence of initial margin collection through credit risk charges, and would avoid illogical outcomes that disrupt markets or result in significant differences between the capital requirements of the Commission and other U.S. regulators.

[18] For example, the Commission's capital rules do not require a broker-dealer to take a deduction when a registered mutual fund customer posts collateral to an independent custodian, since the Commission's rules recognize that a registered mutual fund is not required to post collateral to a broker-dealer if it uses an independent custodian.

c. *Calibrating capital standards to accommodate counterparties exempt from initial margin requirements, including commercial end users, sovereigns and central banks*

The Proposal would exempt commercial end users from posting initial margin to SBSDs, and would permit SBSDs with approved models to calculate a credit risk charge instead of taking a capital deduction for non-collected initial margin.[19] In addition to commercial end users, the BCBS-IOSCO Margin Framework also exempts sovereign and central bank counterparties from posting initial margin. The Proposal's capital rules for initial margin-exempted counterparties should be expanded to include sovereigns and central banks.

We recommend that the SBSD capital rules treat sovereigns and central banks, and any other categories of initial margin-exempted counterparties, in the same manner as the Proposal's treatment of commercial end users. Under this approach, an SBSD's baseline capital requirement would be scaled to the total volume of the margin-exempted counterparty's transaction activity, including a credit risk charge based on the SBSD's uncollateralized counterparty exposure.

We believe that this approach is consistent with the Proposal, which treats SBSDs' counterparty relationships with commercial end users in exactly the same manner, and extends the Commission's own methodology to other categories of exempted counterparties, as recognized in the BCBS-IOSCO Margin Framework.

IV. Re-propose capital and margin proposed standards

In light of the continuing uncertainty with respect to major elements of the margin regime, and the interdependence of capital rules and margin rules, we recommend that the Commission re-propose rules for capital and margin that reflect the Commission's intended approach in both areas.

The Commission itself has acknowledged the interdependence of the capital and margin rules in its proposed cross-border framework by classifying both capital and margin as entity-level requirements.[20] Indeed, under the Commission's proposed capital rules, it would be impossible for an SBSD to calculate its capital requirements without final margin rules in place. Accordingly, the capital rules should be re-proposed concurrently with the margin rules to ensure that each framework supports and complements the other.

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[19] Proposal § 18a-1(e)(2). For broker-dealers that also register as SBSDs, the corresponding credit risk calculation is contained in SEC Rule § 15c3-1e(c).
[20] 78 Fed. Reg. 30,968, 31,011-13 (May 23, 2013).

V. Conclusion

We appreciate the opportunity to comment on the Proposal. Please contact Sebastian Crapanzano at (212) 761-8627 or sebastian.crapanzano@morganstanley.com or Soo-Mi Lee at (212) 762-7495 or soo-mi.lee@morganstanley.com if discussion of any points raised in our comment letter would be helpful.

Respectfully submitted,

Sebastian Crapanzano	Soo-Mi Lee
Managing Director	Managing Director

cc: Hon. Mary Jo White, Chair

Hon. Luis A. Aguilar, Commissioner

Hon. Daniel M. Gallagher, Commissioner

Hon. Kara M. Stein, Commissioner

Hon. Michael S. Piwowar, Commissioner

Stephen Luparello, Director, Division of Trading and Markets

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